

## Massachusetts Secretary of State Proposes New Regulations for Investment Advisers in response to Dodd-Frank Act

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The Massachusetts Securities Division, under the direction of Secretary Galvin, has proposed new regulations relating to the regulation of investment advisers, including hedge fund managers. The proposed regulations are being issued in main part in response to the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") passed by Congress in July 2010 and are intended to "promote consistency" between Massachusetts state requirements for registration and regulation of investment advisers and the federal requirements following passage of the Dodd-Frank Act.

### Change in Exclusion/Exemption Requirements

Currently, Massachusetts exempts from registration any investment adviser whose only clients are "institutional buyers." Under the current regulations, an "institutional buyer" is defined to include: (a) an organization described in Section 501(c)(3) of the Internal Revenue Code with a securities portfolio of more than \$25 million; (b) a fund whose only investors are accredited investors, each of whom has invested a minimum of \$50,000 in such fund; or (c) an entity whose only investors are financial institutions and institutional buyers as set forth in applicable laws and regulations. Massachusetts based investment advisers to hedge funds and other pooled vehicles often rely on section (b) of this definition and remain exempt from registration.

The proposed amendment phases out the exemption provided to advisers of pooled vehicles by altering section (b) of the definition of "institutional buyer" to provide that only advisers to funds whose only investors are accredited investors, each of whom has invested a minimum of \$50,000, which existed prior to the effective date of the regulations and which, as of the effective date of the regulations, ceased to accept new investors, or contributions from existing investors, will continue to qualify for this exemption. The effect of this change is that Massachusetts based investment advisers to pooled vehicles who have less than \$100 million in assets under management and who do not otherwise qualify for an exemption from registration will need to register with the Massachusetts Securities Division. Massachusetts based advisers to pooled vehicles who have over \$100 million in assets under management will be eligible to register with the United States Securities and Exchange Commission (the "SEC").

In addition, the proposed regulations would create new exemptions from registration for certain "exempt reporting" advisers. The provisions mirror certain of the exemptions set forth in the Dodd-Frank Act, including exempting from registration advisers who provide advice solely to one or more 3(c)(7) funds or venture capital funds, provided the investment adviser and its affiliates are not subject to disqualification as described in Section 262 of SEC Regulation A, the adviser files the reports required to be filed with the SEC under the regulations proposed in connection with the implementation of the Dodd-Frank Act, and the adviser pays the required fee. "Venture capital fund" is defined by reference to the SEC rule to be adopted in connection with the Dodd-Frank Act. The final SEC rules relating to these exemptions have not yet been adopted.

The new exemptions would not impact SEC registered advisers, who would still be required to make notice filings with Massachusetts through the IARD.

Amendment to requirements for advisers with custody or discretionary authority over client funds or securities

The proposed regulations also amend the custody requirements for investment advisers registered or required to be registered under Massachusetts law with discretionary authority over, or custody of, client funds or securities.

Under the current regulations, advisers with custody of, or discretionary authority over, client funds or securities generally have the

option of either obtaining a \$10,000 bond or maintaining a positive net worth and a separate account containing cash or liquid securities of \$10,000 (for advisers with custody) or \$5,000 (for advisers with discretionary authority only). The proposed regulations remove the option of maintaining a separate account and instead require each adviser registered or required to be registered with discretionary authority over client assets to obtain a bond of not less than \$50,000. In addition, advisers registered or required to be registered under Massachusetts law who have custody of client funds or securities will be required to comply with the SEC custody rules, which generally require that all client assets be held by a qualified custodian, that the custodian engage in certain reporting to the client, and that (in some cases) the investment adviser undergo an annual custody exam by an independent audit firm.

## Technical and conforming amendments

In addition to the amendments set forth above, the proposed regulations also provide for certain conforming and technical amendments to the regulations. These include, among other things, updating current references to the NASD and NASD rules to reflect creation of the Financial Industry Regulatory Authority, or "FINRA", to amend outdated references to forms which have been updated and to correct certain fee information set forth in the current regulations.

Written comments to the proposed regulations must be submitted by June 24, 2011. A public hearing on the proposed changes will be held on June 23, 2011.

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