



July 22, 2010

## **Enactment of Dodd/Frank Act: Implications for Fund Advisers**

On July 21, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Reform Act). Certain provisions of the Reform Act are immediately effective, and certain provisions will become effective on later dates.

### **Accredited Investor Standard Under Regulation D**

Of note for advisers to private equity and hedge funds offering securities to individuals, certain revisions to the definition of “Accredited Investor” are effective immediately. Effective as of the date of enactment of the Reform Act, July 21, 2010, the value of the primary residence of a natural person is to be excluded for purposes of determining whether such person satisfies the \$1 million net worth threshold under the “Accredited Investor” definition. The term “accredited investor” is used for purposes of determining whether an offering of securities is eligible for an exemption from registration under Regulation D of the Securities Act of 1933, as amended. The SEC is required to review the definition in respect of natural persons and also to provide for further adjustments to the \$1 million threshold every four years, but these changes do not have immediate effect.

### **Registration Under the Advisers’ Act**

Under the Reform Act, an investment adviser will no longer be exempt from registration under the Advisers’ Act of 1940 on the basis that the investment adviser advised fifteen or fewer funds or clients over a 12 month period. Although the Reform Act provides several new exemptions from registration, including an exemption for advisers solely to venture capital funds and an exemption for advisers with assets under management in the United States of less than \$150 million, the Reform Act will subject numerous investment advisers, previously exempt, to registration with the SEC. The registration requirements will be effective one year after enactment of the Reform Act.

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An investment adviser required to register under the Advisers Act is subject to increased fiduciary, reporting and compliance burdens. The following is a brief summary of key current requirements applicable to registered investment advisers:

- **Fiduciary Obligations.** As a fiduciary, a registered investment adviser owes its clients an affirmative duty of utmost good faith to act solely in the best interests of the client and to make full and fair disclosure of all material facts, particularly where the adviser's interests may conflict with the clients' interests. Pursuant to this duty, an adviser must at all times act in its clients' best interests and must be sensitive to the conscious or unconscious prospect of providing less than disinterested advice. Registered investment advisers may seek to modify contractually these standards, but there are limits as to the permissibility of such modifications.
- **Code of Ethics and Transaction Reporting.** Registered investment advisers must have a code of ethics governing their employees and enforcing certain insider trading procedures. At a minimum, the code of ethics must include (1) standards of business conduct for "supervised persons" that require them to comply with applicable federal securities laws, (2) provisions that require "access persons" to report personal securities transactions periodically and which require the adviser to review these reports, (3) provisions requiring supervised persons to report violations of the code of ethics to the adviser's chief compliance officer and (4) provisions that require each supervised person to be provided with the code of ethics and acknowledge receipt thereof.
- **Compliance Programs.** Registered investment advisers must adopt and implement written policies and procedures that are reasonably designed to prevent violations of the Advisers' Act. These policies and procedures must address at a minimum portfolio management processes, including allocation of investment opportunities, accuracy of disclosures made to investors, clients and regulators, proprietary trading, safeguarding of client assets, the accurate creation of required records and their maintenance, privacy protections for client records and information, trading practices, marketing advisory services, processes to value client holdings and assess fees, and business continuity plans.
- **Reporting Obligations; Written Disclosure Statements.** Registered investment advisers are required to file a Form ADV with the SEC and to file an annual update of Part 1A of the Form ADV within 90 days after the end of each fiscal year as well as more frequent updates promptly following certain information in the Form ADV becoming inaccurate. Other reporting obligations such as the filing of a Form 13F may be necessary in some cases depending on the role of the investment adviser. Registered investment advisers are required to provide prospective clients a written disclosure statement (which may be Part II of their Form ADV or a brochure that contains at least the information required to be included in Part II) and annually deliver or offer to deliver an updated version of such disclosure statement.
- **Maintenance of Books and Records.** Registered investment advisers must keep true, accurate and current books and records including advisory business financial and accounting records, records that pertain to providing investment advice and transactions, records that document the adviser's authority to conduct business, advertising and performance records, records relating to the code of ethics



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requirement described above, records regarding the maintenance and delivery of the written disclosure statement and policies and procedures adopted and implemented under compliance rules.

- **SEC Examination.** Registered investment advisers are subject to books and records reviews and compliance examinations by the SEC. In the past, a registered investment adviser generally could expect an audit by the SEC within the first 12 months of its registration and one audit during every three year period thereafter, in each case, depending upon the size of the adviser, the scope of its activities and its discretionary capital under management.
- **Advertising Restrictions.** Registered investment advisers are subject to restrictions on advertising. Advertising must not be false or misleading and must not contain any untrue statement of a material fact. There are also strict restrictions on the use of, among other information, certain performance data that the SEC considers misleading.

In addition to the above, under the Reform Act, investment advisers to certain funds will be subject to additional reporting requirements. The SEC has been empowered to adopt such recordkeeping and reporting requirements as may be necessary and appropriate in the public interest, for the protection of investors or the assessment of systemic risk by the newly formed Financial Stability Oversight Council. At a minimum, records and reports to be maintained and subject to inspection will include for each “private fund” (defined under the Reform Act to include any fund that would be “investment company” under the Investment Company Act of 1940, but for the exceptions contained in section 3(c)(1) or 3(c)(7) of that Act) information regarding (i) amount of assets under management, (ii) use of leverage, (iii) counterparty credit risk exposures, (iv) trading and investment positions, (v) valuation policies and practices, (vi) types of assets held, (vii) side letters, (viii) trading practices, and (ix) such other information as the SEC in consultation with the Financial Stability Oversight Council determines is necessary and appropriate in the public interest and for the protection of investors or for the assessment of systemic risk.

Although the Advisers’ Act registration requirements will not become effective under the Reform Act for one year, investment advisers likely to be required to register should begin to contemplate establishing a compliance framework that will enable them to meet the requirements for investment advisers registered with the SEC. Proactive review of the requirements and advance preparation is advisable. The actual registration process may take longer than previously given the potential volume of new registrations that must be completed within the next 12 months.

For additional information on the implications of the Dodd/Frank Act on the regulation of private equity and hedge funds, please see: <http://www.kslaw.com/Library/publication/ca072010.pdf>.

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