The Dodd-Frank Wall Street Reform and Consumer Protection Act-New Challenges for Fund Managers and Investment Advisers

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On July 21, 2010, President Obama signed the Wall Street Reform and Consumer Protection Act (the "Reform Act") into law. The Reform Act includes a number of provisions that will have a significant impact on domestic and non-U.S. fund managers and investment advisers.

Elimination of the "Private Adviser" Exemption

The Reform Act amends the Investment Advisers Act of 1940 (the "Advisers Act") by deleting the so called "private adviser exemption," that exempted investment advisers with fewer than 15 clients from registration under the Advisers Act. Most fund managers currently rely on this exemption to avoid registration with, and regulation by, the Securities and Exchange Commission (the "SEC") since individual funds are counted as a single client. Additionally, many non-U.S. investment advisers rely on this exemption since, because their principal place of business is outside the U.S., they need only count U.S.-resident clients against the 15 client limit.

In place of the private adviser exemption, the Reform Act mandates new registration and regulation thresholds based on the amount of assets under management ("AUM"). The changes to the Advisers Act will become effective in July 2011.

Fund Managers

Investment advisers to private equity and hedge funds, but not venture capital funds, with $150 million or more of AUM will be required to register with and will be regulated by the SEC.

Beginning in July 2011, fund managers will no longer be able to rely on the private adviser exemption. However, the Reform Act requires the SEC to provide an exemption to any investment adviser that acts solely as an adviser to Private Funds and has less than $150 million of AUM. For purposes of the Reform Act, "Private Fund" is defined as any fund that is excluded from the definition of Investment Company pursuant to Sections 3©(1) or 3©(7) of the Investment Company Act of 1940. The Reform Act also contains specific exemptions for (i) any investment adviser that solely advises small business investment companies that are either licensed or are currently applying for licenses under the Small Business Investment Act of 1958 and (ii) any investment adviser to a "Venture Capital Fund." The term Venture Capital Fund is not defined in the Reform Act. Rather the SEC is directed to define Venture Capital Fund by final rule prior to the effectiveness of the other amendments to the Advisers Act.

Investment Advisers

Investment advisers that do not act exclusively for Private Funds and that have $100 million or more of AUM will be required to register with and will be regulated by the SEC.

Investment advisers that advise clients other than Private Funds will also be unable to rely on the private adviser exemption. The Reform Act increases the general threshold for investment adviser registration under the Advisers Act from $30 million of AUM to $100 million of AUM. The practical effects of the increased registration threshold are discussed in greater detail under the heading "Increased Significance of State Regulation" below.

Non-U.S. Fund Managers and Investment Advisers

An increased number of non-U.S. fund managers and investment advisers will be subject to registration with, and regulation by, the SEC. However, non-U.S. fund managers and investment advisers that meet the definition of "Foreign Private Adviser" will be exempt from registration with the SEC.

The Reform Act creates a new category of investment adviser to be known as a "Foreign Private Adviser." A Foreign Private Adviser is defined as an investment adviser that (i) has no place of business in the U.S., (ii) has, in total, fewer than 15 clients and investors in the U.S. in Private Funds advised by the investment adviser, (iii) has aggregate AUM attributable to clients in the U.S. and investors in the U.S. in Private Funds advised by the investment adviser of less than $25 million, and (iv) neither holds itself out to the public in the U.S. as an investment adviser nor acts as an investment adviser to an investment company registered under the Investment Company Act of 1940 nor has elected to be a "business development company" (as defined under the Investment Company Act of 1940).

The Reform Act does not define the phrases "clients and investors in the U.S." or "attributable to clients in the U.S. and investors in the U.S." Rather, the meaning of those phrases will be left to future SEC interpretation. While it remains uncertain, it seems likely that the SEC will interpret these phrases in a way that significantly extends the SEC's ability to regulate non-U.S. fund managers and investment advisers.

Any non-U.S. fund manager or investment adviser that fails to meet the definition of a Foreign Private Adviser will be subject to the same rules as are applicable to U.S. fund managers and investment advisers and, therefore, should refer to the $150 and $100 million of AUM thresholds discussed above.

However, the application of the Reform Act to non-U.S. fund managers is subject to an additional level of uncertainty. The statutory language that eliminates the registration requirements for fund managers with less than $150 million of AUM states the AUM test in terms of "assets under management in the U.S." Although it is not yet clear how this language will be interpreted, it is possible that non-U.S. fund managers that do not satisfy the definition of Foreign Private Adviser will only need to count funds managed for U.S. clients when applying the $150 million AUM test.

Increased Significance of State Regulation

Currently, investment advisers with less than $25 million of AUM are not permitted to register with the SEC under the Advisers Act and are subject to state regulation. The Reform Act precludes investment advisers with less than $100 million of AUM from registering with the SEC, leaving such investment advisers (including fund managers) subject to regulation by the state(s) in which they conduct their business.

This raises the potential that investment advisers (including fund managers) could be subject to registration with and regulation by several states – the laws and requirements of which may vary. Notwithstanding the foregoing, any investment adviser (including fund managers) with less than $100 million of AUM that would otherwise be required to register with 15 or more states will be permitted instead to register with the SEC.

Additional Recordkeeping and Reporting Requirements

The Reform Act also mandates additional recordkeeping and reporting requirements.

The Reform Act specifically states that the records and reports of any Private Fund advised by a registered investment adviser will be deemed the records and reports of that investment adviser. As such, Private Funds are also subject to these additional requirements.

Registered investment advisers and the Private Funds they advise will be required to report to the SEC on, among other things: (i) the amount of AUM and the 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) any side arrangements whereby certain investors receive more favorable terms than other investors; (vii) trading practices; and (viii) any other information the SEC determines "is necessary and appropriate in the public interest and for protection of investors, or for the assessment of systemic risk."

In addition, the Reform Act authorizes the SEC to require unregistered investment advisers to maintain and provide to the SEC such reports as the SEC deems "necessary and appropriate in the public interest and for protection of investors." The Reform Act does not mandate nor limit the scope or extent of the reporting obligations the SEC may impose on unregistered investment advisers. It is not clear whether the records of Private Funds advised by unregistered investment advisers will be treated as the records of the advisers themselves as is the case with registered investment advisers.

In a separate but related development, on July 21, 2010, the SEC voted unanimously to approve changes to Part II of Form ADV, commonly known as the "client brochure." The new Part II of Form ADV will replace the current "fill in the blank" and "check-the-box" format with a plain English narrative format requiring disclosure concerning the adviser's business, fee structure, investment strategies, disciplinary information, conflicts of interest, and brokerage practices. The new form will also require supplemental resume-like brochures about the individuals servicing clients. The new Form ADV, Part II requirements will become effective in the first quarter of 2011. Registered investment advisers will be required to file the new form electronically, thereby making the form publicly available on the Internet.

Conclusion

The most significant impact of the Reform Act is the requirement for many domestic and certain non-U.S. investment advisers (including fund managers) to register with the SEC by July 2011. Both currently registered investment advisers and those investment advisers (including fund managers) that will be subject to new registration obligations will be subject to increased and expanded disclosure and reporting obligations to the SEC, as the SEC will determine pursuant to new and broad rule-making authority.

In addition, the deletion of the private adviser exemption at the Federal level will have an immediate impact on state investment adviser laws, many of which piggyback on Federal law. This will bring many investment advisers (including fund managers) with AUM under $100 million under the jurisdiction of state regulation.

Investment advisers solely to venture capital funds will remain exempt from registration with the SEC. However, all unregistered investment advisers will be subject to new SEC reporting requirements. The pending SEC rulemaking defining "venture capital fund" will be the subject of continued interest for the private equity industry.

Both domestic and non-U.S. investment advisers (including fund managers) should begin now to assess how the Reform Act is likely to impact their businesses. While a few interpretive issues remain unresolved, the general outline of the new regulatory landscape is clear. We will continue to monitor the interpretive issues highlighted above and will provide further updates as developments warrant.

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