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ALERT — DODD-FRANK RULEMAKING

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The Securities and Exchange Commission has recently taken action on a variety of rulemaking matters required by the Dodd-Frank Act. Following is a summary of those items most relevant to investment advisers and hedge fund managers.

PERFORMANCE FEE RULES

Investment advisers are prohibited from charging performance-based fees except to clients who are "qualified clients." Since the rule was last adjusted for inflation in 1998, a qualified client has been one who has at least $750,000 under management with the adviser or one with a net worth of more than $1,500,000. The rule applies to managed account clients and investors in funds relying on the Section 3(c)(1) exemption.

Dodd-Frank required the SEC to adjust the dollar thresholds for the qualified client test. The new standard is at least $1,000,000 under management or a minimum net worth of $2,000,000 *excluding the client's primary residence*. Exclusion of primary residence mirrors changes to the accredited investor standard under earlier rulemaking and goes beyond what was expressly required by Dodd-Frank.

The new standard is effective as of September 19, 2011. Transition rules provide that existing clients who met the prior standard will be grandfathered. New managed account clients or 3(c)(1) fund investors on or after the effective date will need to meet the heightened standard.

The qualified client test is an SEC rule. Most states, including California, expressly incorporate the test into their own performance fee provisions so the change applies to SEC- and California-registered investment advisers. All advisers should update their investment advisory contracts and/or fund offering materials to ensure compliance with the new standard

SEC AND STATE REGISTRATION

Dodd-Frank increased the dividing line between state and SEC registration from $25 million to $100 million. The SEC estimates that over 3,000 advisers of the current 11,500 SEC-registered advisers will transition to state registration as a result of the amendment.

Recent rulemaking has clarified that advisers currently registered with the SEC will need to declare that they are permitted to remain SEC-registered in a filing in the first quarter of 2012.[1] Advisers transitioning to state registration will have until June 28, 2012 to complete that switch.

NEW REGISTRATION EXEMPTIONS

Three new exemptions from investment adviser registration were created under Dodd-Frank for "exempt reporting advisers"— (i) advisers solely to venture capital funds, (ii) advisers solely to private funds with less and $150 million under management in the U.S., and (iii) certain foreign advisers with no place of business in the U.S.

Recent SEC action adopted rules to implement these exemptions and define certain key terms. Although full registration is not required, exempt reporting advisers will be required to file with the SEC and periodically update certain information on Form ADV. Reports must be filed in the first quarter of 2012.

"BAD ACTOR" DISQUALIFICATIONS

Most hedge funds rely on Rule 506 of Regulation D when selling fund interests to investors. Rule 506 permits private securities offerings to raise unlimited capital from an unlimited number of accredited investors, subject to certain other conditions. Dodd-Frank ordered the SEC to adopt rules to prevent certain felons or other "bad actors" from being involved in Rule 506 offerings. Persons covered by the rule include directors, officers, general partners and managing members of the issuer, solicitors and their affiliates as well as ten percent beneficial owners of the issuer.

The SEC has proposed rules that define these "disqualifying events" to mean certain securities related felonies including the following:

- Criminal convictions, court injunctions or restraining orders in connection with the purchase or sale of a security or making a false filing with the SEC;
- Final orders from state securities or other regulators that prohibit associating with a regulated entity or that are based on fraudulent, manipulative or deceptive conduct; and
- Certain SEC disciplinary orders or suspension or expulsion from self-regulatory organizations.

The proposed rules state that pre-existing convictions, suspensions, injunctions and orders will be disqualifying for Rule 506 offerings after the effective date. Hedge fund managers should confirm that their personnel and greater than ten percent investors are not subject to any disqualifying events. The proposed rules would permit an exception where the issuer can show that it was unaware of the disqualifying event and, in the exercise of reasonable care, could not have know of it.

[1] Because 2012 is a leap year, the 90-day deadline is March 30.

Although Dodd-Frank required the SEC to adopt final rules by July 21, 2011, as of the date of this update no final rules have been adopted. The final scope of disqualifying events remains subject to further clarification.

About Us

The Securities Law Group LLP is a California-based boutique law firm providing specialized legal representation in the areas of investment management, private funds and securities law. Our primary objective is to combine the legal expertise and high quality work product of a large law firm with the service orientation and other advantages of a small law firm. We emphasize value, personalized service, responsiveness, accessibility and accountability.

The Securities Law Group LLP was recently named one of the top law firms with large hedge fund practices by *Hedge Fund Alert*.

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