JACKO LAW GROUP, PC
SECURITIES & CORPORATE COUNSEL

Legal Risk Management Tip
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INVESTMENT ADVISERS AND MANAGERS BEWARE: INITIAL IMPACTS OF THE FINANCIAL REFORM ACT

On Wednesday, July 21, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Reform Act"). The Reform Act has an immediate impact on investment advisers, directly affecting both registration requirements and governance of investment managers of hedge funds. Though the new legislation covers a broad array of areas, Jacko Law Group, PC's ("JLG") July Legal Tip will focus on four of this week's ground-breaking areas:

- The New Definition of "Accredited Investor"
- Elimination of the Private Adviser Exemption
- SEC Unanimously Adopts Rules to Redesign Form ADV Part 2
- Mutual Fund Distribution Fees Rule Proposal

Not only do these monumental changes affect a firm's registration status under SEC or State governance, the revisions and elimination of once existing exemptions have a direct impact on investors as well. The impact on the financial industry is significant and it remains to be seen whether grace or transition periods will be granted, providing firms time to shift gears and regain compliance with the new regulations.

1. The New Definition of "Accredited Investor"

While most of the provisions of the Reform Act will take effect after some transition period, certain changes to **the definition of "accredited investor" under Regulation D take effect immediately**. Specifically, the $1 million net worth standard for natural persons to come within the definition of accredited investor must be exclusive of the person's primary residence. Previously, the net worth calculation included the value of a person's residence, net of any mortgage. The other provisions of the accredited investor definition remain the same, at least for now, but further changes may be coming as the Reform Act authorizes the SEC to make adjustments to the accredited investor definition as it is applied to natural persons.

Importantly, this new definition will apply to new investors as well as existing investors making additional contributions. Absent further clarification by the SEC, recertification of present investors will not be required.

This change will require any private funds or other issuers engaged in ongoing private offerings that have not yet been completed to revise the Private Placement Memorandum and subscription documents to reflect the new net worth standard. It is prudent for you to contact legal counsel as soon as possible to make the necessary modifications to the definition of "accredited investor," as the new test must be applied for all new investors and any existing investors that make additional capital contributions. The Act does not provide for a transition period and there is no grandfathering for private offerings already in progress.

2. Elimination of the Private Adviser Exemption

Another change brought about by the Reform Act is the elimination of the "private adviser" exemption under the Investment Advisers Act of 1940 ("Advisers Act"). That exemption enabled managers to hedge funds and private equity funds to avoid registration if the manager: (1) had fewer than fifteen clients during the prior twelve-month period (with each fund counting as one client); (2) did not hold itself out to the public as an investment adviser (*i.e.*, advertise); and (3) did not advise mutual funds. The new law requires all **managers who act as adviser *solely* to private funds with assets of $150 million or more to register with the SEC**.

The rationale for this portion of the Act is to allow the SEC and the States to more fairly allocate responsibilities so there may be closer regulatory scrutiny to focus on the activities of Advisers.

For those advisers to private funds who will be subject to SEC registration requirements, such advisers will be subject to Rule 206(4)-7 under the Advisers Act and the ensuing rigorous compliance requirements therein. Such requirements will include the need to designate a Chief Compliance Officer, adopt and implement compliance policies and procedures, perform annual compliance reviews, and fulfill Form ADV Parts 1 and 2 public filing requirements.

Additionally, the threshold for SEC registration of advisers who provide management or advisory services to other types of clients, such as separate account clients, has now been raised from $25 million to $100 million, effectively placing the responsibility to regulate a significant portion of smaller advisers, including advisers to smaller private funds, on the states.

3. SEC Unanimously Adopts Rules to Redesign Form ADV Part 2

After years of speculation and commentary, the SEC has adopted rules to redesign Form ADV Part 2, the disclosure document provided by investment advisers to clients which describes the adviser's business practices, investment strategies, fees, conflicts of interest, and much more. The reformat of ADV Part 2 will require a more investor-friendly format that utilizes a "plain English" narrative. In effect, regulators project the new format will provide added protection to investors in comparison to old format, which was primarily a check-the-box form.

In addition to other new requirements, investment advisers will be required to:

- Present information in a consistent, uniform manner, allowing investors to compare information between advisers;

- Provide a client with key information about the individual from whom they are receiving advice and contact information for that person's supervisor, which will appear as a supplement to the brochure;
- Deliver the brochure to a client before or at the time the adviser enters into an advisory contract with the client;
- Provide each client an annual summary of material changes to the brochure and either deliver a complete updated brochure or offer to provide the client with the updated brochure; and
- File both Form ADV Parts 1 and 2 on the IARD system to allow for public access and viewing.

As stated in the official release, "(t)he amended rules and forms will be effective 60 days after publication in the Federal Register. Most investment advisers will begin distributing and publicly posting new brochures in the first quarter of 2011."[1]

4. Mutual Fund Distribution Fees Rule Proposal

The SEC has proposed a new rule which will replace Rule 12b-1 under the Investment Company Act of 1940. In effect, the proposed rule will implement new cumulative limits on sales fees that mutual fund companies can charge investors. The fees, commonly known as 12b-1 fees, are paid by fund investors to companies for sales and marketing, and often provide hundreds of millions of dollars to companies.

The effect of the rule will be to:

- Limit the amount of asset-based sales charges that individual investors pay. In particular, the proposal would restrict these "ongoing sales charges" to the highest fee charged by the fund for shares that have no ongoing sales charge
- Improve transparency of fees for investors
- Encourage retail price competition
- Revise fund director oversight duties

The proposed rule replacing Rule 12b-1 supports underlying principles for transparency in the marketplace as it is "designed to enhance clarity, fairness and competition when investors buy mutual funds."[2]

Conclusion

In the proceeding months we expect to see both refinements to the newly implemented rules by the SEC as well as implementation of additional rules. An estimated 100 rules

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[1] Press Release, U.S. Sec. & Exch. Comm'n, SEC Approves Disclosure Form Changes to Provide Investors Greater Information About Their Investment Advisers (July 21, 2010), *available at* http://www.sec.gov/news/press/2010/2010-127.htm.

[2] Edward Wyatt, *S.E.C. Seeks Mutual Fund Fee Overhaul*, N.Y. TIMES, July 22, 2010, at B1, *available at* http://www.nytimes.com/2010/07/22/business/22sec.html?_r=2&ref=business.

will be proposed in accord with the newly minted Reform Act. JLG is committed to providing legal and compliance updates, support and guidance through this important restructuring time for the financial industry. Please contact us with any questions.

For more information, or to learn about how JLG may be of assistance, please do not hesitate to contact us at (619) 298-2880.

Author: Ann Marie Swanson, Sr. Legal Consultant, Nicole Miller, Paralegal; Editor: Michelle L. Jacko, Esq., Managing Partner, JLG. JLG works extensively with investment advisers, broker-dealers, investment companies, hedge funds and banks on legal and regulatory compliance matters. For more information about this topic and other legal services, please contact us at (619) 298-2880, info@jackolg.com or visit www.jackolg.com. Thank you.