

Meridian Fund Advisers

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SEC Proposes Regulations Implementing Dodd-Frank's Mandated Hedge Fund and Private Equity Fund Registration and Reporting Regime

Summary

In a move to expand their oversight of investment advisers as required by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), the U.S. Securities and Exchange Commission (the "SEC") recently proposed rules requiring most hedge funds and private equity funds to submit to examinations and new disclosure requirements. The SEC's proposals also would expand the reporting requirements applicable to investment advisers already registered with the SEC, establish a new category of "exempt reporting advisers" who will be subject to broad public disclosure requirements, and more precisely define the Dodd-Frank Act's expanded role for U.S. states in terms of investment adviser supervision and regulation. The SEC's proposals are set out in an Implementing Release and an Exemptions Release, together which comprise more than 400 pages of rule proposals, commentaries, and queries. The rule proposals will be subject to a 45-day comment period before final rules are adopted. To allow for consideration of comments submitted near to the mid-January comments due date, final rules cannot be expected from the SEC before mid-February or early March 2011.

For currently unregistered investment advisory firms that are not certain whether they will be required to register, the expected date for the adoption of final rules presents a fairly tight timeline given the need to complete a SEC registration (assuming one will be required) by July 21, 2011. As the SEC is entitled to a 45-day period to review an adviser's registration filing before acting on it, the consensus in the industry is that it would be prudent for an investment adviser to submit its filing by no later than June 1, 2011. In order for an investment advisory firm to be in a position to make a June 1st filing, the firm should start the process of preparing for registration (completing the Form ADV, hiring or designating a Chief Compliance Officer, and compiling written compliance procedures) at least two to three months in advance of such date.

Which Managers are Required to Register with the SEC?

Hedge fund managers and private equity managers ("managers") who are currently unregistered generally rely on the "counting clients/private adviser" exemption under Section 203(b)(3) of the Investment Advisers Act of 1940 (the "Advisers Act"). Under this exemption, a manager with 14 or fewer clients that does not hold itself out to the public as an investment adviser is exempt from registration with the SEC. Effective July 21, 2011, the "counting clients/private adviser" exemption will be revoked. The proposed rules would revise the Advisers

Act by classifying managers of private investment pools into different tiers according to their size and client base. At the highest level of tiers, managers *solely advising private funds* with \$150ML or more in assets under management (AUM) would have to register with the SEC. As proposed, the \$150ML threshold would be calculated quarterly and reflects both contributions and redemptions of investor capital, and investment appreciation and depreciation. If a manager becomes subject to registration due to an increase in AUM above the \$150 million threshold on a calendar quarter-end date, the manager would be permitted one calendar quarter to register with the SEC (unless a lengthier time period is ultimately approved in the final rules). It has been proposed that this limited grace period would not be available to any private fund adviser that has not complied with all applicable SEC “exempt reporting adviser” reporting requirements, as discussed further below.

The threshold AUM for SEC registration purposes is lowered to \$100ML where a manager advises both private funds and separate accounts (even one separate account will disqualify a manager from relying on the \$150ML AUM threshold exemption). See below regarding a brief discussion of the proposed rules applicable to mandatory state registrations of “mid-sized” managers (ranging from \$25ML to \$100ML AUM).

Which Managers will be Exempt from SEC Registration?

As noted above, effective July 21, 2011, the “counting clients/private adviser” exemption will be revoked. In its place there will be a new narrow “foreign private adviser” exemption and exemptions for new categories of investment advisers that the SEC proposes to call “exempt reporting advisers.” Exempt reporting advisers are those that (i) solely manage private funds and have less than \$150 ML AUM, or (ii) solely manage venture capital funds. Entities falling under the “exempt reporting adviser” definition avoid certain substantive requirements of the Advisers Act but will be subject to many of the public filing obligations of a SEC-registered adviser (discussed further below), including significant new reporting obligations concerning each private fund they manage. As contemplated by the Dodd-Frank Act, exempt reporting advisers would be subject to at least some level of ongoing SEC examination.

As regards managers of venture capital funds, a venture capital fund has been defined in the proposed rules as a private fund that (i) represents itself to investors as being a venture capital fund; (ii) only invests in equity securities of private operating companies to provide primarily operating or business expansion capital (not to buy out other investors), U.S. Treasury securities with a remaining maturity of 60 days or less, or cash; (iii) is not leveraged, and its portfolio companies may not borrow in connection with the fund's investment; (iv) offers to provide a significant degree of managerial assistance; (v) or controls its portfolio companies and does not offer redemption rights to its investors. 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. According to SEC, the proposed definition distinguishes venture capital funds from hedge funds and private equity funds by focusing on the lack of leverage of venture capital funds *and the non-public, start-up nature of the companies in which they invest*. The rule therefore focuses on the provision of capital for the operating and expansion of start-up businesses, rather than buying out prior investors.

As for foreign investment advisers, in order for a manager to qualify for the foreign private adviser exemption, the manager must: (i) have no place of business in the United States; (ii) have, in total, 14 or fewer clients in the United States and investors in the United States in private funds advised by the manager; (iii) have aggregate AUM attributable to clients in the United States and investors in the United States in private funds advised by the manager of less than \$25 ML; (iv) not hold itself out generally to the public in the United States as an investment adviser; and (v) not advise a U.S.-registered fund or business development company. If a manager satisfies the requirements of the foreign private adviser exemption, it would be free from the registration, reporting and recordkeeping requirements of a SEC-registered investment adviser. As with all investment advisers, registered or not, foreign private advisers would remain subject to the SEC's anti-fraud rules. In addition, foreign private advisers are proposed to be subject to the SEC's rules on U.S. state and local political contributions and use of placement agents to solicit U.S. local and state government plan investments ("pay-to-play" rules).

Calculating AUM under the Proposed Rules

Currently, registered advisers have a certain amount of discretion with respect to how they calculate their AUM. The SEC is moving to a uniform approach for calculating AUM that can be used for (i) determining whether a manager is eligible to register with the SEC, (ii) disclosing the value of AUM on Part 1 of Form ADV, and (iii) determining whether a manager qualifies for an exemption from registration. The resulting AUM will be deemed an adviser's "regulatory assets under management." With respect to the new "regulatory assets under management" determination, the SEC proposes that an adviser: (i) will no longer be able to opt to exclude proprietary assets, assets managed without receiving remuneration, and assets of non-U.S. clients; (ii) may not deduct any outstanding indebtedness and other accrued, but unpaid liabilities; (iii) must include the AUM for any private fund client in its total AUM calculation, regardless of the type of assets held by the fund; (iv) if acting as a sub-adviser to a private fund, may include only the portion of the value of AUM over which it provides advisory services; (v) include any uncalled capital commitments in the calculation of its regulatory assets under management; and (v) value private fund assets at fair value. The requirement for private funds to value assets at fair value could present difficulties for certain funds whose assets are illiquid, not easily fair valued, and not fair valued for other purposes. The SEC, however, has expressed its view that this approach is necessary in order to implement a more consistent methodology for calculating and reporting AUM. Specifically, the SEC stated in the proposed rules that the "use of the cost basis, for example, could under certain circumstances grossly understate the value of appreciated assets, and thus result in advisers avoiding registration with the SEC. "

Reporting Requirements for "Exempt Reporting Advisers"

The rule proposals provide that exempt reporting advisers would have to share basic information with the SEC, such that exempt reporting advisers would be required to file, and periodically update, reports with the SEC by using the same registration form (Form ADV) as SEC-registered advisers. Rather than completing all of the items on the Form ADV, exempt reporting advisers would fill out a limited subset of items, including basic identifying information for the adviser such as the identity of its owners and affiliates, information about the

private funds the adviser manages, information about other business activities in which the adviser and its affiliates are engaged that may present conflicts of interest and 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. In sum, it is currently proposed that a manager relying on an exemption from SEC registration would be free of certain compliance obligations to which a SEC-registered adviser is subject, but would nonetheless be required to file and periodically update reports with the SEC using the same registration document as those used by fully SEC-registered investment advisers.

New Fund-by-Fund Public Reporting for All SEC-Registered and Exempt Reporting Advisers

Under the proposed rules, managers of private funds, whether SEC-registered or exempt reporting advisers, would be subject to detailed reporting that consists of close to thirty items of information prepared separately for each private fund. The SEC stated in its proposing release that, "*The information would provide us with a more complete understanding of the private funds advised by advisers and would permit us to enhance our assessment of private fund advisers for purposes of targeting our examinations.*" Because this information will be reported on Form ADV, the information would be subject to public review on the SEC's website. The following list includes some of the items required to be disclosed in proposed new Section 7.B.1 of Schedule D of Form ADV:

- Both the gross asset value and the net asset value of a fund (intended to provide a sense of the amount of leverage a fund employs);
- The current value of a fund's Level 1, 2 and 3 assets and liabilities (determined under U.S. GAAP);
- The number of beneficial owners in a fund and the percentage of a fund owned per "category" of investor (individuals versus private funds versus other institutional investors), as well as the percentage of a fund owned by non-U.S. persons ;
- The identities of any other investment advisers or sub-advisers to a fund;
- The Fund's Form D file number for any fund relying on Regulation D under the Securities Act of 1933;
- Auditor information, and a statement as to whether a fund's financial statements are audited;
- Identifying information about a fund's prime broker, custodian, and administrator;
- Identifying information about each marketer of a fund (other than the manager or its employees performing such functions).

Proposed Changes to Form ADV Part 1 Applicable to all SEC-Registered Advisers and Exempt Reporting Advisers

A number of changes were proposed to Part 1 of Form ADV. These amendments would require all SEC-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, as well as 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). New information about the percentage of clients that are non-U.S. persons will be required to be disclosed and additional detail on the adviser's types of institutional clients also will be required to be disclosed. Further, advisers will be required to indicate whether they have assets (not AUM, but rather assets on their own balance sheet) of greater than \$1 billion in order to identify those managers subject to Section 956 of the Dodd-Frank Act, under which rules may be adopted implementing enhanced disclosure and reporting of compensation arrangements and prohibiting incentive-based payment arrangements that encourage inappropriate risk taking. The proposal also would require advisers to provide additional information about their non-advisory activities (business ventures). According to the SEC, the additional required information on Form ADV Part 1 would allow the SEC *"better oversight of these advisers by focusing our examination and enforcement resources on those advisers to private funds that appear to present greater compliance risks."*

Registration and Examination Requirements for "Mid-Sized Advisers" - Delegation of Regulatory Responsibility to the States

The Dodd-Frank Act raised the threshold for SEC (versus state) registration from \$25 million to \$100 million by creating a new category of "mid-sized advisers." A mid-sized adviser, which may not register with the SEC and will be subject to state registration, is defined as an adviser that: (i) has between \$25ML and \$100 ML AUM; (ii) currently is required to be registered in the state where it maintains its principal office and place of business (Wyoming is the only state without registration requirements); and (iii) would be subject to examination by the state where it maintains its principal office and place of business (there are exceptions, however, to this general three-part test). The third requirement was particularly important to the SEC in proposing rules for mid-sized advisers because not all state securities authorities conduct compliance examinations of their state-registered advisers. Congress therefore determined to require a mid-sized adviser to register with the SEC if the adviser is not subject to examination as an investment adviser by the state in which the adviser has its principal office and place of business. The SEC does not intend either to review or evaluate each state's investment adviser examination program. Instead, the SEC has proposed to correspond with each state securities commissioner (or official with similar authority) and request that each advise the SEC whether an investment adviser registered in the state would be subject to examination as an investment adviser by that state's securities commissioner (or agency or office with similar authority). The SEC also stated in the rule proposals that it will request that each state notify the SEC promptly if advisers in the state will begin to be subject to examination or will no longer be subject to examination.

Essentially, these Dodd-Frank amendments to the Advisers Act (Section 203A (a)(2) of the Advisers Act) have shifted primary responsibility for regulatory oversight of many managers to the state securities authorities. As a result, a significant number of managers currently registered with the SEC will be required to withdraw their SEC registrations and register with one or more states. State securities authorities remain responsible, as before the Dodd-Frank Act, generally for regulating advisers with less than \$25 million in assets.