CHANGES IN INVESTMENT ADVISER REGULATION

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CHANGES IN INVESTMENT ADVISER REGULATION

Current Law:

Definition of "Investment Adviser"

- The Investment Advisers Act of 1940 requires the registration of "investment advisers" unless an exemption applies.
- "Investment Adviser" includes any person who for compensation engages in the business of providing advice to others or issuing reports or analyses regarding securities.
- The manager of a private fund that makes investment decisions for the fund and receives management fees is an "investment adviser".
- The registration requirement is broadly defined - persons providing advice regarding market timing, asset allocation, securities valuation, etc. can be covered.

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CHANGES IN INVESTMENT ADVISER REGULATION (continued)

Currently Available Exemptions:

Banks

- U.S. banks and savings associations generally are not required to register.
- Banks that advise registered investment companies (e.g., mutual funds) must register.

Broker-Dealers

- Registered broker-dealers are exempt from separate registration as investment advisers if (i) the investment advice they provide is "solely incidental" to their brokerage business and (ii) no special compensation is paid.

CHANGES IN INVESTMENT ADVISER REGULATION (continued)

Private Fund Advisers:

- Most private fund managers rely upon Section 203(b)(3) of the Advisers Act - the "private advisers exemption".
- Section 203(b)(3) exempts any adviser who (i) had fewer than 15 clients in the preceding 12 months, (ii) does not advise registered investment companies, and (iii) does not hold itself out to the public as an “investment adviser”.
- In counting clients toward the limit of 14, any corporation, partnership, LLC, etc., generally counts as a single client.

CHANGES IN INVESTMENT ADVISER REGULATION (continued)

Regulatory Concerns:

- Growth of hedge fund industry and volume of money managed by unregistered firms created regulatory concerns.
- Often neither the funds nor the managers are regulated (respectively exempt from registration under the Investment Company Act and the Investment Advisers Act).
- SEC's prior attempt to require registration of many fund managers by rule (Investment Advisers Act Rule 204(b)(3)-1) was invalidated by the courts in 2006.
- Registration is not a cure-all: Both Bernard Madoff's and Allen Stanford's firms were registered investment advisers.

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CHANGES IN INVESTMENT ADVISER REGULATION (continued)

Dodd-Frank Act:

General

- On July 21, 2010 President Obama signed the "Dodd-Frank Wall Street Reform and Consumer Protection Act" (the "Act"). The Act fundamentally changes many areas of financial regulation.

- Title IV of the Act, the "Private Fund Advisers Registration Act of 2010" (the "Private Advisers Act") amends the Investment Advisers Act.

- The Private Advisers Act deletes the "private advisers exemption" in Section 203(b)(3) of the Investment Advisers Act and requires the registration of most "private fund" advisers.

- "Private Fund" is defined as any issuer that relies upon the registration exemptions in Section 3(c)(1) or 3(c)(7) of the Investment Company Act.

CHANGES IN INVESTMENT ADVISER REGULATION (continued)

Tie-In to Investment Company Act:

- Most private funds, including hedge funds, private equity funds and many ABS issuers, including most ABCP conduits and CDOs, rely upon the Section 3(c)(1) or 3(c)(7) exemptions.
- Section 3(c)(1) exempts any issuer not engaged in a public offering of its securities that has not more than 100 beneficial holders of its securities (excluding short-term paper).
- Section 3(c)(7) exempts any issuer not engaged in a public offering of its securities if all of the securityholders are "qualified purchasers" (e.g., companies having at least $25 million in investments).
- The investment managers of Section 3(c)(1) and 3(c)(7) companies ("private fund advisers") typically rely upon the "private advisers exemption" now being deleted.

CHANGES IN INVESTMENT ADVISER REGULATION (continued)

Exemptions from New Registration Requirement:

- “Foreign private advisers”. Defined as an adviser who (i) has no U.S. place of business, (ii) has fewer than 15 U.S. clients, iii) manages less than $25 million of assets for U.S. clients (including investors in private funds advised by the adviser), and (iv) does not hold itself out to the public as an investment adviser in the U.S. or advise any registered investment company.
- Advisers who (i) advise only private funds, and (ii) have less than $150 million of U.S. assets under management. Such advisers will remain subject to recordkeeping and reporting requirements.
- The SEC is directed to provide an exemption by rule for advisers to “venture capital funds” (as defined by the SEC). Such advisers will remain subject to recordkeeping and reporting requirements.

CHANGES IN INVESTMENT ADVISER REGULATION (continued)

- Advisers registered as commodity trading advisers with the Commodity Futures Trading Commission not engaged “predominately” in providing securities-related advice.
- Advisers who advise only small business investment companies generally will be exempt.
- “Family offices” (as defined by the SEC), i.e., advisers formed to provide advice to members of a single family.

CHANGES IN INVESTMENT ADVISER REGULATION (continued)

Enhanced Recordkeeping Requirements:

- The Private Advisers Act creates new recordkeeping and reporting requirements for registered private fund advisers.
- Among other items, records must be kept of:
  - Ø assets under management
  - Ø use of leverage
  - Ø counterparty credit risk exposures
  - Ø trading and investment positions
  - Ø valuation policies and practices
  - Ø any side arrangements granting preferred rights to certain investors
  - Ø trading practices

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CHANGES IN INVESTMENT ADVISER REGULATION (continued)

Enhanced Recordkeeping Requirements (cont'd):

- The private fund adviser will be required to file such reports as the SEC shall determine by rule. The SEC also will be required to conduit periodic examinations of the records of private fund advisers.
- Reports filed by private fund advisers generally will be kept confidential, but may be shared by the SEC with the Congress, other federal agencies, self-regulatory agencies and the new Financial Stability Oversight Council (the "Council").
- The Act establishes the Council as an oversight organization to identify systemic risk to the U.S. financial system.
- The SEC can require advisers to disclose client information to the SEC if needed to assess "systemic risk."

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CHANGES IN INVESTMENT ADVISER REGULATION (continued)

Other Applicable Requirements:

- The Investment Advisers Act regulates both registered and unregistered investment advisers.
- Advisers currently relying upon the private advisers exemption remain “investment advisers” and are subject to certain Investment Advisers Act provisions (e.g., anti-fraud provisions).
- However, registered advisers are subject to many additional regulations; e.g., enhanced recordkeeping and disclosure requirements; obligation to maintain written compliance procedures; limitations on performance fees; and certain customer documentation and asset custody requirements.
- The Private Advisers Act therefore imposes substantial new compliance duties on registered private fund advisers.

CHANGES IN INVESTMENT ADVISER REGULATION (continued)

Changes to Allocation of Federal/State Regulatory Responsibilities

Current Law

- All States have their own securities laws ("Blue Sky laws") and the Blue Sky laws in all States but one (Wyoming) provide for the registration of investment advisers.
- The Investment Advisers Act bifurcates regulatory responsibility for investment advisers between the SEC and the States. Generally, small advisers register with the States and larger advisers with the SEC.
- Subject to certain exceptions, the Investment Advisers Act prohibits advisers from registering with the SEC unless they have at least $25 million in assets under management.
- The Investment Advisers Act also prohibits the States from requiring the registration of advisers who are registered with the SEC.

CHANGES IN INVESTMENT ADVISER REGULATION (continued)

<u>Changes</u>

- The Private Advisers Act increases the threshold required for an adviser to qualify for SEC registration from $25 million to $100 million in assets under management.
- Advisers currently registered with the SEC who do not meet the higher threshold will be required to withdraw their SEC registrations and (depending upon local law) may become subject to State registration.
- The goal is to remove a number of smaller advisers from SEC oversight so that the SEC can focus more resources on newly-registered private fund advisers.
- SEC registration is still permitted for certain advisers who don't meet the higher threshold (e.g., advisers who would be required to register with 15 or more States).

CHANGES IN INVESTMENT ADVISER REGULATION (continued)

Change in Registration Procedures:

- Investment advisers register with the SEC and the States on Form ADV.
- The SEC recently approved significant changes to Form ADV disclosure requirements.
- Registered investment advisers are required to deliver a disclosure document (a “brochure”) to clients and prospective clients.
- The amendments expand the disclosures required in the brochure and require that they appear in a specified format.
- They also require that the advised deliver a “brochure supplement” to disclose specified information regarding individual advisory employees.
- Currently registered advisers must comply with the new disclosure requirements when they next file an “Annual Updating Amendment” for a fiscal year ended on or after December 31, 2010.

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CHANGES IN INVESTMENT ADVISER REGULATION (continued)

Change in Qualified Client Definition:

- Section 205(a)(i) of the Investment Advisers Act generally prohibits registered investment advisers from charging fees based on capital gains or capital appreciation in the client's account.
- Exceptions are made for "qualified clients", including clients having at least $750,000 of assets under management with the investment adviser or having a net worth of at least $1,500,000.
- The SEC is directed to adjust these amounts for inflation not later than July 21, 2011 and to readjust them every five years.

CHANGES IN INVESTMENT ADVISER REGULATION (continued)

Other Items:

- Many securities offerings are sold to "accredited investors" without registration under the Securities Act of 1933 pursuant to Regulation D under the Securities Act.
- "Accredited investor" is defined to include (among others) natural persons having an annual income of $200,000 (or $300,000 with spouse) over specified periods or net worth of $1,000,000.
- Individual accredited investors can no longer count equity in their primary residence toward the $1,000,000 net worth test (and generally must deduct negative equity).
- As of July 21, 2014 the SEC must increase the net worth test to an amount greater than $1,000,000.

CHANGES IN INVESTMENT ADVISER REGULATION (continued)

Other Items:

- The General Accounting Office is directed to undertake studies to determine whether (i) any other changes should be made to the eligibility criteria for investors in private funds, and (ii) whether a self-regulatory organization should be formed to oversee private funds.
- The SEC is directed to add disqualification provisions to Rule 506 of Regulation D by July 21, 2011.
- In consequence, Regulation D will no longer be available to issuers and/or placement agents who (or whose officers or directors) are subject to specified criminal convictions, disciplinary actions or court orders.