Dodd-Frank and New SEC Rulemaking Initiatives

A New Regulatory Landscape for Investment Advisers

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GARVEY SCHUBERT BARER

Attorneys

GSBLAW.COM

BEIJING NEW YORK PORTLAND SEATTLE WASHINGTON, D.C.

Contact

Seymour H. Bucholz
sbucholz@gsblaw.com
212.965.4531

Andrew J. Goodman
agoodman@gsblaw.com
212.965.4534

David A. Riley
driley@gsblaw.com
206.816.1385

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By Seymour H. Bucholz with the assistance of MaryLyn R. Carabello.

Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act, signed into law on July 21, 2010, will impact virtually every professional investment adviser when its provisions go into effect after a one-year transition period. Beginning next July, key changes made by Title IV in the 1940 Investment Advisers Act will affect the entire U.S. asset management industry from smaller and mid-sized firms providing traditional advisory and retirement account firms, to managers of private-equity, venture and hedge funds, to the largest fund managers handling billions of dollars of assets.[1]

Like numerous other Dodd-Frank provisions affecting a broad spectrum of financial services and requiring extensive rule-making by other federal agencies, important specifics of the Title IV investment advisory changes will be implemented through the adoption of a number of new SEC regulatory initiatives. This summary is provided to alert our clients and friends on the impact of both Title IV and the SEC's rule-making proposals published on November 19, 2010, as described below.

I. Smaller and Mid-sized Advisory Firms: The $ 100 Million Threshold

Current Regulation

Under current law, an advisory firm may register with the SEC if it has at least $25 million in assets under management (AUM), and must register if its AUM is at least $30 million. Accordingly, advisory firms which reach or exceed this threshold have been able to rely on a single national registration and to follow a single set of regulations governing all SEC-registered investment managers, regardless of the states in which their businesses are operating. Firms too small to qualify for SEC registration have been generally relegated to complying with the

1 This article does not consider activities or regulation of advisers to investment companies governed by the Investment Company Act of 1940.

registration, compliance and inspection requirements of their home state securities regulators and, if they operate in more than one state, to satisfying several different state regulators.

Dodd-Frank Changes

After July 21, 2011, the AUM threshold minimum for SEC registration will increase to $100 million, thereby requiring all currently SEC-registered firms with lesser AUM amounts to withdraw from SEC registration and to apply for registration with the securities agencies in their respective home states. If these firms do business in other states, they will need to register in those jurisdictions as well.

The switch from federal to state registration for such smaller and mid-sized firms will mean that, starting next July, such firms will be subject to inspection by their local securities commissions. Each state will require compliance with its own policies and rules on such matters as management and employee qualifications, customer accounts, account management contracts, marketing literature, compensation limitations, potential conflicts disclosures, reporting requirements and the like.

Impact: State Initiatives

According to SEC and NASAA[2] estimates, this AUM threshold change will result in the shifting of approximately 4,100 smaller to mid-sized advisory firms from SEC to state jurisdiction. State securities commissions are clearly concerned about the increased oversight burdens and potential disruptions which may result from moving thousands of advisory firms to the exclusive jurisdiction of the states in a relatively short time-frame, especially when most state governments are experiencing substantial budget deficits and staffing and service reductions at all levels. Recognizing the potential challenges, NASAA appears to be encouraging state securities commissions to consult on maximizing use of resources and coordinating regulatory efforts, by such measures as improving consistency in registration and compliance rules from state-to-state and sharing their respective compliance staffs in order to boost field examination capacity, although we are not aware of any specific proposals announced as of this writing.

New SEC Transition Rules

On November 19, 2010, the SEC announced its proposals for transitioning smaller and mid-sized advisory firms from federal to state regulation, through proposed rule Release No. IA-3110. The Release proposes grace periods for the transition, so that, after the July 2011 Title IV effective date, (i) an investment adviser will have 30 days to prepare and report an accurate assessment of its current AUM, and (ii) if its AUM falls under the $100 million SEC registration threshold, the adviser will have an additional 60 days to withdraw such registration and to file a replacement registration with the applicable state regulatory agency.

2 NASAA (North American Securities Administrators Association) is comprised of all U.S. state and territorial securities administrators and the various securities administrators of Canada and Mexico.

Interplay of Federal and State Requirements in Adviser Registration

The Congressional intent expressed through Dodd-Frank is to encourage federal or state oversight for virtually every investment adviser, including those that may have been previously exempt under various safe harbor or other provisions. However, the Release highlights a number of exceptions to the new AUM threshold determinant of federal or state registration which, we believe, may complicate this seemingly straight-forward approach. For example, the Release makes clear that, if an investment adviser is, for some reason, (i) not "required to be registered" with a state securities authority or (ii) is not subject to state inspection and/or examination, the advisory firm will be required to register with the SEC, regardless of its inability to meet the $100 million AUM threshold. Furthermore, the Release indicates that a firm which does not satisfy the AUM threshold for SEC registration will nevertheless be permitted to register with the SEC if it conducts business in 15 or more states, in order avoid forcing smaller and mid-sized advisers to seek multiple state registrations.

AUM Computation Rules

The Release proposes detailed new rules for calculating investment advisers' AUM for all purposes under Dodd-Frank, and establishes a category of "regulatory assets under management." Among other things, the new definition of regulatory assets refers to all assets held in any accounts under the management authority of the adviser and (i) includes uncalled capital commitments from investors, (ii) eliminates previously excluded deductions for indebtedness and liabilities carried in managed accounts, and (iii) requires managed assets to be computed at fair value rather than at cost basis, even when such assets are illiquid, distressed or otherwise difficult to value.

New/Expanded Information and Reporting Requirements

As authorized and directed under Dodd-Frank, the SEC is taking initial steps, through the Release, to require new and/or expanded disclosures in Form ADV filings made through the IARD system.[3] These disclosure requirements will affect all investment advisory firms, including those which previously were, and those which now will be, exempt from SEC registration. Although the full extent of the first information-gathering requirements set forth in the Release is not entirely clear at this early stage, it appears that its effect will be to require smaller and mid-sized advisory firms, even if not registered with the SEC, to provide, via an expanded Form ADV, enhanced disclosure about such matters as the types of clients they service (including non-U.S. clients), their firm's advisory and non-advisory activities, their financial industry affiliations, their employees, their outside service providers, especially auditors, prime brokers, custodians, administrators and marketing firms. In addition, as discussed below, advisors of private funds, such as hedge funds and venture capital funds, which were previously exempt from any SEC oversight, will now be required to provide significant information on the pooled investment funds they control.

3 The Investment Adviser Registration Depository system through which Form ADV filings are submitted and maintained for federally and state-registered advisers.

II. Investment Managers of Private Funds

Current Private Adviser Exemption and Private Funds

Under existing law, an investment adviser with fewer than 15 clients, which does not hold itself out to the public as an investment adviser or manage assets for a registered investment company or business development company, has been exempt from investment adviser registration with the SEC. This "private adviser" exemption was relied upon in the past by many larger and mid-sized investment advisory firms managing so-called "private funds." Generally, "private funds," including hedge funds and private equity, venture and mixed or other funds, are pooled investment vehicles which are excluded from the definition of an "investment company" under the Investment Company Act of 1940 because (i) the specific private fund's securities are not publicly offered and (ii) are held by no more than 100 beneficial owners who meet various investor qualification requirements. Until now, an adviser/manager for fewer than 15 private funds, no matter how large their AUM, has not been subject to SEC registration, reporting or oversight.

New Regulatory Regime for Private Funds

Dodd-Frank entirely eliminates the private adviser exemption for private fund managers, who will now become subject to SEC reporting, registration and oversight requirements beginning next July. Dodd-Frank's Title IV provisions, combined the Release mentioned above and a companion Release IA-3111 (Companion Release) issued the same day, will create the following regulatory categories for all investment advisers managing private funds:

- Advisers managing private funds with $150 million or more in aggregate AUM will now be required to register with the SEC and will be subject to the full extent of Commission reporting, examination and oversight requirements;
- An adviser managing <u>only</u> private funds which contain, collectively, less than $150 million in AUM, will be entitled to a "private fund adviser exemption" from SEC registration, but, despite such exemption, will be subject to new reporting requirements discussed below;
- Private advisers of venture capital funds will, as set forth in the Companion Release, be exempted from SEC registration, but will also be required to comply with new SEC reporting requirements;
- Although not discussed here, a number of other registration exemptions are being provided, through Dodd-Frank and related SEC rule-making, for a variety of special purpose advisers, such as "family offices" (generally family-controlled advisory firms providing services to immediate family members), advisers to insurance companies or to small business investment companies, commodity pool advisers registered with the CFTC, and certain smaller foreign private fund advisers.

The Private Fund Adviser Exemption

As proposed in the Companion Release, an adviser to private funds collectively holding less than $150 million in private fund assets under management in the U.S. (calculated in accordance with the AUM methodology mentioned above) will be entitled to a private fund adviser exemption if it advises only private funds as defined in Section 402 of Dodd-Frank. The exemption as proposed will also be available to a non-U.S. adviser if all U.S. clients of the adviser qualify as private funds, but the Companion Release is inviting comments on whether the availability of the exemption to a non-U.S. adviser should be restricted through further rule-making. The Companion Release proposes a transition period of three months to allow an exempt private fund adviser whose AUM levels increase above the $150 million threshold sufficient time to become a fully-registered adviser.

Exemption for Venture Capital Fund Advisers

Under the Companion Release, a venture capital fund adviser will be able to avoid registration if it (i) invests in equity securities of non-public companies in order to provide operating and business expansion capital, (ii) controls, or provides significant managerial assistance to, its portfolio companies, (iii) does not employ leverage in excess of 15% of the fund's investor capital (including uncalled capital commitments) and complies with specific rules concerning borrowings, (iv) does not offer redemption rights, (v) represents itself to be a venture fund, and (vi) is not a registered investment company or a business development company.

Information from Private Fund Advisers

As mentioned above, Release IA-3110 proposes numerous changes to Form ADV, intended to provide the SEC with information often available to private fund investors but not previously accessible to regulators because of the private adviser exemption. Accordingly, the proposed ADV format will require, among other things, information on the organization and domicile of the private fund, the names of directors, trustees and managers, and the names and SEC registrations of any co-advisers or sub-advisers. The proposed form will also elicit information on a private fund's gross and net assets, the category of investment strategy used, the number and types of investors in the fund and the minimum required investment. Additionally, it is proposed that the form will seek expanded disclosure on the extent of potential conflicts of interest (for example, whether clients of the adviser or any related entities are solicited to invest in a particular fund), and the extent to which a fund may use "soft dollar" brokerage transactions. In connection with outside service providers such as auditors, prime brokers, custodians and administrators, the proposed ADV changes will seek to identify the types of services provided and the qualifications of the provider (such as the degree of independence of any fund auditor, inter-relationships with custodial or trustee institutions, and the like). As authorized by Dodd-Frank, much, if not all, of this information will be required from "exempt reporting advisers" as well as from registered advisors of the larger funds, and the Release has specifically invited public comment on whether "reporting requirements should be identical for exempt reporting advisers as they are for registered advisers."

III. Conclusion: Stay Tuned and Get Ready

It should be noted that the Release and the Companion Release discussed above are as yet only SEC proposals for which industry and public comments are being solicited, and that, after the comment period, the SEC staff may recommend deletions, additions or other changes prior to adoption by the Commission. Also, while SEC staff members are engaged with finalizing the proposals in the Release and Companion Release, other SEC staff members will be working on still more Dodd-Frank releases, including one on mandatory disclosure of potential systemic risks for investment advisers and their funds, and another mandating the types of records to be maintained by private fund advisers, both scheduled to be issued early next year.

However, despite the lack of finality on the pending rule proposals, a number of things are already clear: (i) thousands of smaller and mid-sized investment advisory firms will be switching to new state registration and compliance regimes next July, (ii) private fund advisers, whether or not exempt from registration under the $150 million threshold or otherwise, will be learning to adjust to a new regulatory environment with reporting and disclosure requirements not previously familiar to them, and (iii) all investment advisers will be operating under expanded disclosure requirements from a significantly amended Form ADV.

The Dodd-Frank Title IV provisions mandate extensive changes and, together with current and anticipated SEC rule-making initiatives, will affect virtually all participants in the investment advisory industry in the U.S. It is not too soon for each investment advisory firm that may be impacted by the changes to begin to plan for July 2011.

Contact

Seymour H. Bucholz
sbucholz@gsblaw.com
212.965.4531

Andrew J. Goodman
agoodman@gsblaw.com
212.965.4534

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driley@gsblaw.com
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GSBLAW.COM

SEATTLE

Second & Seneca Building
1191 Second Avenue
18th Floor
Seattle, WA 98101-2939
206.464.3939 Tel
206.464.0125 Fax

NEW YORK

100 Wall Street
20th Floor
New York, NY 10005-3708
212.431.8700 Tel
212.334.1278 Fax

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