

SECURITIES UPDATE



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NEW REQUIREMENTS FOR ADVISERS TO PRIVATE FUNDS

On July 21, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). Title IV of the Dodd-Frank Act codifies the Private Fund Investment Advisers Registration Act of 2010 ("Title IV"), which significantly alters the regulatory landscape for advisers to certain private funds.

Title IV not only changes investment adviser registration requirements and exemptions under the Investment Advisers Act of 1940, as amended (the "Advisers Act") and increases regulation of private funds managed by investment advisers registered with the Securities and Exchange Commission (the "SEC"), it also shifts federal and state jurisdiction for regulating investment advisers and mandates additional governmental studies and rulemaking regarding private funds and certain market activities. The material provisions of Title IV, as well as other provisions of the Dodd-Frank Act relevant to certain larger private funds and their advisers, are summarized below.

REGISTRATION OF PRIVATE FUND ADVISERS

General. Advisers Act §203(b) currently provides an exemption from federal registration for an adviser with fewer than 15 clients (none of whom were registered investment companies or business development companies) and who did not hold itself out to the public as an investment adviser. SEC rules define the term "client" in a way that allows each advised fund to be counted as a single client without looking through and counting the fund's underlying investors. Thus, a private fund adviser providing investment advice to hundreds of fund investors is not required to register with the SEC. Title IV eliminates this "fewer than 15" exemption. Certain foreign and equity

fund advisers will continue to be eligible for exemptions but may be subject to recordkeeping and reporting requirements.

Private Fund Definition. Advisers Act §202(a), as amended by Title IV, defines "private fund" as an issuer that would be an investment company, as defined under §3 of the Investment Company Act of 1940, but for the exemptions granted privately-offered funds under §3(c)(1) (fewer than 100 investors) or §3(c)(7) (only investors are "qualified purchasers"). Because the definition of a "private fund" is limited to funds excepted by §§3(c)(1) and 3(c)(7), traditional futures funds and other funds that hold a limited amount of securities are not "private funds" under Title IV.

Impact on Private Fund Advisers.

Private fund advisers will become subject to numerous requirements, including (i) the obligation to file a Form ADV with the SEC as well as annual Form ADV updates and to provide a written brochure (which can be Part II of Form ADV) to its clients; (ii) restrictions on performance-based client fees; (iii) restrictions on fees paid to third party solicitors of clients; (iv) certain books and records maintenance requirements; and (v) adoption of a compliance system, including policies and procedures designed to prevent securities law violations and designation of a chief compliance officer to administer these policies.

Title IV Effective Date. In general, the provisions of Title IV will become effective one year after enactment (i.e., July 21, 2011). Private fund advisers may register voluntarily during the one-year transition period.

CHANGES TO CURRENT EXEMPTIONS FROM REGISTRATION FOR PRIVATE FUND ADVISERS

Removal of Fewer than 15 Client Exemption. The current exemption from SEC registration for an investment adviser who had fewer than 15 clients and who did not hold itself out to the public as investment adviser, will no longer be available (other than for certain foreign private funds) after July 21, 2011.

Limitation on Intrastate Exemption. Currently, the Advisers Act exempts from SEC registration any investment adviser all of whose clients are residents of the state within which such investment adviser maintains his or its principal office and place of business, and who does not furnish advice or issue analysis or reports with respect to securities listed or admitted to unlisted trading privileges on any national securities exchange. Beginning July 21, 2011, this exemption will no longer be available to an investment adviser to private funds even if all of its clients are within the adviser's home state.

Limitation on CFTC-Registered Exemption. Currently, any investment adviser that is registered with the Commodities Futures Trading Commission ("CFTC") as a commodity trading adviser whose business does not consist *primarily* of providing securities-related advice is exempt from SEC registration (unless such adviser acts as an investment adviser to an investment company or a business development company). This exemption will no longer be available to an investment adviser to a private fund if, after the date of enactment, the business of the adviser becomes *predominantly* the provision of securities-related advice.

NEW EXEMPTIONS AND EXCLUSIONS FROM REGISTRATION

Foreign Private Adviser Exemption. Title IV provides an exemption for a "foreign private adviser," defined as any investment adviser who:

- has no place of business in the United States;
- has, in total, fewer than 15 U.S. clients (including U.S. investors in private funds advised by the investment adviser);
- has aggregate assets under management attributable to U.S. clients (including U.S. investors in private funds advised by the investment adviser) of less than \$25 million (or such higher amount set by the SEC by rule); and
- neither holds itself generally to the U.S. public as an investment adviser nor acts as an investment adviser to a registered investment company or a company that has elected to be a business development company.

As a practical matter, many currently unregistered non-U.S. advisers will likely be required to register, because non-U.S. advisers must count assets attributable to U.S. investors in the non-U.S. funds they manage towards the \$25 million asset limit.

SBIC Adviser Exemption. Title IV adds an exemption for any investment adviser, other than a business development company, who solely advises (i) small business investment companies ("SBICs") licensed under the Small Business Investment Act of 1958, (ii) entities notified by the Small Business Administration that they may proceed to qualify for an SBIC license or (iii) applicants for an SBIC license that are affiliated with another licensed SBIC.

Venture Capital Fund Adviser Exemption. Title IV adds an exemption from registration for an investment adviser that acts as an investment adviser *solely* to one or more "venture capital funds," with such term to be defined by the SEC through a rulemaking process. Exempt venture capital fund advisers will be required to maintain such records and provide such annual or other reports to the SEC as the SEC determines necessary or appropriate in the public interest or for the protection of investors.

Small Private Fund Adviser Exemption. New Advisers Act §203(m) directs the SEC to promulgate an exemption from registration for any investment adviser that acts *solely* as an adviser to private funds and has assets under management in the U.S. of less than \$150 million. An exempt "small" investment adviser will be required to maintain such records and provide such annual or other reports to the SEC as the SEC determines necessary or appropriate in the public interest or for the protection of investors.

Family Office Exclusion. Title IV amends the definition of "investment adviser" to exclude a "family office," which term will be defined by SEC rulemaking but must be consistent with the SEC's previous exemptive policy for family offices. Such rules must also recognize the range of organizational, management and employment structures and arrangements employed by family offices and include a grandfathering provision for certain advisers who were not registered or required to be registered under the Advisers Act on January 1, 2010, and were providing investment advice before January 1, 2010 to certain individuals and entities affiliated with the family office. A grandfathered entity will be deemed to be an investment adviser for purpose of the general anti-fraud provisions of the Advisers Act.

CHANGE IN STATE/FEDERAL REGISTRATION LINE

Current Registration Regime. Currently, the Advisers Act provides that an investment adviser is subject to regulation by the securities regulator in each state where it maintains a place of business or where during the preceding 12 month period it had had more than five clients.

- In states that have enacted an investment adviser statute, an investment adviser must register with the applicable state(s), unless an exemption from registration is available.
- If an investment adviser has over \$25 million of assets under management ("AUM") (the "\$25 Million Threshold"), the investment adviser *may choose* to register with the SEC instead of the state securities regulator(s).
- Once an investment adviser has \$30 million or more of AUM, it *must* register with the SEC, unless an exemption from registration is available, and may then withdraw its registration with the state securities regulator(s), if any.
- Notwithstanding the \$25 Million Threshold, an investment adviser must register with the SEC, unless an exemption from registration is available, if upon submission of its application for SEC registration it is required to register with the securities regulators of 30 or more states, and thereafter would be required to register with the securities regulators of at least 25 states.

Increase to Registration Threshold. Title IV would expand the current prohibition on SEC registration to an investment adviser who:

- is required to be registered with the state securities regulator in the state where it maintains its principal office and place of business, and if registered, would be subject to examination as an investment adviser by such regulator; and
- has AUM above the \$25 Million Threshold, but below \$100 million of AUM (or such higher amount as determined by the SEC by rule) (the "\$100 Million Threshold").
- This expanded prohibition would *not* apply to:
 - ◆ an adviser to an investment company registered under the Investment Company Act;
 - ◆ a company which has elected to be a business development company and has not withdrawn the election; or

- ◆ an investment adviser that would be required to register with 15 or more states because of the \$100 Million Threshold.

RECORDKEEPING, REPORTING AND DISCLOSURE RULES FOR PRIVATE FUNDS

General Recordkeeping and Reporting

Requirements. Title IV authorizes the SEC to mandate broad recordkeeping and reporting requirements for registered advisers to private funds. The SEC may vary such reporting requirements according to the type or size of private fund being advised. The records and reports of any private fund advised by an investment adviser shall be deemed to be the records and reports of the investment adviser and would be subject to periodic and special examination by the SEC.

Required Information. The records and reports *must* include the following information for each private fund:

- the amount of assets under management and use of leverage (including off-balance sheet leverage);
- counterparty credit risk exposure;
- trading and investment fund positions;
- valuation policies and practices of the fund;
- types of assets held;
- side arrangements or side letters, whereby certain investors in a fund obtain more favorable rights or entitlements than other investors;
- trading practices; and
- such other information as the SEC, in consultation with the Financial Stability Oversight Council created under the Dodd-Frank Act (the "Oversight Council") determines is necessary and appropriate in the public interest and for the protection of investors or for the assessment of systemic risk.

Information Sharing. The SEC must make all records and reports available to:

- the Oversight Council as are necessary for the purpose of assessing systemic risk;
- necessary to comply with any request for information from any other Federal department or agency or any self-regulatory organization requesting a report or information for purposes within the scope of its jurisdiction; and
- necessary to comply with any order of U.S. court in an action brought by the U.S. or the SEC.

The SEC must also report annually to Congress on how the SEC has used the data collected to monitor the markets for the protection of investors and the integrity of the markets.

Confidentiality of Information. Title IV provides that neither the SEC nor the Oversight Council may be compelled to disclose private fund information but also states that this confidentiality requirement does not authorize the SEC or the Oversight Council to withhold information from Congress. The confidentiality requirement also does not prevent the SEC or the Oversight Council from complying with proper requests for information from any other Federal department, agency or self-regulatory organization or an order of a U.S. Court in an action brought by the government or the SEC. In addition, Title IV:

- imposes the same confidentiality requirements on other Federal agencies, departments and self-regulatory organizations that receive private fund information;
- exempts the SEC, the Oversight Council and other such recipients of private fund information from the Freedom of Information Act; and
- states that any "proprietary information of an investment adviser" obtained by the SEC shall be subject to the same limitations on public disclosure as facts the SEC ascertains during an examination, as provided by Advisers Act §210(b). Title IV defines such proprietary information as:
 - ◆ the investment or trading strategies of the investment adviser;
 - ◆ analytical or research methodologies;
 - ◆ trading data;
 - ◆ computer hardware or software containing intellectual property; and
 - ◆ any additional information the SEC determines to be proprietary.

Disclosures Concerning Certain Advisory Clients.

Advisers Act §210(c) prohibits the SEC from requiring an investment adviser to disclose the identity, investment or affairs of any of its clients, except as may be necessary or appropriate in a particular enforcement investigation or proceeding. Title IV provides a new exception from this prohibition, "for purposes of assessment of potential systemic risk."

Adjustment for Advisers to Mid-Sized Funds. New Advisers Act §203(n) directs the SEC to take into account the size, governance, and investment strategy of mid-sized

private funds to determine whether they pose systemic risk and to adjust the registration and examination procedures to reflect the level of systemic risk posed by such funds.

SEC/CFTC Joint Registrants. Title IV requires the SEC and the CFTC to jointly promulgate rules with regard to the recordkeeping and reporting of private funds for investment advisers registered under the Advisers Act and the Commodity Exchange Act no later than July 21, 2011.

ADJUSTMENT TO ACCREDITED INVESTOR & QUALIFIED CLIENTS STANDARDS

Accredited Investor Standards. Current SEC rules define the term "accredited investor" applicable to certain private offering exemptions from registration under the Securities Act of 1933 (the "Securities Act"). The applicable rules currently categorize a natural person as an "accredited investor" based on either the person's net worth (\$1 million, *including* the person's primary residence) or the person's prior or anticipated net income.

Title IV fixes the net worth threshold at more than \$1 million for a natural person accredited investor for a period of four years beginning on the date of enactment.

- This threshold applies either individually or jointly with the person's spouse and, unlike the current threshold, *excludes* the value of the individual's primary residence. *This provision affects all private offerings under Regulation D (not just offerings by private funds).*
- The standard would apply to new investors and to current investors making additional purchases unless the SEC otherwise provides by rule or order.
- Except for this net worth threshold, the SEC *may* review and adjust or modify the accredited investor standards by notice and comment rulemaking during this initial four year period.
- The SEC *must* review the natural person accredited investor standards at least once every four years thereafter and, if necessary, adjust or modify them by notice and comment rulemaking as it deems appropriate for the protection of investors, in the public interest and in light of the economy.

Qualified Client Standard under Advisers Act Performance Fee Rule. The SEC is directed to adjust the dollar tests used in the definition of "qualified client" by July 21, 2011, and every 5 years thereafter, for the effects of inflation. Adjustments must be made in multiples of \$100,000.

Disqualification under Regulation D. The SEC must promulgate rules by July 21, 2011, expanding the issuer disqualification provisions for any Regulation D offering to match the much broader "bad boy" disqualification provisions of Regulation A and provide additional bases for disqualification, including state administrative orders.

OTHER CHANGES TO THE ADVISERS ACT

Custody of Client Assets. Title IV specifically authorizes the SEC to prescribe rules requiring registered investment advisers to safeguard client assets over which the adviser has custody, including verification of such assets by an independent public accountant. Current custody rules have been promulgated under Advisers Act §206(4), which directs the SEC to define by rule and prescribe means reasonably designed to prevent, such acts, practices and courses of business as are fraudulent, deceptive or manipulative. This new provision appears merely to bolster the authority the SEC currently exercises under Advisers Act §206(4).

Clarification of Rulemaking Authority. Title IV provides that the SEC may not define the term "client" to include an investor in a private fund for purposes of the anti-fraud provisions, if such private fund has entered into an advisory contract with the investment adviser.

State-Regulated Advisers. The Dodd-Frank Act amends Advisers Act §205(a) to clarify that the section, which imposes various restrictions on investment advisory contracts, does not apply to State-registered investment advisers.

Authority To Restrict Mandatory Pre-Dispute Arbitration. The SEC is authorized to prohibit or impose conditions or limitations on any mandatory arbitration agreements between investment advisers, broker-dealers or municipal securities dealers and their clients if the SEC finds it "in the public interest and for the protection of investors."

Effect on Commodity Exchange Act. The Advisers Act is amended to clarify that the Advisers Act does not relieve any person of any obligation or duty or affect the availability of any right or remedy available to the CFTC or any private party arising under the Commodity Exchange Act governing commodity pools and commodity pool operators.

STUDIES AND RULES AUTHORIZED

Studies Authorized. Title IV mandates seven studies, three by the Comptroller General and four by the SEC, with an additional optional SEC study authorized, covering such wide-ranging topics as the feasibility of forming a self-regulatory organization to oversee private

funds, compliance costs associated with the current custody rules, the definition of "accredited investor," eligibility to invest in private funds, and short selling and other trading practices. In general, reports to Congress with respect to these studies will be due in one to three years.

SEC Rulemaking. The SEC's rulemaking process will now commence pursuant to the following directives contained in Title IV:

- no later than July 21, 2011, issue final rules defining "venture capital fund;"
- provide an exemption for advisers to private funds with United States AUM of less than \$150 million (no specified timing);
- provide registration and examination procedures for advisers to mid-sized private funds (no specified timing);
- provide a definition of "family office" (no specified timing);
- upon completion of an optional review of the definition of "accredited investor" the SEC may make adjustments to the definition (other than modifying the \$1 million net worth standard for natural persons), for the protection of investors, in the public interest and in light of the economy;
- upon completion of the mandated review of the definition of "accredited investor" (required four years after enactment and at least every four years thereafter) the SEC may make adjustments to the definition for the protection of investors, in the public interest and in light of the economy; and
- no later than July 21, 2011, the SEC and the CFTC must jointly issue rules to establish the form and content of the reports required to be filed with the SEC and the CFTC by dually registered investment advisers.

OTHER PROVISIONS OF INTEREST

Potential Registration of Systemically Important Private Funds by Federal Reserve. Under the Dodd-Frank Act, the new Oversight Council will have the authority to designate any U.S. or foreign non-bank financial company as systemically important, thereby making the company subject to systemic risk regulation by the Federal Reserve. The term "nonbank financial company" generally means a company, other than a bank holding company, that is predominantly engaged in "financial activities," defined to include providing investment advisory services.

As the principal activities of private equity funds, hedge funds, and their advisers, would appear to constitute "financial activities," the Oversight Council would have authority to designate private investment funds and/or their advisers as systemically significant enough to warrant supervision by the Federal Reserve. Any private investment fund designated for systemic risk regulation by the Federal Reserve will be subject to prudential standards covering capital requirements, leverage, restrictions on acquisitions, addition reporting of credit exposures, periodic stress tests and potential assessments for the new orderly resolution fund to cover the cost of resolving systemically important firms.

Volker Rule Restrictions. The Dodd-Frank Act imposes limitations on fund sponsorship and investment activities by banks, bank holding companies, and certain non-bank financial companies. These provisions prohibit proprietary trading and investments in, and sponsorship of, private equity or hedge funds by banks. They also prohibit banking entities from extending credit to, or engaging in certain other specified transactions with, private equity and hedge funds for which they act as investment manager, adviser, or sponsor, or that they organize and offer.

These new restrictions may require banking entities to divest or substantially reduce their interests in hedge funds and private equity funds. Regulations implementing these new rules must be issued within 15 months, with an effective date no later than two years after enactment. Banking entities will generally have two years from the date the restrictions take effect to bring themselves into compliance, subject to the availability of up to three one-year extensions.

Regulation of Incentive-Based Compensation Arrangements. The Dodd-Frank Act gives authority to federal banking regulators and the SEC to examine, and impose restrictions on, incentive-based compensation arrangements at any "covered financial institution." These institutions will be required to disclose to the appropriate regulator the structures of all incentive-based compensation arrangements to enable the regulator to determine whether such structures (i) provide any executive officer, employee, director or principal shareholder with excessive compensation, fees or benefits, or (ii) could lead to material financial loss to the institution.

A covered financial institution includes not only banking institutions, but also registered broker-dealers, investment advisers and "any other financial institution" that the federal regulators jointly determine should be treated as such. Any institution with assets below \$1 billion is excluded.

Compensation Arrangements of Brokers, Dealers and Investment Advisers. The Dodd-Frank Act authorizes the SEC to examine, and where appropriate, issue rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for brokers, dealers, and investment advisers that the SEC deems contrary to the public interest and the protection of investors.

If you have any additional questions regarding this Update or have any other Securities Law needs, please contact any member of the Securities Law Group.

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