August 25, 2010

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). The Dodd-Frank Act may, depending upon regulations to be issued by the Securities and Exchange Commission (the "SEC"), impose significant new registration and compliance burdens on managers of venture capital funds. Managers of other private equity funds, hedge funds and fund of funds will almost certainly be subject to these requirements. This *Alert* discusses some of the major provisions introduced by the Dodd-Frank Act as well as their impact on venture capital and other private funds.

Investment Advisers Act of 1940: exemptions to registration

Under the Investment Advisers Act of 1940 (the "Advisers Act"), "investment advisers"[1] are required to register with the SEC and are subject to various regulatory and record keeping requirements unless they qualify for an exemption. Managers of venture capital and other private funds typically are considered to be investment advisers. Prior to the Dodd-Frank Act, many venture capital and private equity fund managers avoided registration by relying on the "private investment adviser" exemption which exempted firms that (i) had fewer than 15 clients over the course of the preceding 12 months and (ii) neither had held themselves out generally to the public as an investment adviser nor acted as an investment adviser to any investment company registered under the Investment Company Act of 1940. Title IV of the Dodd-Frank Act, the "Private Fund Investment Advisers Registration Act of 2010" (the "Private Fund Act"), has replaced the private investment adviser exemption with new, more narrow exemptions.

The most notable exemption to registration in the Private Fund Act exempts private fund managers that provide advice *solely* to one or more "venture capital funds." While this exemption may provide some relief to managers identifying their funds as venture capital funds, whether these managers are indeed exempt will depend on the definition of "venture capital fund" to be provided by the SEC within one year of enactment. A single non-qualifying fund or client will disqualify a firm that otherwise manages other qualifying venture capital funds. Consequently, the precise definition of venture capital funds will be critically important for managers of multiple funds with varying structures or operations.

Other limited exemptions to registration are also provided for by the Dodd-Frank Act. Private fund managers with less than $150 million under management are exempt, but those with less than $100 million under management may be subject to state registration or examination. Foreign fund managers with no U.S. place of business that have fewer than 15 U.S. investors and less than $25 million under management attributable to U.S. investors are also exempt. Finally, certain family offices are exempt from registration.

If a firm is not exempt, registration will be required beginning July 21, 2011. Among other things, the firm will be required to file and maintain current a Form ADV, designate a chief compliance officer, comply with certain marketing restrictions, admit only "qualified clients" as investors and establish and maintain a compliance program (including written policies and procedures designed to prevent violations of the Advisers Act and a system of disclosure and in some cases pre-approvals of securities transactions). These firms will also be subject to periodic, on-site SEC inspections which are typically unannounced.

Whether or not a firm is exempt from registration, all investment advisers will be required to maintain certain specified records and comply with reporting requirements to be established by the SEC. In the case of registered firms, information required to be maintained and subject to inspection will include the amount and types of assets under management and the use of leverage (including off-balance-sheet leverage), trading and investment policies, valuation policies and practices, side letters with investors and other information determined by the SEC to be necessary and appropriate for the protection of investors or for the assessment of systemic risk. Information required to be maintained and reported by managers that are exempt from registration will be determined by the SEC as necessary or appropriate in the public interest or for the protection of investors.

Volcker Rule

Section 619 of the Dodd-Frank Act (the "Volcker Rule") amends the Bank Holding Company Act of 1956 to broadly prohibit banking entities from engaging in proprietary trading and private sponsorship of investment funds. As a general rule, the Volcker Rule would restrict covered banking entities from sponsoring or investing in a hedge fund, private equity fund, or such similar funds as the regulators may, by rule, determine.[2]

Notwithstanding this general rule, the Volcker Rule will allow banking entities to make and retain an investment in a hedge fund or private equity fund so long as the banking entity's interest in the fund does not exceed more than 3% of the total ownership interests of the fund. Additionally, a banking entity is permitted to sponsor a private equity or hedge fund so long as (i) its investment is made to provide the fund with sufficient initial equity and to attract unaffiliated investors and (ii) its investment represents not more than 3% of the total ownership interests of the fund within one year of the date on which the fund is established. In any event, a banking entity's aggregate investments in private equity funds and hedge funds may not exceed 3% of the Tier 1 capital of the banking entity. The Volcker Rule will become effective on the earlier of 12 months after the date on which final implementing regulations are issued or July 21, 2012.

Accredited investor standard

Private funds and other issuers raising capital in private offerings often rely on the Regulation D exemptions from registration under the U.S. Securities Act of 1933. Many Regulation D exemptions require that securities or fund interests be offered only to "accredited investors." The Dodd-Frank Act changes the definition of "accredited investor," effective immediately.

Prior to the Dodd-Frank Act, a natural person was an accredited investor if (i) such person had an individual income in excess of $200,000 in each of the two most recent years or joint income with their spouse exceeding $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year; or (ii) such person's net worth, together with their spouse, exceeds $1 million at the time of purchase. For the purpose of determining net worth, individuals previously could include the value of their primary residence.

Under the Dodd-Frank Act, individuals may no longer include the value of their primary residence for the purpose of determining net worth under the accredited investor definition. The other provisions of the accredited investor definition remain unchanged.

Recommendations

It is uncertain how far the venture capital fund exemption to investment adviser registration will extend. Although certain managers may self-identify their funds as venture capital funds, one or more of these funds may not be covered by the SEC's eventual venture capital fund definition. Because of this uncertainty, all private fund managers should familiarize themselves with the investment adviser registration process and engage in at least some initial planning in the event that registration and compliance with other provisions of the Advisers Act becomes necessary.

All issuers relying on the "accredited investor" definition in connection with private offerings should immediately revise their subscription documents to reflect the modified net worth calculation.

If you have any questions about this *Alert,* please contact one of your Cooley team members.

Notes

1 "Investment adviser" is broadly defined to include any person who, for compensation, engages in the business of advising other as to value of or the advisability of investing in securities or issues analyses or reports concerning securities.

2 The Volcker Rule broadly defines "hedge fund" and "private equity fund" as a company or other entity that is exempt from registration as an investment company pursuant to section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940. While the Volcker Rule does not specifically mention bank investments in venture capital funds, for the purposes of the Volcker Rule a venture capital fund will almost certainly be included in this definition.