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Beware: Dodd-Frank Act Implications for Private Investment Funds

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The Dodd-Frank Act, which was signed into law on July 21, 2010, makes broad, sweeping changes to the regulation of the financial industry. Among these are changes to the Investment Advisers Act of 1940 (the "Advisers Act" or the "Act") that could have a significant impact on two investment fund types that are prevalent in Southern California – private equity funds and private real estate funds.

Notably, the Dodd-Frank Act will eliminate the "private adviser exemption" currently relied upon by many private fund managers to avoid registration under the Advisers Act. Fortunately for some, the Dodd-Frank Act creates new Advisers Act exemptions, including an exemption that will generally allow advisers with less than $150 million under management to remain free from the Act's registration requirements. Also, private real estate funds and certain other private funds may be able to conclude that they do not invest in "securities," in which case the Advisers Act likely does not apply to the fund's manager and no exemption is required. Fund managers that are subject to the Advisers Act and are unable to qualify under a post-Dodd-Frank exemption, however, will soon likely have to succumb to the burdens of registration as an investment adviser.

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Advisers Act – generally

Under the Advisers Act and related rules promulgated by the Securities and Exchange Commission ("SEC"), unless an exemption applies, an investment adviser is generally required to register with the SEC if the adviser's assets under management equal or exceed a certain amount (currently $30 million in most cases, and increased to $100 million on July 21, 2011, the date applicable provisions of the Dodd-Frank Act concerning the Advisers Act go into effect), or register under an investment adviser statute of applicable state law.

The Advisers Act defines an "investment adviser," subject to certain exceptions, as "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 in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities."

Do fund managers give investment advice for compensation?

Based on the definition above, a key element in determining if a person is an investment adviser subject to the Advisers Act is whether the person "advises others" "for compensation." In most instances, private investment funds are structured as either limited partnerships or limited liability companies, with the general partner (in the case of a limited partnership) or manager (in the case of a limited liability company) vested with varying degrees of authority as to the fund's investment decisions, and in return receives management fees and/or a carried interest in the fund.

In light of current case law and SEC releases and statements, it is generally prudent to conclude that the general partner or manager of a private investment fund does "advise others" (by making investment decisions on behalf of the fund's investors) "for compensation" (in the form of a management fee and/or carried interest). As a result, to avoid registration under the Act, private investment funds are commonly structured to take advantage of an exemption from the Act.

Current exemption for many investment funds – but not for long

Currently, many managers to private investment funds have not registered under the Advisers Act in reliance upon the "private adviser exemption" under Section 203(b)(3) of the Act. The "private adviser exemption" generally exempts an adviser from the Act's registration requirements if it has had fewer than 15 clients during the preceding 12-month period, does not hold itself out as an investment adviser, and does not advise registered investment companies or business development companies. However, the Dodd-Frank Act will eliminate this exemption effective July 21, 2011 (according to the current adoption timetable), which will require many private fund managers to register under the Act, unless another exemption applies.

Exemptions after the Dodd-Frank Act

Although the Dodd-Frank Act will eliminate the "private adviser exemption," it will also create several new Advisers Act exemptions. Of the new exemptions, a likely candidate for managers of private investment funds to seek continued exemption under the Act is an exemption available if the investment adviser "acts solely as an adviser to private funds and has assets under management in the United States of less than $150,000,000." While the Dodd-Frank Act requires that the SEC implement record retention and reporting requirements for advisers to private funds with less than $150,000,000 under management, and also allows for the SEC to implement registration and examination procedures for such advisers, it is likely that whatever the SEC implements in this regard will be less burdensome than that required of advisers subject to full registration under the Advisers Act.

The Dodd-Frank Act will also create an exemption from registration under the Advisers Act for advisers acting as an investment adviser solely to one or more venture capital funds. However, the SEC has until July 2011 to define the term "venture capital fund" and until that term is defined it will remain unclear to what extent this might be a viable exemption for certain private investment funds.

Advisers Act perhaps inapplicable to real estate and other funds

Private funds of most every type have commonly relied on the "private adviser exemption" because of its relative simplicity and ease of compliance. As such, some funds may have never conducted a thorough legal analysis as to whether the fund's manager would be subject to the Advisers Act, even absent an exemption.

In addition to the "advises others" and "for compensation" elements discussed earlier, a third component to being an "investment adviser" subject to the Advisers Act is whether advice is given with respect to investment in "securities." If no advice is given as to investment in securities, the Advisers Act should not apply.

As an example, real estate funds that hold investments directly as fee interests in real property, regardless of the value of the investments, may not be subject to the Advisers Act, because those investments may not fall within the definition of what constitutes a security. Advisers to real estate and certain other funds that will not qualify for a post-Dodd-Frank exemption may want to consult with counsel as to whether the fund's holdings are not "securities," as an alternative means to avoid registration under the Advisers Act.

Real estate funds that hold title through wholly owned limited liability companies or other holding entities, or that invest in other funds, participating mortgages, mortgage notes or other investments, will need to be particularly vigilant in their analysis, as these types of investments are often considered securities by the SEC and under state securities laws (irrespective of the fact that the underlying assets may be in the form of real property). Fund managers that are uncertain as to the Act's applicability may want to consider seeking an exemption from the SEC pursuant to Section 206A of the Act.

For those with no way out – the time to act is now

Advisers of funds that invest in securities, and will not qualify for a post-Dodd-Frank exemption, would be wise to start considering and preparing for the implications of registering under the Advisers Act. Advisers registered under the Act are subject to the Act's recordkeeping and custody requirements and may be subject to annual surprise audits by an independent public accountant. Also, an adviser's carried interest, as currently structured, could violate the Act's rules regarding permitted adviser compensation if the fund's investors are not "qualified clients" as defined under the Act. Advisers that are subject to registration under the Act but fail to do so may be subject to significant consequences and liabilities, including potential judicial invalidation of the fund's governing agreements.

In conclusion, all private investment funds should take a close look at Advisers Act implications that may apply to them once the Dodd-Frank Act amendments go into effect. If the fund's manager is subject to the Act, and a post-Dodd-Frank exemption will not apply, the fund and its manager will need to review the fund's structure, governing documents and controls and procedures, and begin taking steps to prepare for compliance with the Act.

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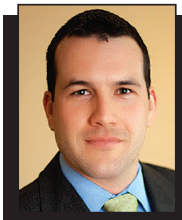

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