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# “What keeps you up at night?”

## Dodd-Frank financial reform act alters regulatory regime for advisers to hedge funds and other investment advisers

By Craig F. Zappetti and Justin B. Ettelson

### SUMMARY

**On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Act”), which will have a significant impact on the regulatory regime applied to hedge fund and private fund advisers. Managers of hedge funds, private equity funds and some venture capital funds will now be subject to the registration requirements and regulatory regime of either the SEC or a state securities regulator.**

Hedge funds and private funds have come under increased scrutiny by Congress and the Securities and Exchange Commission (the “SEC”) because of the perception that the complex trading strategies and lack of transparency associated with these funds contributed to the financial system crisis and continue to contribute to volatile securities markets. The Private Fund Investment Advisers Registration Act of 2010, or Title IV of the Act, modifies the intrastate adviser exemption and eliminates the private adviser exemption. Many hedge and private fund advisers relied on these exemptions to avoid the requirement to register with the SEC as an investment adviser. As a result, managers of hedge funds, private equity funds and some venture capital funds will find themselves subject to the registration requirements and regulatory regime of either the SEC or a state securities regulator.

### PRIVATE AND INTRASTATE ADVISER EXEMPTIONS

Prior to the Act, private fund advisers relied upon one of several exemptions from registration provided by Section 203(b) of the Investment Advisers Act of 1940, the most common being the intrastate adviser and private adviser exemptions. The intrastate adviser exemption was available to advisers if all of the clients of the adviser resided in the same state in which the adviser was located. This exemption has been eliminated so that advisers must now register even if they have a single private fund client. The private adviser exemption was available to an

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adviser who had fewer than 15 clients and did not hold himself out to the public as an investment adviser, nor acted as an adviser to any registered investment company. Now, domestic private fund advisers must register with the SEC if the adviser acts solely as an adviser to private funds and has, at a minimum, assets of \$150 million under management in the United States. A private fund, as defined by the Act, is an issuer that would be an investment company under the Investment Company Act of 1940 except for the exemptions provided for by sections 3(c)(1) and 3(c)(7). These sections apply to issuers whose securities are owned by less than 100 beneficial owners and who do not presently propose to make a public offering, and issuers whose securities are owned exclusively by qualified purchasers and who at the time of sale do not propose to make a public offering of such securities, respectively.

### EXEMPTIONS FROM REGISTRATION

The Act provides for the following new categories of exemption from registration:

- An investment adviser that acts as an adviser to one or more venture capital funds is not subject to registration pursuant to the “Venture Capital Fund Advisers” exemption. The SEC is charged under the Act with issuing final rules to define the term “venture capital fund” by July 21, 2011;
- An adviser who (1) has no place of business in the United States; (2) has fewer than 15 clients and investors in the United States in private funds; (3) has assets under management attributed to clients in the United States of less than \$25,000,000, or such higher amount as the SEC deems appropriate; and (4) does not hold itself out to the public in the United States as an investment adviser, is exempt from registration pursuant to the “Foreign Private Adviser” exemption;
- An adviser who solely advises small business investment companies that are licensees under the Small Business Investment Act of 1958 is exempt from registration;

- An adviser who provides advice to any “family office” is exempt from registration. The Act requires the SEC to define the term “family office,” which has been previously defined to include one or more members of a single family; and
- An adviser of private funds that has assets under management in the United States of less than \$150,000,000 is exempt from registration. Such advisers, however, are required to maintain records and provide to the SEC such annual or other reports deemed necessary by the SEC.

### THRESHOLD FOR ADVISERS SUBJECT TO SEC REGISTRATION

The Act also increases the assets under management threshold for SEC registration from \$25,000,000 to \$100,000,000. Hereafter, advisers with less than \$100,000,000 of assets under management will register with and be subject to regulation in the state where the adviser is located. Those with assets under management in excess of \$100,000,000, will continue to be registered with and subject to regulation by the SEC.

### RECORDKEEPING REQUIREMENTS

The Act contains additional recordkeeping requirements for advisers, copies or extracts of which the SEC may require to be produced during an examination. These records include:

- assets under management;
- use of leverage;
- off-balance-sheet leverage;
- counterparty credit risk exposure;
- trading and investments positions;
- trading practice;
- valuation policies and practices;
- types of assets held;
- side arrangement or letters evidencing more favorable rights for certain investors; and
- other information deemed necessary by the SEC to monitor systemic risk.

## ADJUSTING THE ACCREDITED INVESTOR STANDARD

Finally, the Act requires the SEC to adjust the net worth standard for an individual accredited investor under Regulation D of the Securities Act of 1933 to \$1,000,000, excluding the value of the individual's primary residence. This standard will remain in effect for four years, at which time the SEC may periodically upwardly adjust the minimum net worth standard for individual investors.

If you would like to discuss how these new requirements or other aspects of the Act may apply to you, please contact the authors.

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