Client Alert.

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SEC Implements Advisers Act Provisions of Dodd-Frank; Extends Investment Adviser Registration Deadlines

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The Securities and Exchange Commission on June 22, 2011 adopted new rules under the Investment Advisers Act of 1940 (Advisers Act) to implement provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). The Commission extended until March 30, 2012 the compliance deadline for advisers currently relying on the "private advisers" exemption contained in Section 203(b)(3) of the Advisers Act. The new rules "will fill a key gap in the regulatory landscape," Chairman Mary Schapiro said in her opening statement. This alert summarizes the new rules and how they affect investment advisers.

RELEASE NO. IA-3222:
EXEMPTIONS FOR ADVISERS TO VENTURE CAPITAL FUNDS, PRIVATE FUND ADVISERS WITH LESS THAN $150 MILLION IN ASSETS UNDER MANAGEMENT, AND FOREIGN PRIVATE ADVISERS

The Dodd-Frank Act

Prior to the enactment of the Dodd-Frank Act, Section 203(b)(3) of the Advisers Act exempted investment advisers with 14 or fewer clients during the preceding 12 months and who did not hold themselves out to the public as investment advisers. The exemption did not apply to advisers to registered investment companies and "business development companies."

The Dodd-Frank Act eliminated the old "private adviser" exemption in Section 203(b)(3) and replaced it with a provision that provides that the Advisers Act will not apply to "any investment adviser that is a foreign private adviser."[1] The revisions to Section 203(b)(3) closed the Advisers Act exemption most frequently relied upon by investment advisers, except with respect to "foreign private advisers."

Although it eliminated the "private adviser" exemption, the Dodd-Frank Act created several new exemptions, including, among other things, exemptions for advisers to venture capital funds and for advisers to certain private funds.

- Section 203(l) provides that "no investment adviser that acts as an investment adviser solely to 1 or more venture capital funds shall be subject to the registration requirements of this title with respect to the provision of investment advice relating to a venture capital fund."[2]

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[1] Dodd-Frank Act, Section 403.

[2] Dodd-Frank Act, Section 407.

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- Section 203(m) provides that the Commission shall provide an exemption from the registration requirements to any investment adviser of "private funds," if each of such investment adviser acts solely as an adviser to private funds and has assets under management in the United States of less than $150 million.[3]

The Commission voted unanimously to implement these exemptions.

The Venture Capital Fund Exemption

New Rule 203(l)-1 defines "venture capital funds." The Commission intended to distinguish venture capital funds from other types of private funds, such as hedge funds and private equity funds, and to address Congressional concerns about systemic risk.

The rule defines a venture capital fund as a "private fund"[4] that:

- holds no more than 20 percent of the fund's capital commitments in non-qualifying investments (other than short-term holdings)
  - "Qualifying investments" generally consist of equity securities of "qualifying portfolio companies" that are directly acquired by the fund;
- does not borrow or otherwise incur leverage, other than limited short-term borrowing (excluding certain guarantees of qualifying portfolio company obligations by the fund);
- does not offer its investors redemption or other similar liquidity rights except in extraordinary circumstances;
- represents itself as pursuing a venture capital strategy to its investors and prospective investors; and
- is not registered under the Investment Company Act of 1940 (Investment Company Act) and has not elected to be treated as a business development company.

A "qualifying portfolio company" is defined by Rule 203(l)-1(c)(4) as any company that:

- is not a reporting or foreign traded company and does not have a control relationship with a reporting or foreign traded company;
- does not incur leverage in connection with the investment by the private fund and distribute the proceeds of any such borrowing to the private fund in exchange for the private fund investment; and
- is not itself a fund (*i.e.*, is an operating company).

Investments in the 20% "basket" can be outside the strict venture capital-oriented equity investment parameters imposed on the remaining 80% of the fund. This basket allows venture capital funds to invest in "legitimate one-off investments," thereby giving them flexibility while maintaining their core venture capital nature. While the definition limits the amount of non-qualifying investments, it allows the adviser to choose how to allocate those investments. Thus, one venture capital fund may take advantage of some opportunities to invest in debt whereas others may seek limited opportunities in publicly offered securities.

[3] Dodd-Frank Act, Section 408.

[4] "Private fund" is defined by the Dodd-Frank Act as an investment fund that would be an investment company but for the exemptions in Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act of 1940.

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Rule 203(l)-1 also grandfathers any pre-existing fund as a venture capital fund if it satisfies certain criteria. A grandfathered "venture capital fund" includes any private fund that:

- represented to investors and potential investors at the time the fund offered its securities that it pursues a venture capital strategy;
- has sold securities to one or more investors prior to December 31, 2010; and
- does not sell any securities to, including accepting any capital commitments from, any person after July 21, 2011.

A grandfathered fund thus includes any fund that has accepted all capital commitments by July 21, 2011 (including capital commitments from existing and new investors) even if none of the capital commitments has been called by such date.

The Exemption for Investment Advisers Solely to Private Funds with Less than $150 Million in Assets under Management

The Commission adopted a rule implementing Section 203(m) of the Dodd-Frank Act, which exempts advisers solely to "private funds" with total assets of less than $150 million from the registration requirements.[5]

The Commission expanded the scope of the exemption to include any fund that is exempt under Section 3 of the Investment Company Act. As originally proposed, the rule excluded only "private funds" as defined in the Dodd-Frank Act (that is, only funds that would be investment companies but for the exemptions contained in Section 3(c)(1) and 3(c)(7) of the Investment Company Act). Thus, an investment adviser could rely upon the Section 203(m) exemption if it advised a real estate fund relying on the exemption contained in Section 3(c)(5)(C) Investment Company Act.

The rules prescribe how to calculate assets under management to determine whether an adviser qualifies for this exemption.

An adviser must aggregate the value of all assets of private funds it manages to determine if the adviser is below the $150 million threshold, calculated in the manner required by the instructions to Form ADV. Advisers must count proprietary assets, assets managed without compensation, and uncalled capital commitments. In addition, advisers must look to the market value of the private fund assets, or the fair value of those assets when market value is unavailable, and must calculate the assets on a gross basis, *i.e.*, without deducting liabilities, such as accrued fees and expenses or the amount of any borrowing.

Advisers relying on this exemption must annually calculate the amount of the private fund assets under management and report these amounts in annual amendments to Form ADV. Advisers reporting $150 million or more of private fund assets under management no longer qualify for the private fund adviser exemption. Thus, advisers may be required to register under the Advisers Act if assets under management appreciate above the threshold at the end of the reporting period, but not between reporting periods.

All of the private fund assets of an adviser with a principal office and place of business in the United States are considered to be "assets under management in the United States," even if the adviser has offices outside of the United States. A non-U.S. adviser, however, need only count private fund assets it manages at a place of business in the United States toward the $150 million asset limit under the exemption. Non-U.S. advisers may not rely on the exemption if they have any clients that are United States persons other than a private fund.

[5] See footnote 4.

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The Foreign Private Advisers Exemption
Section 403 of the Dodd-Frank Act creates a "foreign private adviser" exemption. (This exemption replaced the old "private adviser" exemption in Section 203(b)(3)).

Section 202(a)(30) defines a "foreign private adviser" as any investment adviser that:

- has no place of business in the United States;
- has, in total, fewer than 15 clients in the United States and investors in the United States in private funds advised by the investment adviser;
- has aggregate assets under management attributable to clients in the United States and investors in the United States in private funds advised by the investment adviser of less than $25 million; and
- does not hold itself out generally to the public in the United States as an investment adviser.

Rule 202(a)(30)-1 defines certain terms in Section 202(a)(30) for purposes of this exemption, including: (i) "investor"; (ii) "in the United States"; (iii) "place of business"; and (iv) "assets under management." The SEC also included the safe harbor and many of the client counting rules that appeared in old Rule 203(b)(3)-1.

Given the limited scope of the foreign private adviser exemption, it is unlikely that many non-U.S. advisers will rely on it.

Subadvisory Relationships and Advisory Affiliates
Subadvisers may rely on each of the new exemptions, provided that they satisfy all applicable terms and conditions. The SEC will treat as a single adviser two or more affiliated advisers that are separately organized but operationally integrated, which could result in a requirement for one or both advisers to register.

RELEASE NO. IA-3221:
RULES IMPLEMENTING AMENDMENTS TO THE INVESTMENT ADVISERS ACT OF 1940

The Dodd-Frank Act
The Dodd-Frank Act generally defines a covered mid-sized investment adviser as an investment adviser with between $25 and $100 million in assets under management, and that is subject to registration and examinations as an investment adviser with the state in which it maintains its principal office and place of business.[6]

New Section 203A(a)(2) of the Advisers Act provides that no covered mid-sized investment adviser shall register federally unless the adviser:

- advises a registered investment company;
- advises a "business development company"; or
- is required to register with 15 or more states.

As a result, mid-sized investment advisers that desire federal registration will have to structure their investment operations so that they would be required to register with 15 or more states, or advise a business development company (BDC) or registered investment company. Alternatively, mid-sized investment advisers may register with the Commission if they are not subject to registration and examinations in the state where they maintain their principal office and place of

[6] Dodd-Frank Act, Section 203A(a)(2)(B).

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business.

Dodd-Frank's $100 million floor generally bars smaller and mid-sized investment advisers from choosing federal registration over state registration, and the Commission estimates that approximately 3,200 SEC-registered advisers will be required to withdraw their registrations and register with one or more state securities authorities.[7]

Transition to State Registration

The SEC adopted new Rule 203A-5 to provide for an orderly transition to state registration for mid-sized advisers that will no longer be eligible to register with the Commission.

Under the rule, *each* adviser registered with the Commission on January 1, 2012 must file an amendment to its Form ADV no later than March 30, 2012. These amendments will identify mid-sized advisers no longer eligible to remain registered with the Commission. Mid-sized advisers no longer eligible must withdraw their registrations with the Commission after filing their Form ADV amendments by filing Form ADV-W no later than June 28, 2012. Mid-sized advisers registered with the Commission as of July 21, 2011 must remain registered with the Commission (unless an exemption from Commission registration is available) until January 1, 2012.

Until July 21, 2011, when the amendments to Section 203A(a)(2) take effect, advisers applying for registration with the Commission that qualify as covered mid-sized advisers under Section 203A(a)(2) of the Advisers Act may register with either the Commission or the appropriate state securities authority. Thereafter, all such advisers are prohibited from registering with the Commission and must register with the state securities authorities.

The SEC adopted several amendments to Item 2.A. of Part 1A of Form ADV to reflect the new threshold for registration and the revisions the SEC made to related rules in response to the enactment of the Dodd-Frank Act.

Assets under Management

In most cases, the amount of assets an adviser has under management will determine whether the adviser must register with the Commission or one or more states. Section 203A(a)(2) of the Advisers Act defines "assets under management" as the "securities portfolios" with respect to which an adviser provides "continuous and regular supervisory or management services."

The Commission revised the instructions to Part 1A of Form ADV to implement a uniform method for advisers to calculate assets under management for purposes of determining eligibility to register and for other regulatory purposes. Advisers must include in their regulatory assets under management securities portfolios for which they provide continuous and regular supervisory or management services, regardless of whether these assets are family or proprietary assets, assets managed without receiving compensation, or assets of foreign clients. The revised instructions also clarify that an adviser must calculate its regulatory assets under management on a gross basis, that is, without deduction of "any outstanding indebtedness or other accrued but unpaid liabilities."

In addition, the Commission provided guidance concerning how advisers to private funds must determine the amount of assets under management.

- First, an adviser must include in its calculation of regulatory assets under management the value of any private fund over which it exercises continuous and regular supervisory or management services, regardless of the nature of the assets held by the fund.

[7] See Rules Implementing Amendments to the Investment Advisers Act of 1940, Release No. IA-3221.

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- Second, an adviser must include the amount of any uncalled capital commitments made to a private fund managed by the adviser.
- Third, advisers must use the market value of private fund assets, or the fair value of private fund assets where market value is unavailable.

Switching between State and Commission Registration

Rule 203A-1 is designed to prevent an adviser from having to switch frequently between state and Commission registration as a result of changes in the value of its assets under management or the departure of one or more clients. The amended rule provides a buffer for mid-sized advisers with assets under management close to $100 million to determine whether and when to switch between state and Commission registration. The rule raises the threshold above which a mid-sized investment adviser must register with the Commission to $110 million; but, once registered with the Commission, an adviser need not withdraw its registration until it has less than $90 million of assets under management. In addition, the SEC decided that eligibility for registration be determined annually as part of an adviser's annual updating amendment, allowing an adviser to avoid the need to change registration status based on fluctuations that occur during the course of the year.

Exemptions from the Prohibition on Registration with the Commission

The Commission created three exemptions from the prohibitions on registration as an adviser with the Commission.

First, the Commission eliminated the exemption in Rule 203A-2(a) from the prohibition on Commission registration for nationally recognized statistical rating organizations. Second, the SEC amended Rule 203A-2(b), the exemption available to pension consultants, to increase the minimum value of plan assets required to rely on the exemption from $50 million to $200 million. Third, the Commission adopted amendments to the multi-state adviser exemption to align the rule with the multi-state exemption that Congress provided for mid-sized advisers in Section 410 of the Dodd-Frank Act. Amended Rule 203A-2(d) permits all investment advisers who are required to register as an investment adviser with 15 or more states to register with the Commission, rather than 30 states, as currently required.

The Commission rescinded, as proposed, Rule 203A-4, which provided a safe harbor from Commission registration for an investment adviser that is registered with the state securities authority of the state in which it has its principal office and place of business based on a reasonable belief that it is prohibited from registering with the Commission because it does not have sufficient assets under management.

Exempt Reporting Advisers: Sections 407 and 408

To implement new Sections 203(l) and 203(m) of the Advisers Act, the SEC adopted a new rule that requires advisers relying on those exemptions from registration to submit to the Commission, and to periodically update, reports that consist of a limited subset of items on Form ADV. As amended, Rule 204-1 requires an exempt reporting adviser, like a registered adviser, to amend its reports on Form ADV: (i) at least annually, within 90 days of the end of the adviser's fiscal year; and (ii) more frequently, if required by the instructions to Form ADV. Similarly, the Commission amended General Instruction 4 to Form ADV to require an exempt reporting adviser, like a registered adviser, to update promptly Items 1 (Identification Information), 3 (Form of Organization), and 11 (Disciplinary Information) if they become inaccurate in any way, and to update Item 10 (Control Persons) if it becomes materially inaccurate.

When an adviser ceases to be an exempt reporting adviser, new Rule 204-4 requires the adviser to file an amendment to its Form ADV to indicate that it is filing a final report. An exempt reporting adviser wishing to register with the Commission can file a single amendment to its Form ADV that will serve both as a final "report" as an exempt reporting adviser and an application for registration under the Advisers Act.

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Other Amendments to Form ADV

The Commission amended Form ADV to require a mid-sized adviser registering with the Commission to affirm, upon application and annually thereafter, that it is either: (i) not required to be registered as an adviser with the state securities authority in the state where it maintains its principal office and place of business; or (ii) is not subject to examination as an adviser by that state. The Commission provided an explanation of what "required to register" and "subject to examination" means.

The Commission adopted a number of amendments to Form ADV that will improve its ability to oversee investment advisers. As amended, Form ADV requires advisers to provide the Commission with additional information about three areas of their operations.

- First, the Commission requires advisers to provide additional information about private funds they advise.
- Second, the Commission expands the data advisers provide the Commission about their advisory business (including data about the types of clients they have, their employees, and their advisory activities), as well as about their business practices that may present significant conflicts of interest (such as the use of affiliated brokers, soft dollar arrangements, and compensation for client referrals).
- Third, the Commission requires additional information about advisers' non-advisory activities and their financial industry affiliations. Some additional changes to the Form improve the Commission's ability to assess compliance risks and also to identify advisers that are subject to the Dodd-Frank Act's requirements concerning certain incentive-based compensation arrangements.

Amendments to "Pay to Play" Rule

The Commission amended the scope of the Commission's "pay to play" rule so that it applies both to exempt reporting advisers and foreign private advisers. The rule currently applies to advisers either registered with the Commission or unregistered in reliance on the "private adviser" exemption under Section 203(b)(3) of the Advisers Act. Second, the SEC amended the rule to add municipal advisors to the categories of registered entities – referred to as "regulated persons" – excepted from the rule's prohibition on advisers paying third parties to solicit government entities. Finally, the Commission extended the date by which advisers must comply with the ban on third-party solicitation from September 13, 2011 to June 13, 2012.

Books and Records

The Commission adopted amendments to Rule 204-2 under the Advisers Act, the "books and records" rule. The first amendment updates the rule's "grandfathering provision" for investment advisers that are currently exempt from registration under the "private adviser" exemption, but will be required to register after the exemption is eliminated on July 21, 2011.

Technical and Conforming Amendments

The SEC adopted several technical and conforming amendments as a result of the Dodd-Frank Act.[8] For the sake of brevity, these changes are not discussed.

RELEASE NO. IA-3220:
FAMILY OFFICES

The Commission voted unanimously to adopt Rule 202(a)(11)(G)-1 under the Advisers Act, which provides an exemption

[8] Rules Implementing Amendments to the Investment Advisers Act of 1940, Release No. IA-3221.

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from most provisions of the Advisers Act to certain family offices. To qualify for the exemption, a family office must:

- provide advice about securities only to certain "family clients";
- be wholly owned by family clients and exclusively controlled (directly or indirectly) by one or more family members and/or family entities; and
- not hold itself out to the public as an investment adviser.

Rule 202(a)(11)(G)-1(d)(4) provides that "family clients" include current and former family members, certain employees of the family office (and, under certain circumstances, former employees), charities funded exclusively by family clients, estates of current and former family members or key employees, trusts existing for the sole current benefit of family clients or, if both family clients and charitable and non-profit organizations are the sole current beneficiaries, trusts funded solely by family clients, revocable trusts funded solely by family clients, certain key employee trusts, and companies wholly owned exclusively by, and operated for the sole benefit of, family clients (with certain exceptions).

Relevant Links

- **Opening Statement of Chairman Mary Schapiro:** **http://www.sec.gov/news/speech/2011/spch062211mls-items-1-2.htm**
- **Statement of Commissioner Kathleen L. Casey:** **http://www.sec.gov/news/speech/2011/spch062211klc-items1-2.htm**
- **Statement of Commissioner Troy A. Paredes:** **http://www.sec.gov/news/speech/2011/spch062211tap-items-1-2.htm**
- **IA-3222: Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less than $150 Million in Assets under Management, and Foreign Private Advisers:** **http://www.sec.gov/rules/final/2011/ia-3222.pdf**
- **IA-3221: Rules Implementing Amendments to the Investment Advisers Act of 1940:** **http://www.sec.gov/rules/final/2011/ia-3221.pdf**
- **IA-3220: Family Offices:** **http://www.sec.gov/rules/final/2011/ia-3220.pdf**

The Dodd-Frank Act prohibits the SEC from excluding from its definition of family office persons not registered or required to be registered on January 1, 2010 that would meet all of the required conditions under Rule 202(a)(11)(G)-1 but for their provision of investment advice to certain clients specified in Section 409(b)(3) of the Dodd-Frank Act.[9] In addition, Rule 202(a)(11)(G)-1(e)(2) provides that family offices currently exempt from registration under the Advisers Act in reliance on the private adviser exemption and that do not meet the new family office exclusion are not required to register with the Commission as investment advisers until March 30, 2012.

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[9] Dodd-Frank Act, Section 409(b)(3) and (c).

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