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REGULATION OF CROSS-BORDER INVESTMENT ADVISERS AFTER THE DODD-FRANK ACT

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The Dodd-Frank Wall Street Reform and Consumer Protection Act, enacted on July 21, 2010, provides new thresholds for the registration or exemption of foreign advisers who provide investment advisory services in the United States, and it creates a new regulatory framework for advisers who provide advice to private funds that are sold in the United States. This article provides a general summary of the effect of the Dodd-Frank Act on registration requirements for foreign investment advisers who offer their services in the United States in order to help them analyze the registration requirements that will apply to them under U.S. law.

The Dodd-Frank Act changes the thresholds for registration or exemption of foreign investment advisers who offer advisory services in the United States.

Background. The Investment Advisers Act of 1940 (Advisers Act) and the rules and regulations of the Securities and Exchange Commission (SEC) regulate anyone who acts as an investment adviser in the United States. The term "**investment adviser**" 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, purchasing, or selling securities. The Advisers Act makes it unlawful for an investment adviser to use an instrumentality of interstate commerce (such as the mails, a telephone, or the Internet) in connection with his or its advisory business unless the adviser is registered under the Advisers Act, or unless a specific exclusion or exemption applies to the adviser.

Change: The Dodd-Frank Act amended the Advisers Act to create a new exemption from registration for any person who is a "**foreign private adviser**." Under the new exemption, any investment adviser is exempt from federal registration if the adviser meets all of the following qualifications:

- It does not hold itself out generally to the public in the United States as an investment adviser;

- It has no place of business in the United States;
- It has, in total, fewer than 15 clients and investors in “private funds” (see below) in the United States that it advises;
- It has aggregate assets under management attributable to clients in the U.S. and investors in the United States in private funds advised by the investment adviser of less than $25 million; and
- It does not act as an investment adviser to an entity that is registered as an investment company or that has elected business development company status under the Investment Company Act of 1940.

Note that, for purposes of the fewer-than-15 threshold, the new foreign private adviser exemption counts both the number of clients in the United States and the number of U.S. investors in “private funds” advised by the adviser. Similarly, for purposes of the $100 million assets-under-management threshold, the new private foreign adviser exemption counts both assets under management attributable to U.S. clients and assets under management attributable to U.S. investors in “private funds” that the adviser manages.

Application of the new registration requirement for foreign private advisers to foreign advisers who advise private funds.

A “**private fund**” is defined as an issuer that would be an investment company (that is, a company that is in the business of investing in securities) under the Investment Company Act of 1940 but for:

- the exclusion contained in section 3(c)(1) of the Investment Company Act (which generally excludes any investment company whose outstanding securities are beneficially owned by fewer than 100 persons and that does not make a public offering of its securities); or
- the exclusion contained in section 3(c)(7) of the Investment Company Act (which generally excludes any investment company that is exclusively owned by “qualified purchasers” (i.e., very high-net-worth investors) and that does not make a public offering of its securities).

Because the new foreign private adviser exemption counts the number of investors in U.S. private funds and the amount of their assets under management against the thresholds for the exemption, for the first time a substantial number of foreign advisers who manage the assets of private funds that are sold into the United States will be subject to registration under the Advisers Act. Note that the changes will affect foreign advisers not only in connection with new funds being sold in the United States but also in connection with existing funds that they may have managed for many years without previously needing to be registered.

A new regulatory framework is being developed that will apply to foreign advisers to private funds who do not qualify for the foreign private adviser exemption.

Foreign advisers who advise private funds and who are required to register under the Advisers Act will be subject to a new regulatory framework that is currently being shaped under an array of statutory provisions. The Dodd-Frank Act provides that:

- The SEC is empowered to set record keeping, reporting, and examination standards for registered investment advisers with respect to private funds they advise. Within 12 months after enactment of the Dodd-Frank Act, the SEC and the Commodities Futures Trading Commission (CFTC) must jointly adopt rules as to the form and content of reports to be filed with them concerning the private funds advised by registered advisers.
- The SEC must maintain the confidentiality of much of the information reported to it about private funds by the registered advisers of private funds, and the confidential information will not be subject to disclosure under the Freedom of Information Act.
- Not later than one year after enactment, the SEC must adopt rules defining the term "venture capital fund" and rules exempting venture capital funds from private fund reporting.
- Within 12 months after the enactment of the Dodd-Frank Act, the SEC must adopt rules that will exempt investment advisers from registration who have up to $150 million of assets under management if they act solely as advisers to private funds.
- The SEC is directed to undertake rulemaking that will define the terms of an exclusion for "family offices" from the definition of the term "investment adviser."
- The SEC is prohibited from adopting rules that provide for the treatment of investors in private funds as "clients" of the investment advisers to the private funds they advise for the purpose of applying the standards of care required by investment advisers in dealing with their clients, but only with respect to advisers that have investment management agreements with the private funds they advise that provide for the duties and responsibilities of the adviser to the fund.

Significance: The initial impact of the new regulatory framework for investment advisers to private funds will be to require many advisers to private funds to register who were not previously required to do so. Although the Dodd-Frank Act identifies a number of categories of information that advisers to private funds will be required to report concerning the funds they advise, the extent and nature of the required reporting will develop over time as the SEC completes the studies and reports regarding private fund advisers that it is required to undertake, and as the SEC adopts new rules based on its findings. These reporting requirements must be in place by July 21, 2011.

The Dodd-Frank Act also significantly tightens the "accredited investor" standard that governs the qualification of high-net-worth investors for participation in private funds and other private offerings under the Securities Act of 1933.

Changes: The Dodd-Frank Act requires the SEC to adjust the net-worth requirement for "accredited investor" status under SEC Regulation D to provide that the individual net worth of any natural person, or the joint net worth of that person with his or her spouse, must be more than $1 million excluding the value of the primary residence of the person. The Dodd-Frank Act requires the SEC to undertake a study of whether other aspects of the accredited investor standards need to be adjusted, and it requires the SEC to make adjustments to the terms of the accredited investor definition as appropriate, provided that the net-worth standard may not be readjusted until four years after enactment of the Dodd-Frank Act.

Significance: Previously the $1 million net-worth standard for accredited investors did not require exclusion of the value of an investor's principal residence. Although Regulation D provides an alternative income test for accredited investors (individual income of not less than $200,000 in each of the last two years, or joint income with the individual's spouse of $300,000 in each of those years, and a reasonable expectation of the same income level in the current year), the net-worth test is generally relied upon, and the removal of the value of the investor's principal residence from the net-worth determination may be expected to substantially reduce the pool of accredited investors eligible to participate in private funds in the future.

Private funds are commonly sold exclusively to accredited investors, in part because Regulation D relieves the issuer in a private offering that is made exclusively to accredited investors from the requirement to provide each investor with all of the information that would have been required to be provided in a Securities Act registration statement. Since private funds typically provide for subsequent investments by existing investors, and since many of the investors in existing private funds will have been determined to be accredited on the basis of their net income at the time of their initial investment, the change in the net-worth standard for accredited investors will have immediate importance for existing private funds as well as for private funds about to be launched.

The Dodd-Frank Act requires the SEC to determine whether a fiduciary standard should apply to brokers and dealers when they advise their customers about the value of investing in specific securities.

Changes: The Dodd-Frank Act requires the SEC to study whether the standard of care that the Advisers Act applies to investment advisers when they provide personalized investment advice about securities should be applied to brokers and dealers when they advise their retail customers concerning securities investments. Within six months after enactment of the Dodd-Frank Act, the SEC must submit a report on its findings and conclusions to Congress, and it may then commence any rulemaking that is necessary or appropriate in the public interest "…to address the legal or regulatory standards of care for

brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers for providing personalized investment advice to such retail customers." (§ 913(b)(10))

Significance: At the time the Dodd-Frank Act was passed by Congress, there was a great deal of discussion over whether broker-dealers who give investment advice in connection with securities sales should be subject to the same fiduciary standards as investment advisers giving personalized investment advice. The proponents of the Dodd-Frank Act expressed confidence that the SEC would use the powers given to it under the act to adopt rules that would require broker-dealers to be subject to the same standards as investment advisers. If rules of this kind are adopted, they may significantly affect the manner in which brokers and dealers may sell private funds and other securities in the United States.

For more information, please contact the author of this article to assist you in meeting your compliance requirements:

Ward B. Hinkle
Investment Management Practice Group Leader
716.848.1281
whinkle@hodgsonruss.com

Mr. Hinkle concentrates his practice in the areas of federal and state securities laws, including the representation of investment advisers and public and private investment companies.

OR CONTACT ONE OF THE OTHER MEMBERS OF THE HODGSON RUSS INVESTMENT MANAGEMENT PRACTICE GROUP:

Ronald J. Battaglia, Jr.
716.848.1699
rbattaglia@hodgsonruss.com

Janet N. Gabel
716.848.1350
jgabel@hodgsonruss.com

Patricia C. Sandison
716.848.1619
psandison@hodgsonruss.com

John J. Zak
716.848.1253
jzak@hodgsonruss.com