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Changes to Investment Advisers Act under the Dodd-Frank Reform Act

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The Investment Advisers Act imposes registration and other regulatory requirements on an “investment adviser,” which generally includes any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities.

The SEC has proposed rules to implement provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act that, among other things:

- Facilitate registration of advisers to hedge funds and other private funds with the SEC;
- Implement the Dodd-Frank Reform Act's mandate to require reporting by some advisers that are currently exempt from SEC registration;
- Increase the asset threshold triggering advisers to register with the SEC (as opposed to registration at the state level);
- Adopt provisions governing the reporting obligations for “exempt reporting advisers”;
- Define “venture capital fund”; and
- Define “family office.”

The SEC anticipates adopting final rules in the first half of 2011.

Background

Historically, advisers to private funds have been able to avoid registering with the SEC because of an exemption that applies to advisers with fewer than 15 clients — an exemption that counted only each fund as a client, as opposed to each investor in a fund as a client. As a result, some advisers to hedge funds and other private funds have remained outside of the SEC's regulatory oversight.

The Dodd-Frank Reform Act eliminated this so-called private adviser exemption. Consequently, many previously unregistered advisers, particularly those to hedge funds and private equity funds, will, absent an alternative exemption, be required to register with the SEC and be subject to its regulatory oversight, rules, and examination. Advisers who or which are not otherwise exempt will be required to register with the SEC before

July 21, 2011.

By registering with the SEC, an adviser becomes subject to a range of substantive provisions of the Advisers Act, including requirements to develop, implement, update and supervise a variety of compliance policies and procedures. Implementing a compliance program is not a standard process, but rather requires customization to fit the particular business of an adviser. A registering adviser should not delay in assessing the steps to be taken to implement a compliance program and designing a plan for timely implementation.

SEC-registered advisers are required to designate a chief compliance officer and to assess the adequacy and effectiveness of its compliance policies at least annually. Newly registering advisers become subject to periodic and “for cause” examinations by the SEC, which generally focus on the records of the adviser.

Reporting Requirements

Under the proposed rules, advisers to private funds would be required to provide:

- Basic organizational and operational information about the funds they manage, such as information about the amount of assets held by the fund, the types of investors in the fund, and the advisers' services to the fund; and
- Identification of five categories of “gatekeepers” who or which perform critical roles for advisers and the private funds they manage (i.e., auditors, prime brokers, custodians, administrators, and marketers).

In addition, the SEC has implemented a completely revamped Form ADV and proposed other amendments to the adviser registration forms to improve its regulatory program. These amendments would require all registered advisers to provide more information about their advisory business, including information about:

- The types of clients they advise, their employees, and their advisory activities; and
- Their business practices that may present significant conflicts of interest (such as the use of affiliated brokers, soft dollar arrangements, and compensation for client referrals).

The proposal also would require advisers to provide additional information about their non-advisory activities and their financial industry affiliations.

Reporting Requirements for “Exempt Reporting Advisers”

While many private fund advisers will be required to register with the SEC, some private fund advisers may not need to if they are able to rely on one of the new exemptions from registration provided under the Dodd-Frank Reform Act, including exemptions for:

- Advisers solely to “venture capital funds”;

- Advisers solely to private funds with less than $150 million in assets under management in the U.S.; and
- Advisers solely to a single “family office.”

The SEC may nevertheless impose some reporting requirements upon advisers relying upon either of the first two of these exemptions (“exempt reporting advisers”).

Under the proposed rules, exempt reporting advisers would nonetheless be required to file, and periodically update, reports with the SEC, using the same registration form as registered advisers. Rather than completing all of items on the form, however, exempt reporting advisers would be required to fill out only a limited subset of items, including:

- Basic identifying information for the adviser and the identity of its owners and affiliates;
- Information about the private funds the adviser manages and about other business activities that the adviser and its affiliates are engaged in that may present conflicts of interest that may present significant risk to clients; and
- The disciplinary history of the adviser and its employees that may reflect on their integrity.

Exempt reporting advisers would file reports on the SEC's investment adviser electronic filing system (IARD), and these reports would be publicly available on the SEC's website.

Reallocation of Regulatory Responsibility

The Dodd-Frank Reform Act raises the threshold for SEC registration to $100 million (from the prior $25 million threshold) by creating a new category of advisers called “mid-sized advisers.” A mid-sized adviser, which generally may not register with the SEC and will be subject to state registration, is defined as an adviser that:

- Manages between $25 million and $100 million for its clients;
- Is required to be registered in the state where it maintains its principal office and place of business; and
- Would be subject to examination by that state, if required to register.

As a result of this amendment to the Advisers Act, about 4,100 of the current 11,850 registered advisers will be required to switch from registration with the SEC to registration with the states. These advisers will continue to be subject to the Advisers Act's general anti-fraud provisions.

Specific Exemptions

Definition of “Venture Capital Fund”

The SEC is proposing a definition of “venture capital fund” that is designed to implement the intent of Congress in exempting advisers who or which only manage venture capital funds from registration under the Advisers

Act. Under the proposed definition, a venture capital fund is a fund that:

- Is a private fund;
- Represents itself to investors as being a venture capital fund;
- Only invests in (i) equity securities of private operating companies to provide primarily operating or business expansion capital (not to buy out other investors), (ii) U.S. Treasury securities with a remaining maturity of 60 days or less, or (iii) cash;
- Purchased at least 80 percent of the equity securities of each qualifying company directly from the private company;
- Is not leveraged and its portfolio companies may not borrow in connection with the fund's investment;
- Offers to provide a significant degree of managerial assistance, or controls its portfolio companies;
- Does not offer redemption rights to its investors; and
- Is neither registered under the Advisers Act nor has elected to be treated as a "business development company."

Private Fund. A “private fund” is one that would be required to register as an investment company but for the exemptions provided in Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act of 1940, as amended. Among other things, 3(c)(1) funds may have no more than 100 beneficial owners, and 3(c)(7) funds may have more than 100 beneficial owners but all must be “qualified purchasers.”

Held Out as a Venture Fund. The fund must have represented itself to investors as a venture capital fund. This will likely be controversial as there are many funds that are fundamentally similar to venture funds but have attempted in the past to market themselves differently to their investors.

Investments in Private Operating Companies. The fund must invest solely in “qualifying portfolio companies.” A “qualifying portfolio company” is a company that:

- Is not publicly traded (or controlled by a publicly traded company), measured at the time of each investment in the portfolio company by the fund.
- Does not borrow or issue debt obligations, directly or indirectly, in connection with the private fund's investment in the portfolio company. This requirement may be an issue for companies that engage in various recapitalizations that involve combined debt and equity issuances.
- Does not redeem, exchange, or repurchase any securities of the company, or distribute to pre-existing security holders cash or other company assets, directly or indirectly, in connection with the private fund's investment in such company. This provision is intended to require the portfolio company to use the invested funds only for operating capital or expansion.
- Is not itself a fund, whether an investment company (but for certain exemptions), a private fund or a commodity pool.

Other Investment Limitations. The fund must own solely "equity securities," cash, cash equivalents, or U.S. Treasury securities with a maturity of 60 days or less. Under the definition provided in the Exchange Act of 1934, as amended, "equity securities" generally include common stock, preferred stock, warrants, and convertible securities (including convertible debt). This ownership restriction would impose limitations on the types of debt investments a fund may make. For example, venture capital funds sometimes engage in non-convertible short-term bridge lending to their portfolio companies pending an upcoming financing, which would be prohibited by the proposed new rules.

Direct Acquisition. The fund must acquire at least 80 percent of the equity securities of each qualifying company directly from the private company. Secondary transactions with a portfolio company's existing investors or founders would be limited.

Control or Managerial Assistance. The fund must control or have an arrangement pursuant to which the fund or the investment adviser provides "significant guidance and counsel" concerning the management, operations, or business objectives and policies of each qualifying portfolio company.

No Leverage. The fund must not incur leverage. The fund may not borrow, issue debt obligations, provide guarantees, or otherwise incur leverage in excess of 15% of the fund's aggregate capital contributions and uncalled committed capital, and any such leverage must be non-renewable and for a term of less than 120 calendar days. This requirement effectively removes buyout funds that utilize leverage for purposes of their acquisitions and investments.

No Redemption Rights. The fund must not offer redemption rights to its investors. The fund may only issue securities the terms of which do not provide a holder with any right, except in "extraordinary circumstances," to withdraw, redeem, or require the repurchase of such securities.

Under a proposed grandfathering provision, existing funds that make venture capital investments would generally be deemed to meet the proposed definition, as long as they have represented themselves as venture capital funds. The SEC is proposing this approach because it could be difficult or impossible for advisers to conform existing funds, which generally have terms in excess of 10 years, to the new definition.

Definition of Private Fund Advisers with Less than $150 Million in Assets under Management in U.S.

The SEC also is proposing an exemptive rule that would implement the new statutory exemption for private fund advisers with less than $150 million in assets under management in the United States. An adviser could advise an unlimited number of private funds, provided the aggregate value of the adviser's private fund assets is less than $150 million. The assets under management would be calculated on a quarterly basis in the manner provided in the rule. Such advisers would still, however, be subject to the scaled reporting requirements described above. In order to rely on the

exemption, a U.S. adviser would have to meet the conditions of the exemption with respect to all of its private fund assets under management.

Definition of "Family Office"

The SEC has issued the proposed definition of "family office" for purposes of the exemption from registration requirements under the Advisers Act for advisers to family offices. Prior to the family office exemption, advisers to family offices relied on either (1) the exemption for private advisers to fewer than 15 clients (under prior Section 203(b)(3) of the Advisers Act) or (2) on no-action letter relief from the SEC. The Dodd-Frank Reform Act eliminated the first exemption and effectively codified the no-action letter positions.

Under proposed new Section 202(a)(11)(G), family offices are not investment advisers subject to the Advisers Act. The family office must satisfy three general conditions: (1) the family office may only advise one family client[1], which includes family members[2] and key employees[3]; (2) the family members must wholly own and control the family office; and (3) the family office may not hold itself out to the public as an investment adviser.

The requirement that the family office be wholly owned and controlled, either directly or indirectly, by family members, ensures that any profits generated by the family office from managing family assets only accrue to family members.

The SEC will not rescind previously issued exemptive orders. A family office in receipt of an exemptive order, even though not technically within the new exemption provided for family offices, may continue to rely on such order.

In the event that an adviser to a family office does not specifically fit the new statutory exemption, the adviser may seek an exemptive order from the SEC under the existing exemptive order process.

Please contact Amy Bowler (abowler@hollandhart.com or (303) 290-1086) if you have questions concerning the information contained in this alert or require assistance with matters relating to the Investment Advisers Act.

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1. Family client means: any family member (defined below); any key employee (defined below); any charitable foundation, charitable organization, or charitable trust, in each case established and funded exclusively by one or more family members or former family members; any trust or estate existing for the sole benefit of one or more family clients; any limited liability company, partnership, corporation, or other entity wholly owned and controlled (directly or indirectly) exclusively by, and operated for the sole benefit of, one or more family clients, provided that if any such entity is a pooled investment vehicle, it is excepted from the definition of "investment company" under the Investment Company Act of 1940; any former family member, provided that from and after becoming a former family member the individual shall not receive investment advice from the family office (or invest additional assets with a family office-advised trust, foundation or entity) other than with respect to assets advised (directly or indirectly) by the family office immediately prior to the time that the individual became a former family member, except that a former family member shall be permitted to receive investment advice from the family office with respect to additional investments that the former family member was contractually obligated to make, and that relate to a family-office advised investment existing, in each

case prior to the time the person became a former family member; or any former key employee, provided that upon the end of such individual's employment by the family office, the former key employee shall not receive investment advice from the family office (or invest additional assets with a family office-advised trust, foundation or entity) other than with respect to assets advised (directly or indirectly) by the family office immediately prior to the end of such individual's employment, except that a former key employee shall be permitted to receive investment advice from the family office with respect to additional investments that the former key employee was contractually obligated to make, and that relate to a family-office advised investment existing, in each case prior to the time the person became a former key employee.

2. Family member means: the founders, their lineal descendants (including by adoption and stepchildren), and such lineal descendants' spouses or spousal equivalents; the parents of the founders; and the siblings of the founders and such siblings' spouses or spousal equivalents and their lineal descendants (including by adoption and stepchildren) and such lineal descendants' spouses or spousal equivalents. Former family member means a spouse, spousal equivalent, or stepchild that was a family member but is no longer a family member due to a divorce or other similar event. Founders means the natural person and his or her spouse or spousal equivalent for whose benefit the family office was established and any subsequent spouse of such individuals.

3. Key employee means any natural person (including any person who holds a joint, community property, or other similar shared ownership interest with that person's spouse or spousal equivalent) who is an executive officer, director, trustee, general partner, or person serving in a similar capacity of the family office or any employee of the family office (other than an employee performing solely clerical, secretarial, or administrative functions with regard to the family office) who, in connection with his or her regular functions or duties, participates in the investment activities of the family office, provided that such employee has been performing such functions and duties for or on behalf of the family office, or substantially similar functions or duties for or on behalf of another company, for at least 12 months.
