

# Legal Update

## DODD-FRANK ACT REQUIRES HEDGE FUND MANAGERS TO REGISTER WITH THE SEC

**JULY 2010**

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") is expected to be signed into law later this week. The Dodd-Frank Act includes the Private Fund Investment Advisers Registration Act (the "Private Fund Act"), which significantly amends the Investment Advisers Act of 1940, as amended (the "Advisers Act"). While the Private Fund Act will require many hedge fund managers to register as investment advisers with the Securities and Exchange Commission (the "SEC"), many of the details of the Private Fund Act will be worked out during the year following its enactment through the SEC's rule-making process.

This Legal Update is divided into two parts. Part I highlights the key provisions of the Private Fund Act. Part II highlights other areas of the Dodd-Frank Act that may be of interest to hedge fund managers and other investment managers.

### Contact Us:

For more information about the Dodd-Frank Act, the Private Fund Act or investment adviser registration and regulation, please contact your regular Kleinberg Kaplan attorney.

## **Part I. Key Provisions of the Private Fund Act**

### Investment Adviser Registration

Historically, an investment adviser that managed private funds (*i.e.*, funds that are exempt from registering as investment companies under section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940, as amended) ("Private Funds") was exempted from registering with the SEC as a registered investment adviser (an "RIA") based on an exemption for investment advisers with fewer than 15 clients that did not hold themselves out to the public as investment advisers (with each fund generally counting as one client) (the "Private Adviser Exemption"). The Private Fund Act eliminates the Private Adviser Exemption. As a result, investment advisers that manage Private Funds will be required to register with the SEC as RIAs within one year of the enactment of the Private Fund Act, unless such advisers qualify for one of the exemptions in the Advisers Act, including the new exemptions described below.

An investment adviser registering with the SEC must file its Form ADV with the SEC at least 45 days prior to the date that it intends for its registration to be effective. Additionally, it may take several months to prepare the necessary documentation to complete the investment adviser registration process and to implement the appropriate compliance policies and procedures that need to be in place as of the date that such registration is effective. As such, investment advisers that plan on registering as a result of the Private Fund Act should contact Kleinberg Kaplan shortly in order to discuss and begin planning the registration process.

### New Exemptions from Registration

The Private Fund Act provides for a number of new exemptions from investment adviser registration, including the following:<sup>1</sup>

- *Less Than \$150 Million Assets Under Management Exemption* - The Private Fund Act directs the SEC to adopt an exemption from investment adviser registration for an investment adviser that acts solely as an adviser to Private Funds and has assets under

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<sup>1</sup> The Private Fund Act also provides an exemption from investment adviser registration for investment advisers that solely advise small business investment companies.

management in the United States<sup>2</sup> of less than \$150 million. Although these investment advisers are exempt from registration, the Private Fund Act requires such investment advisers to maintain records and provide the SEC with annual or other reports as the SEC determines necessary or appropriate in the public interest or for the protection of investors.

- *Foreign Private Adviser Exemption* - The Private Fund Act provides an exemption from investment adviser registration for an investment adviser that: (i) has no place of business in the United States;<sup>3</sup> (ii) has, in total, fewer than 15 clients and investors in the United States<sup>4</sup> in Private Funds that are advised by such investment adviser; (iii) has aggregate assets under management attributable to clients in the United States and investors in the United States in Private Funds advised by such adviser of less than \$25 million, or such higher amount as the SEC may deem appropriate; and (iv) neither holds itself out generally to the public in the United States as an investment adviser nor acts as investment adviser to any registered investment company or business development company. Nothing contained in the Private Fund Act appears to preclude foreign investment advisers from relying on the less than \$150 million assets under management exemption discussed above.
- *Venture Capital Fund Exemption* - The Private Fund Act provides an exemption from investment adviser registration for investment advisers that act as investment advisers solely to one or more "venture capital funds," which the SEC is required to define within one year of the Private Fund Act's enactment. Although such investment advisers will be exempt from registration, the Private Fund Act requires them to maintain such records and provide the SEC with annual or other reports as the SEC determines necessary or appropriate in the public interest or for the protection of investors. *It is unclear how the SEC will define "venture capital funds." Given the amount of time that the SEC has to define such term and the time that it takes to complete the registration process, investment advisers that believe that they may qualify for this exemption may nonetheless consider the need to prepare to register with the SEC.*
- *Family Office Exemption* - The Private Fund Act requires the SEC to define a "family office" and to provide an exemption from investment adviser registration for investment

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<sup>2</sup> It is unclear how the phrase "assets under management in the United States" will be interpreted by the SEC.

<sup>3</sup> It is unclear how the phrase "no place of business in the United States" will be interpreted by the SEC.

<sup>4</sup> It is unclear how the phrase "clients and investors in the United States" will be interpreted by the SEC.

advisers that provide investment advice solely to family offices in a manner that is consistent with the SEC's previous exemptive policy and subject to certain other considerations.

- In addition, the Private Fund Act preserves the exemption from investment adviser registration for certain investment advisers that are registered as commodity trading advisers with the Commodity Futures Trading Commission (the "CFTC") and whose business does not primarily involve providing investment advice with respect to securities. However, if the business of any such investment adviser that manages a Private Fund becomes predominately the provision of securities-related advice, such investment adviser must register with the SEC as an RIA (unless another exemption is available).

#### Mid-Sized Private Fund Advisers

The Private Fund Act requires the SEC to provide registration and examination procedures for investment advisers to "mid-sized private funds," which reflect the systemic risks posed by such funds. However, because the Private Fund Act does not define a "mid-sized private fund," the scope of this provision is unclear. Further information about this provision should be provided through the SEC rule-making process.

#### Asset Thresholds for Federal Registration of Investment Advisers

Currently, an investment adviser that is regulated or required to be regulated by a state is ineligible to register with the SEC as an RIA unless it has at least \$25 million in assets under management or acts as an investment adviser to a registered investment company or business development company. Investment advisers with less than \$25 million in assets under management typically must register in the state(s) in which they have an office or have more than a certain number of clients, unless the state provides an exemption.

Under the Private Fund Act, an investment adviser that has assets under management between \$25 million and \$100 million (either of which may be increased by the SEC) and that is registered as an investment adviser in the state in which its principal office or place of business is located and where the state conducts investment adviser examinations, may no longer register with the SEC as an investment adviser, unless it would be required to register with 15

or more states.<sup>5</sup> This provision will transfer substantial regulatory authority from the SEC to the states.

#### Records and Reports of Private Funds

The Private Fund Act provides the SEC with broad authority to require RIAs to maintain records and file reports with respect to the Private Funds that they advise, as necessary or appropriate for the public interest and for the protection of investors or for the assessment of systemic risk. The scope of such recordkeeping requirements, and the scope and frequency of such reports, is to be determined by the SEC. Further, the Private Fund Act allows the SEC to establish different reporting requirements for different classes of investment advisers, based on the type or size of Private Fund being advised.

The SEC is generally required to maintain the confidentiality of the information it receives from RIAs about Private Funds (and is specifically exempted from disclosure under the Freedom of Information Act ("FOIA")), subject to the SEC's obligation to provide the information it receives during any such examination or inspection to other agencies of the United States government, each of which is subject to substantially the same confidentiality standards and FOIA exemptions as are applicable to the SEC.

#### Custody of Client Accounts

The Private Fund Act requires RIAs to take such steps to safeguard client assets over which they have custody, including verification of such assets by an independent public accountant, as the SEC may prescribe. Earlier this year, the SEC amended the custody rule for investment advisers, Rule 206(4)-2 under the Advisers Act, to provide for independent verification of client assets managed by an RIA. However, the amended custody rule generally provides that RIAs that manage pooled investment vehicles that are subject to an annual financial statement audit by an independent public accountant that is registered with, and subject to regular inspection by, the Public Company Accounting Oversight Board, and that distribute such audited financial statements prepared in accordance with generally accepted accounting principles ("GAAP") to investors in the pools within 120 days (or 180 days for funds of funds) after the end of each fiscal year, are deemed to have satisfied the independent verification

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<sup>5</sup> It remains to be seen whether the SEC will grandfather existing RIAs that would no longer be eligible to be registered after this provision becomes effective.

requirement with respect to such vehicles. (See Kleinberg Kaplan's March 2010 legal update entitled "SEC Adopts Amendments to the Investment Adviser Custody Rule" - click [here](#).) It is unclear whether the SEC will reevaluate its position regarding the independent verification requirements applicable to Private Funds.

#### "Accredited Investor" Standard

Immediately following the Private Fund Act's enactment and during the four-year period thereafter, the net worth standard for natural person "accredited investors" will be \$1 million at the time of purchase, excluding the value of each such person's primary residence (the net worth standard is currently \$1 million, but it includes the value of a primary residence). The SEC will also be required to review the natural person "accredited investor" standard every four years to determine whether it should be modified. The revised accredited investor standard applies to all private placements of securities, not just those offered by Private Funds.

*In order for Private Fund investment advisers to ensure that investors subscribing for interests in such funds (including in the case of additional subscriptions) comply with the new "accredited investor" standard, such investment advisers will need to promptly update their subscription documents (including any documentation relating to additional subscriptions) prior to accepting new or additional capital from investors in order to reflect the new "accredited investor" standard. **Such investment advisers should contact their regular Kleinberg Kaplan attorney in order to update the appropriate documentation.***

#### Suitability Requirement of Investors Being Charged a Performance-Based Fee

Generally, RIAs may charge performance-based fees (or allocations) only to those clients and investors in the funds they manage that are "qualified clients" (*i.e.*, generally, an investor with a net worth of at least \$1.5 million or that has \$750,000 under management with the RIA at the time of investment, or the RIA's other knowledgeable advisory personnel). The Private Fund Act requires the SEC to periodically adjust the dollar threshold components of the "qualified client" standard to account for the effects of inflation. It is unclear whether RIAs will be permitted to continue to charge performance-based fees to their existing non-"qualified client" investors with respect to either existing or new investments by such investors. This issue will likely be clarified through SEC rule-making.

**Part II. Other Areas of the Dodd-Frank Act that May Interest Hedge Fund Managers**

Shareholder Input on Pay

Congress has expressed its concern about executive pay in a manner which may be of interest to activist hedge fund managers.

Under the Dodd-Frank Act, at least every three years, public issuers generally would have to submit their executive compensation arrangements to a non-binding shareholder vote. Every six years, shareholders would be able to vote on whether such non-binding votes should be held more frequently.

The Dodd-Frank Act also requires the SEC to direct national securities exchanges to require issuers of listed securities to have compensation committees consisting entirely of independent directors.

With respect to certain financial institutions, federal regulators will be empowered to prohibit incentive-based payment arrangements if they are deemed to be "excessive" or they could lead to material financial losses for such institutions.

Banking Entities Owning Hedge Funds

The Dodd-Frank Act generally prohibits insured depository institutions and their affiliates (each, a "Banking Entity") from investing in Private Funds, except in limited circumstances. A Banking Entity may sponsor a Private Fund only if it satisfies certain criteria. If such criteria are satisfied and the Banking Entity sponsors a Private Fund, it may also invest in such Private Fund, but the amount of such investment must be limited to not more than 3% of the total ownership interest of the Private Fund within one year after the date of the fund's establishment (subject to extension by the Federal Reserve) and must be "immaterial" to the Banking Entity. "Immaterial" is not defined in the Private Fund Act, but in no case may the aggregate of all interests of the Banking Entity in all such Private Funds exceed 3% of the Tier 1 capital of the Banking Entity.

Financial Stability Oversight Council

In an attempt to prevent a future financial crisis, the Dodd-Frank Act establishes a Financial Stability Oversight Council (the "Council") consisting of various heads of regulatory agencies,

including the U.S. Treasury Department (the "Treasury"), the Federal Reserve, the Federal Deposit Insurance Corporation (the "FDIC"), the SEC and others, as well as one independent member with insurance expertise chosen by the President and confirmed by the Senate.

The Council is charged with identifying risks to U.S. financial stability, responding to emerging threats and promoting market discipline by discouraging bailouts. The Council is authorized to make various recommendations to regulators and to require Federal Reserve supervision of nonbank financial companies (including hedge funds and investment advisers) that might pose risks to the financial stability of the United States, which supervision may require reporting by such companies.

#### Liquidation Authority

Title II of the Dodd-Frank Act establishes the Orderly Liquidation Authority (the "OLA"), under which a bank or a "nonbank financial company" as defined in the Dodd-Frank Act (each a "Financial Company") can be put into receivership and then liquidated upon a determination by the FDIC and the board of governors of the Federal Reserve that, among other things, (i) such entity is in default or in danger of default and (ii) the failure of the Financial Company and its resolution would have serious adverse effects on financial stability of the United States. If the Financial Company does not consent to the appointment of the receiver, the Secretary of the Treasury will petition the U.S. District Court for the District of Columbia for an order appointing the receiver. The District Court will have 24 hours within which to consider such a petition. If it does not rule within that time, it will be deemed to have granted the petition for appointment of a receiver. The receiver is the FDIC and in the case of a broker or dealer, the Securities Investor Protection Corporation will also be involved as the trustee.

Once the receivership has been established under the OLA, it would immediately supersede any pending bankruptcy case for the Financial Company, to the extent one has been filed, and prevent the commencement of such a case, if one has not been filed. Although many of the procedural rules for the OLA have not yet been written, it is clear that proceedings under the OLA would be different from proceedings under the Bankruptcy Code. For instance, under the OLA, the receiver may treat similarly situated creditors differently if it determines that such treatment is necessary to maximize the value of the assets. As such, creditors of, and investors in, a Financial Company will now need to consider the impact of the OLA in addition to the Bankruptcy Code when evaluating investments.

Derivatives

The Dodd-Frank Act provides for the regulation of derivatives by the CFTC and the SEC (with the SEC to regulate security-based derivatives, and the CFTC to regulate others). Derivative contracts designated by the regulators must be cleared through a regulated clearinghouse and traded either on a regulated exchange or trading facility. Swap dealers, and certain derivatives dealers designated as "major swap participants" by the regulators, will be required to register and be subject to capital requirements and other rules to be promulgated by the regulators. We intend to publish in the near future a separate Legal Update regarding the impact that the Dodd-Frank Act will have on derivatives trading by hedge funds.

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