Senate Passes Final Wall Street Reform Legislation (The Dodd-Frank Act)

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On July 15, 2010, the U.S. Senate (the "Senate") voted 60-39 to approve the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Bill"). The Bill, which is expected to be signed into law by the President, will implement broad based changes to the regulatory landscape governing U.S. financial markets. Of particular importance to investment advisers managing private investment funds is Title IV of the Bill, entitled the "Private Fund Investment Advisers Registration Act of 2010," which is summarized below.

Registration of Investment Advisers to Private Funds

Under the current regulatory regime, advisers to private investment funds (such as hedge funds and private equity and venture capital funds) often rely upon the exemption from registration provided by Section 203(b)(3) of the Investment Advisers Act of 1940, as amended (the "Advisers Act"), which exempts from registration with the Securities and Exchange Commission (the "SEC") any investment manager that (i) had fewer than 15 clients in the prior 12 month period and (ii) does not hold itself out generally to the public as an investment adviser (the "Private Adviser Exemption"). The Bill will amend the Advisers Act to eliminate the Private Adviser Exemption in its entirety, and also to carve out advisers to private funds (as defined below) from a separate exemption provided for intrastate investment advisers. As a result, private fund advisers, as well as certain other unregistered advisers with few clients who previously relied on the Private Adviser Exemption, will be required to register with the SEC or state securities regulators to the extent they do not qualify for another exemption.

The Bill introduces several new exemptions that unregistered advisers previously relying on the Private Adviser Exemption should be aware of, including as follows:

Private Fund Advisers: Section 408 of the Bill provides an exemption from registration for investment advisers whose clients consist solely of "private funds," and whose assets under management ("AUM") are less than $150,000,000 in the aggregate. A private fund is defined as an issuer of securities that would be an investment company within the meaning of the Investment Company Act of 1940, as amended (the "1940 Act"), but for the provisions of Section 3(c)(1) or 3(c)(7) of the 1940 Act. The Bill further provides that, in the course of prescribing regulations to carry out the provisions of Title IV, the SEC must take into account the size, governance and investment strategy of mid-sized

private funds with respect to the systemic risk they may pose and must provide for registration and examination procedures which reflect such level of systemic risk.

Venture Capital Fund Advisers: Section 407 of the Bill provides an exemption for investment advisers whose clients consist solely of "venture capital funds." The Bill does not define what will constitute a venture capital fund for this purpose, but includes a requirement that the SEC define the term pursuant to its rulemaking authority within one year of the enactment of the Bill.

Foreign Private Advisers: Section 403 of the Bill provides an exemption for an investment adviser that is a "foreign private adviser." A foreign private fund adviser is defined as an adviser that (i) has no place of business in the United States, (ii) has, in total, fewer than 15 clients and investors in private funds managed by the adviser who are domiciled in or residents of the United States, (iii) has aggregate assets under management attributable to clients in the United States and investors from the United States which are invested in private funds advised by the adviser of less than $25,000,000 or such higher amount as the SEC may deem appropriate, and (iv) does not hold itself out generally to the public in the United States as an investment adviser.

SBIC Advisers: Section 403 of the Bill also provides an exemption for advisers whose only clients are small business investment companies (other than SBICs that have elected to be regulated as business development companies under the 1940 Act). The exemption will also include advisers to entities that are actively in the process of qualification as small business investment companies with the Small Business Administration.

Family Offices: Section 409 of the Bill also provides an exemption from the definition of an "investment adviser" within the meaning of the Advisers Act for any "family office," as such term will be defined by rule, regulation or order of the SEC. Section 409 further provides that the definition adopted by the SEC must be consistent with the SEC's prior exemptive policies relating to family offices, and details certain preexisting advisory relationships which, without further factors, should not result in an adviser being excluded from the definition of a family office.

Thresholds for Federal Registration

In addition to the above, the Bill will raise the thresholds for federal registration, such that an investment adviser that is required to be registered with one or more state securities regulators, may opt to instead register with the SEC only if such adviser (i) has assets under management of at least $100,000,000, or (ii) has assets under management between $25,000,000 and $100,000,000 and would otherwise be required to register with 15 or more state regulators.

Reports and Records

The Bill requires certain records and reports to be maintained by a registered adviser to a private fund, which will be subject to inspection by the SEC, and to provide such reporting as the SEC may by rule require. These records and reports include:

(i) AUM and use of leverage;
(ii) counterparty credit risk exposure;
(iii) trading and investment positions;
(iv) valuation policies and practices of the fund;
(v) types of assets held;
(vi) side arrangements or side letters;
(vii) trading practices; and
(viii) such other information that the SEC determines is necessary.

This information will be shared with the Financial Stability Oversight Council for systemic risk. The public disclosure of proprietary information will be subject to certain confidentiality restrictions.

In addition, the Bill provides that the SEC will require investment advisers that are *exempt* from registration by reason of the exemptions noted above for private fund advisers and venture capital fund advisers to maintain such record and provide such reporting as the SEC determines to be necessary or appropriate in the public interest or for protection of investors.

Rulemaking Authority

The Bill grants the SEC rulemaking authority to make, issue, amend and rescind rules, including rules and regulations defining technical, trade and other terms, except that the SEC may not, for purposes of the anti-fraud provisions set forth in paragraphs (1) and (2) of Section 206 of the Advisers Act, define “client” to include an investor in a private fund managed by an investment adviser, if such private fund has entered into an advisory contract with such adviser.

Accredited Investor Standard

The Bill requires the SEC to revise the accredited investor standard for a natural person by requiring individual net worth of such person, or joint net worth with the spouse of that person, at the time of investment should be $1,000,000, *excluding the value of the primary residence of such natural person*. This change increases the net worth requirement by reason of the exclusion of the value of the primary residence. The SEC will further review the accredited investor standard as it applies to natural persons and may by notice and comment rulemaking make such

further adjustments as it deems appropriate (other than any further adjustment to the net worth standard with respect to the period of four years following the enactment of the Bill). In addition, the SEC will be required to review the revised net worth amount at least every 4 years, and may adjust the $1,000,000 (excluding the value of the primary resident) requirement with respect to periods after the initial four year period following enactment of the Bill.

Qualified Client Standard

The Bill provides that the SEC, in determining a dollar amount test (e.g. net worth) with respect to clients that shall be "qualified" for purposes of assessment of performance based fees by an investment adviser, shall, by order within one year of the enactment of the Bill and at least every five years thereafter, adjust such dollar amount for inflation (with such adjustment to be rounded to the nearest $100,000 increment). Under current regulations the net worth test for a natural person is set at $1,500,000; this threshold may be increased substantially as a result of an inflation adjustment following the enactment of the Bill.

Areas of Additional Study

In addition to the foregoing requirements applicable to investment advisers and managers, Title IV of the Bill will require additional study to be conducted in several areas, including General Accounting Office reviews of the accredited investor standard and eligibility to invest in private funds, feasibility of a self-regulatory organization to oversee private funds and the impact of short selling practices.

Investment advisers and managers with questions about either of the Bill should contact Jeffrey D. Collins or Robert G. Sawyer in Foley Hoag's Investment Management Group at 617 832 1000.