Massachusetts Secretary of State Proposes Amended New Regulations for Investment Advisers in response to Dodd-Frank Act

January 12, 2012

THE FOLEY ADVISER - JANUARY 12, 2012

The Massachusetts Securities Division has amended proposed rules relating to the regulation of investment advisers. We outlined the previous proposals in our April 21, 2011 Foley Adviser - "Massachusetts Secretary of State Proposes New Regulations for Investment Advisers in response to Dodd-Frank Act."

The amended proposal, after consideration of previously submitted public comments, makes substantive changes to (i) the definition of "institutional buyer," (ii) the proposed private fund adviser exemption (including the introduction of a grandfathering provision), and (iii) requirements for advisers with discretion over, or custody of, client funds.

Proposed Change to the Definition of Institutional Buyer

Currently, Massachusetts exempts from registration any investment adviser whose only clients are "institutional buyers," including pooled investment vehicles in which each investor is "accredited" and has invested at least $50,000. The amended proposal would phase out the exemption provided to advisers of such funds by limiting it to advisers whose funds existed prior to the effective date of the regulations and which, as of the effective date of the regulations, ceased to accept new investors. Such funds would be permitted to accept additional investments from investors that were in the fund as of the effective date of the regulation.

This exemption would be unavailable to advisers to private funds that come into existence after the effective date or that remain open to new investors.

Proposed Private Fund Exemption

Massachusetts' original proposed new exemption for advisers would have conditionally exempted from registration advisers whose only clients were 3(c)(7) funds and venture capital funds. The original Massachusetts proposal did not provide for an exemption for advisers to 3(c)(1) funds. Massachusetts' amended proposal would now exempt advisers to 3(c)(1) funds from registration where the fund investors are all "qualified clients", as defined by the Investment Advisers Act of 1940. Generally, an investor with a $2 million net worth or $1 million under management of the adviser is a "qualified client." The amended proposal would require the value of the beneficial owner's primary residence to be excluded from the net worth calculation.

As an additional condition of the exemption from registration, advisers to 3(c)(1) funds would have to disclose in writing at the time of the investor's subscription the services and duties provided or owed by the adviser to individual investors in the fund and any other material information affecting the rights or responsibilities of the investors. If no services or duties are to be provided or owed to the individual investors, then this fact must also be disclosed.

Additionally, the adviser must obtain annually audited financial statements for each 3(c)(1) fund that is not a venture capital fund and must deliver a copy of those audited financial statements to the investors.

Grandfathering Provisions

Massachusetts has amended the proposed private fund adviser exemption to allow certain private fund advisers currently in operation to claim the private fund exemption even when they advise a 3(c)(1) fund with non-qualified client investors.

In order to qualify for the grandfathering, the following requirements must be met:

- The fund must have existed prior to the effective date of the proposed regulation;
- The fund must have ceased to accept investors who are not "qualified clients" as of the effective date;
- The adviser must be in compliance with investment adviser registration requirements as of the effective date;
- The adviser must disclose in writing the information on the services, duties and material information to investors (as noted in more detail above); and
- The adviser must deliver annual audited financial statements for the fund to investors.

Custody and Discretion Requirements

Massachusetts requires compliance with minimum financial requirements for advisers with discretionary authority over client funds, which can be met by obtaining a surety bond. The original April proposal proposed to increase the surety bond level from $10,000 to $50,000. The amended proposal has eliminated this requirement and proposes to maintain the $10,000 surety bond.

The proposal to adopt the SEC custody rule has also been changed in one respect. Rule 206(4)-2 generally exempts advisers from the independent verification of assets requirement if the adviser has custody of the funds and securities of clients solely as a consequence of its authority to make withdrawals from client accounts to pay its advisory fees. The amended proposals require that in order to be exempt from the independent verification requirement (in the case that custody is solely a consequence of deduction of advisory fees), the adviser must

- have written authorization from the client to deduct advisory fees; and
- send the qualified custodian and client an invoice or statement of the amount of the fee to be deducted from the client's account each time a fee is directly deducted.

For a copy of the proposed regulations and further information, click here.