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SEC Dodd-Frank Advisers Act Rulemaking: Part I

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The Dodd-Frank Act eliminates the "private advisers" exemption in Section 203(b)(3)of the Investment Advisers Act of 1940, raises the floor for Advisers Act registration, and creates additional exemptions. The new SEC rules provide more details on the new statutory exemptions, explain how investment advisers may determine whether they meet the applicable assets under management floors, and address other implementing issues. Part I of this article focuses on the new floors and other implementing issues. Part II, which will appear next month, focuses on the new Advisers Act exemptions.

The Investment Advisers Act of 1940, as amended (Advisers Act) requires "investment advisers" within the meaning of the Advisers Act with assets under management (AUM) in excess of the new statutory floor to register with the Securities and Exchange Commission (Commission or SEC), unless they qualify for an exemption from registration. Among other things, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) repealed Section 203(b)(3) of the Advisers Act, the "private adviser" exemption, which many investment advisers relied upon. Section 203(b)(3) exempted from registration certain investment advisers having fewer than 15 clients in any 12-month period if they met certain conditions.[1] In applying the numerical limit in the old Section 203(b)(3), which the Dodd-Frank Act repealed, the SEC generally permitted investment advisers to count as a single "client" any fund they advised, but the SEC did not require such funds to count the individual investors as separate clients. Accordingly, private fund managers had been able to rely upon the private advisers exemption in Section 203(b)(3) and advise a substantial number of separate funds (not more than 14 in any 12-month period) without becoming subject to SEC registration.

An investment adviser that is required to register, that is not otherwise exempt (and that previously relied on the "private adviser" exemption in Section 203(b)(3) on July 20, 2011), may delay registering with the SEC until March 30, 2012.[2] It should be noted that initial applications for registration can take up to 45 days to be approved. Accordingly, advisers relying on this transition provision to remain unregistered until March 30, 2012, should file a complete application, both

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Part 1 and a brochure(s) meeting the requirements of Part 2 of Form ADV by February 14, 2012.

The Dodd-Frank Act does not require all investment advisers to register with the SEC. Although the Dodd-Frank Act replaced the Section 203(b)(3) exemption with a more narrow exemption, it generally raised the floor (discussed below) on Advisers Act registration for most "investment advisers" to register with the SEC and added certain new exemptions from the registration requirements in the Advisers Act.

The most important of the new exemptions are as follows:

- ***Advisers Solely to Venture Capital Funds.*** Section 203(l) provides that "no investment adviser that acts as an investment adviser solely to one 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."[3]
- ***Advisers Solely to Private Funds with Less Than $150 Million in AUM.*** 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.[4]
- ***Foreign Private Advisers.*** Section 203(b)(3), as revised, created a new exemption for "foreign private advisers."
- ***Family Offices.*** The Dodd-Frank Act adds an exclusion from the definition of "investment adviser" in Section 202(a)(11) that will apply to any "family office," as defined by rule, regulation or order of the Commission.[5]

Investment advisers that register with the SEC will not be subject to state registration requirements.[6] "Investment advisers" that do not register under the Advisers Act as a result of falling short of the applicable floor may have to register under applicable state law instead, although some states are considering granting exemptions if the investment adviser otherwise qualifies for an exemption under the Advisers Act. If an investment adviser does not register with the SEC on the basis of an exemption, it may also be required to register as an investment adviser under applicable state law, but some states provide exemptions to investment advisers that are exempt under the Advisers Act. California, for example, is currently considering granting an analogous exemption with respect to the Section 203(m) exemption if the investment adviser has more than $100 million in assets under management, and an analogous Section 203(l) exemption. In the event a state does not grant such an exemption, if an investment adviser is eligible for SEC registration (but SEC registration is not required), many investment advisers will choose to register with the SEC rather than register with the applicable state authorities. State registration can be more onerous as it may require registration in multiple states and compliance with state rules regarding investment advisers and investment adviser representatives.

New SEC Releases

On June 22, 2011, the Commission published three releases that implement provisions of the Dodd-Frank Act relating to investment advisers.

Exemptions Release. In Release No. IA-3222, the Commission implemented the venture capital, private funds, and foreign private advisers exemptions as set forth in Section 203(l), 203(m), and 203(b)(3) of the amended Advisers Act. In the final release, the SEC adopted many of the relevant rules substantially as proposed but also made several modifications to some of the proposed rules. Part II of this article will discuss the new Commission rules and the implementing releases.[7]

Family Offices Release. In Release No. IA-3220, the Commission adopted Rule 202(a)(11)(G)-1 under the Advisers Act, which defines the term "family office."[8] Investment advisers that fall within the new definition of family office will not be subject to most provisions of the Advisers Act. The policy rationale for this decision is that disputes among family members concerning the operation of the family office could be resolved within the family unit or, if necessary, through state courts under laws designed to govern family disputes. Below, we summarize what we consider are the most important parts of Rule 202(a)(11)(G)-1 and Release No. IA-3220.[9]

Implementing Release. In Release No. IA-3221, the Commission implemented various amendments to the Advisers Act.[10] Among other things, Release No. IA-3221 addresses the following issues:

- The new Advisers Act floors for registration;
- Transitions to state registration for investment advisers that fall below the applicable floors;
- Calculation of assets under management;
- Mechanisms for switching between state and Federal registration;
- Certain exemptions from the prohibitions on registration with the Commission;
- Requirements for "exempt reporting advisers";
- Certain changes to Form ADV;
- Amendments to the "pay to play" rules;
- Amendments to the books and records requirements; and
- Certain technical and conforming amendments.

We begin Part I of this article by explaining jurisdiction under the Advisers Act, since many foreign investment advisers will find themselves subject to the new Advisers Act rulemaking. We then proceed to discuss the applicable floors and other implementing issues, as set forth in Release No. IA-3221: Rules Implementing Amendments to the Investment Advisers Act of 1940. In Part II of this article, we will discuss the new exemptions under the Advisers Act, as set forth in: (1) 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; and (2) Release No. IA-3220: Family Offices.

Jurisdiction Under the Advisers Act

In Release No. IA-3222,[11] the Commission stated that non-U.S. investment advisers, even with no place of business in the United States and no U.S. clients may be subject to registration under the Advisers Act, unless exempt, if there is sufficient U.S. jurisdictional means. It is possible that the SEC will determine that non-U.S. investment advisers falling within the definition of "investment adviser" that use U.S. jurisdictional means, since they are not subject to state law regulation, registration or examination, generally will be required to register with the SEC at any size, unless otherwise exempt.

The Commission has suggested that the test of jurisdictional means for non-U.S. investment advisers is whether there are "conduct or effects" in the United States.[12] A foreign investment adviser also could potentially be subject to U.S. jurisdictional means by using U.S. mails or any means or instrumentality of U.S. interstate commerce.[13] Section 202(a)(10) defines "interstate commerce" to include "trade, commerce, transportation, or communication . . . between any foreign country and any State . . . ."

In certain cases, the Commission has allowed a non-U.S. investment adviser to use limited U.S. jurisdictional means without being subject to Advisers Act jurisdiction. In the *Gim-Seong Seow* no-action letter,[14] the SEC staff noted that a non-U.S. investment adviser to clients residing outside the United States may use limited U.S. jurisdictional means without triggering the registration requirements of the Advisers Act. In that no-action letter, the non-U.S. investment adviser obtained information about securities issued by U.S. issuers through U.S. jurisdictional means, gave advice abroad about those securities to its non-U.S. clients, and effected transactions in securities through U.S. broker-dealers on behalf of those clients.[15] In contrast, the SEC staff stated in that no-action letter that a domestic adviser dealing exclusively with foreign clients must register if it uses any jurisdictional means in connection with its advisory business.[16]

The SEC staff previously has taken the position that the substantive provisions of the Advisers Act generally should not govern the relationship between an investment adviser located outside the U.S. and its foreign clients, even though the adviser is registered under the Advisers Act. In Release No. IA-3222, the Commission noted that nothing in that release was intended to withdraw any prior statement of the Commission. To enable the Commission to monitor and enforce a registered foreign adviser's performance of its obligations to its U.S. clients and to ensure the integrity of U.S. markets, a registered foreign adviser must comply with certain Advisers Act recordkeeping requirements and provide the Commission with access to foreign personnel with respect to all its activities.[17] In one no-action letter, the SEC staff suggested that the Advisers Act could govern a relationship between a foreign adviser and its non-U.S. clients if the adviser's activities involved conduct or effects in the United States.[18] In a later no-action letter in 1998, subject to heavy conditions and representations, the SEC staff said it would not recommend enforcement action when registered investment advisers did not comply with the Advisers Act with respect to their foreign clients if they comply with applicable foreign law.[19] Of course, a registered foreign adviser would always have to comply with the Advisers Act with respect to its U.S. clients.

It should be noted that when a foreign adviser advises a foreign client that is an intermediate conduit used to advise U.S. clients, Section 208(d) of the Advisers Act would operate to prevent the adviser from considering the conduit as a foreign client. In such event, the full compliance obligations of the Advisers Act would apply. It is uncertain what the compliance obligations of a foreign adviser would be with respect to U.S. investors, as opposed to U.S. clients.

Non-U.S. investment advisers, in certain cases, can be subject to U.S. jurisdiction if they are affiliates of U.S. registered investment advisers. In the *Unibanco* letter and its progeny (Unibanco letters),[20] the SEC staff provided assurances that it would not recommend enforcement action, subject to certain conditions, against a non-U.S. unregistered adviser that is affiliated with a Commission-registered adviser, despite sharing personnel and resources. Generally, the staff has provided assurances that it will not recommend enforcement action in situations in which the unregistered non-U.S. adviser, often termed a "participating affiliate" in these letters, and its registered affiliate are separately organized; the registered affiliate is staffed with personnel (located in the U.S. or abroad) who are capable of providing investment advice; all personnel of the participating affiliate involved in U.S. advisory activities are deemed "associated persons" of the registered affiliate; and the Commission has adequate access to trading and other records of the participating affiliate and to its personnel to the extent necessary to enable it to identify conduct that may harm U.S. clients or markets. The Commission noted that although the *Unibanco* letters were developed by the staff in the context of the "private adviser" exemption, the Commission did not intend to withdraw any prior statement of the Commission or the views of the staff as expressed in the *Unibanco* letters, and that that the staff would provide guidance, as appropriate, based on facts that may be presented to the staff regarding the application of the *Unibanco* letters in the context of the new foreign private adviser exemption and the private fund adviser exemption.

Rules Implementing Amendments to the Investment Advisers Act of 1940

Raising the Floors for Advisers Act Registration

The concept of "covered mid-sized investment adviser" is central to understanding the applicable Advisers Act floors for registration. 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.[21] Wyoming, New York, and Minnesota do not currently subject investment advisers to registration and examination. Investment advisers with a principal place of business in these three states would not currently be considered subject to registration and examinations in the state where they maintain their principal office and place of business, and, therefore, would not be covered mid-sized investment advisers.[22] The Commission will maintain a list of states that do not subject advisers registered with them to examination on the Commission's website, which will be available to advisers using IARD to register or amend their registration forms.

Following the effective date of the Dodd-Frank Act, new Section 203A(a)(2)(A) of the Advisers Act provides that no covered mid-sized investment adviser shall register federally unless: (1) the adviser advises a registered investment company; (2) the investment adviser advises an electing "business development company;" or (3) the adviser is required to register with 15 or more states. Non-covered mid-sized investment advisers are not subject to this prohibition. Until January 1, 2012, the prohibition of Section 203A(a)(2) will not apply to an investment adviser registered with the Commission on July 21, 2011.[23]

The amendments do not affect Section 203A of the Advisers Act, which provides that no investment adviser that is regulated or required to be regulated as an investment adviser in the state in which it maintains its principal office and place of business shall register under Section 203, unless the investment adviser has assets under management of not less than $25 million, or is an investment adviser to an investment company registered under the Investment Company Act.

First, small investment advisers with under $25 million in assets under management generally may not register with the SEC.

Currently, Rule 203A-1(a)(2) generally provides that if the state where the adviser maintains its principal office and place of business has enacted an investment adviser statute, the adviser may register with the Commission if it has assets under management of at least $25 million but less than $30 million. The Commission amended the Rule to eliminate the current buffer for advisers that have assets under management between $25 million and $30 million that permits these advisers to remain regulated by the states. The Commission replaced it with a similar buffer for mid-sized advisers. Rule 203A-1(a) provides, following its revision, if the adviser is a "covered mid-sized investment adviser," unless the adviser advises a registered investment company or the investment adviser advises an electing "business development company," the adviser may, but will not be required to register with the Commission, if it has assets under management of at least $100 million but less than $110 million, and it need not withdraw its registration unless it has less than $90 million of assets under management.[24] Advisers may begin relying on the Commission amendment to the buffer in Rule 203A-1 on September 17, 2011. 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.

Based on these principles, one can derive several conclusions regarding how the new floors will affect investment adviser registration.

First, small investment advisers with under $25 million in assets under management generally may not register with the SEC, unless the state in which they maintain their principal office and place of business has not enacted an investment adviser statute (*e.g.,* Wyoming), or unless they act as an investment adviser to a registered investment company, in which cases they must register with the SEC under the Advisers Act, unless otherwise exempt.[25] Presumably, non-U.S. investment advisers with their principal office and place of business in a foreign country falling within the definition of "investment adviser" that use U.S. jurisdictional means,[26] since they are not subject to a state law investment adviser statute, generally will be required to register with the SEC at any size, unless otherwise exempt. However, it is possible that the SEC could take the position that non-U.S. investment advisers that met the requirements of U.S. jurisdictional means and that had less than $25 million in assets under management would not have to register with the SEC if it had assets under management of less than $25 million and if the foreign country where they are located had enacted an investment adviser statute.

Second, non-covered mid-sized investment advisers with between $25 million and $100 million in assets under management generally will be required to register with the SEC, unless an exemption applies.[27] As discussed above, 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.[28] The Commission noted that advisers with their principal office and place of business in Minnesota, New York, and Wyoming with assets under management between $25 million and $100 million must register with the Commission, unless otherwise exempt. Presumably, mid-size non-U.S. investment advisers with their principal office and place of business in a foreign country falling within the definition of "investment adviser" that use U.S. jurisdictional means,[29] since they are not subject to state law registration or examination, will generally be required to register with the SEC, unless otherwise exempt. However, as noted above, it is possible that the SEC could take the position that such a foreign investment adviser would not have to register with the SEC if the foreign country required investment adviser registration and examinations.

Third, covered mid-sized investment advisers with between $25 million and $100 million in assets under management generally will be prohibited from registering with the SEC unless (1) they advise a registered investment company or a company that has elected to be a "business development company," in which case they are required to register under the Advisers Act, unless otherwise exempt;[30] or (2) they are required to register with 15 or more states, in which case they will be permitted to register under the Advisers Act.[31] If the covered mid-sized investment adviser has between $100 million and $110 million in assets under management, it will be permitted, but not required, to register with the Commission.[32] It is uncertain whether foreign investment advisers that are subject to registration and examinations as an investment adviser with the country in which they maintain their principal office and place of business would fall within the definition of a "covered mid-sized investment adviser."

Fourth, investment advisers with more than $110 million in assets under management generally will be required to register with the SEC, unless an exemption applies.[33]

As a result, the minimum assets under management threshold for Commission registration for most U.S. investment advisers that do not manage registered investment companies or business development companies will be $100 million in general, and $25 million for advisers that would either (1) not be subject to registration and examination in the state in which they maintain their respective principal offices and places of business or (2) otherwise be required to register with 15 or more states. If the investment adviser has its principal office and place of business in a state that has not enacted an investment adviser statute, then it would be required to register at any size, unless otherwise exempt.

If a mid-sized adviser is prohibited from registering with the Commission, the Commission noted that it would be possible for a mid-sized investment adviser to receive an order permitting the adviser to register with the Commission.[34]

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. The transition requirements are addressed both to existing registrants and new applicants.

Existing Registrants. 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.[35] These amendments will respond to new items in Form ADV and will identify mid-sized advisers no longer eligible to remain registered with the Commission.[36] Advisers will determine their assets under management based on the current market value of the assets as determined within 90 days prior to the date of filing the Form ADV.[37] Mid-sized advisers that are no longer eligible for Commission registration under Section 203A(a)(2) of the Advisers Act, and are not otherwise exempted by Rule 203A-2 from such prohibition, must withdraw their registrations with the Commission after filing their Form ADV amendments by filing Form ADV-W no later than June 28, 2012.[38] 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, which is the date by which the Commission expects the programming of IARD will be completed.[39]

New Applicants. Until July 21, 2011, when the amendments to Section 203A(a)(2) took effect, advisers applying for registration with the Commission that qualify as covered mid-sized advisers under Section 203A(a)(2) of the Advisers Act could 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. Covered 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. Covered mid-sized investments advisers that are no longer eligible for Commission registration under Section 203A(a)(2) of the Advisers Act, and are not otherwise exempted by Rule 203A-2 from such prohibition, 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 investment advisers that previously relied on the "private adviser" exemption in Section 203(b)(3) on July 20, 2011, that register with the appropriate state securities authority, if required to register under the Advisers Act, generally will be permitted to remain unregistered under the Advisers Act, until March 30, 2012, but should file a complete application, both Part 1 and a brochure(s) meeting the requirements of Part 2 of Form ADV at least by February 14, 2012. Generally speaking, advisers that have assets under management of more than $100 million (for permissive registration) and more than $110 million (for mandatory registration) will continue to register with the Commission (unless, with respect to mandatory registration, an exemption from registration with the Commission otherwise is available).[40] Larger investment advisers that previously relied on the "private adviser" exemption in Section 203(b)(3) on July 20, 2011, generally will be permitted to remain unregistered under the Advisers Act, until March 30, 2012, but should file a complete application, both Part 1 and a brochure(s) meeting the requirements of Part 2 of Form ADV at least by February 14, 2012. Registration under the Advisers Act will preempt state law registration.[41]

Amendments to Form ADV

The Commission adopted several amendments to Item 2.A. of Part 1A of Form ADV to reflect the new threshold for registration discussed above and the revisions in related rules adopted in response to the enactment of the Dodd-Frank Act. Item 2.A. now requires each adviser registered with the Commission (and each applicant for registration) to identify whether it is eligible to register with the Commission because it: (1) is a large adviser that has $100 million or more of regulatory assets under management (or $90 million or more if an adviser is filing its most recent annual updating amendment and is already registered with the Commission); (2) is a mid-sized adviser that does not meet the criteria for state registration or is not subject to examination; (3) has its principal office and place of business in Wyoming (which does not regulate advisers) or outside the United States; (4) meets the requirements for one or more of the revised exemptive rules under Section 203A discussed below; (5) is an adviser (or subadviser) to a registered investment company; (6) is an adviser to a business development company and has at least $25 million of regulatory assets under management; or (7) received an order permitting the adviser to register with the Commission. The Commission stated that each adviser must check at least one of these items on Form ADV, or indicate that the adviser is no longer eligible to remain registered with the Commission.

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)(3) 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." Instructions to Form ADV provide advisers with guidance in applying this provision, and until now have permitted advisers to exclude certain types of assets that otherwise would have to be included.[42] These assets include proprietary assets, assets an adviser manages without receiving compensation, and assets of foreign clients. The amendments improve consistency by eliminating choices the instructions had provided advisers that have enabled some of them to opt in or out of federal or state regulation (by including or excluding a class of assets).

Eligibility for registration is to be determined annually as part of an adviser's annual updating amendment.

The Commission revised the instructions to Part 1A of Form ADV to implement a uniform method for advisers to calculate assets under management that will be used under the Advisers Act for regulatory purposes in addition to assessing whether an adviser is eligible to register with the Commission.[43] In Part 1A, the Commission changed the terminology used to refer to an adviser's "regulatory assets under management" in order to acknowledge the "regulatory" purposes of this reporting requirement and to distinguish it from the assets under management disclosure that advisory clients receive in Part 2 of Form ADV.[44]

The Commission also amended Rule 203A-3 to continue to require that the calculation of "assets under management" for purposes of Section 203A of the Advisers Act be the calculation of the securities portfolios with respect to which an investment adviser provides continuous and regular supervisory or management services, as reported on the investment adviser's Form ADV.[45] The revised instructions, however, provide that 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.[46] The revised instructions to Form ADV 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."[47]

In addition, the Commission revised the Form ADV instructions to provide guidance regarding how an adviser that advises private funds must determine the amount of assets it has 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,[48] regardless of the nature of the assets held by the fund.[49] A sub-adviser to a private fund would include in its regulatory assets under management only that portion of the value of the portfolio for which it provides continuous and regular supervisory or management services. Second, an adviser must include the amount of any uncalled capital commitments made to a private fund managed by the adviser.[50] Third, advisers must use the market value of private fund assets, or the fair value of private fund assets where market value is unavailable, which would include illiquid assets.[51] The Commission stated that while many advisers will calculate fair value in accordance with GAAP or another international accounting standard, other advisers acting consistently and in good faith may utilize another fair valuation standard. Thus, if these conditions are met, the general partner could retain discretion over the determination of fair value.

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 SEC decided that eligibility for registration is to be determined annually as part of an adviser's annual updating amendment. This allows an adviser to avoid the need to change registration status based on fluctuations that occur during the course of the year.[52]

Rule 203A-1(b) provides rules for switching to or from Commission registration. If an investment adviser is registered with a state securities authority, it must apply for registration with the Commission within 90 days of filing an annual updating amendment to its Form ADV reporting that it is eligible for Commission registration and is not relying on an exemption from registration under Sections 203(l) or 203(m) of the Advisers Act.[53] With respect to exempt reporting advisers, General Instruction 15 to Form ADV provides that this safe harbor period would only be available to an adviser that has complied with all applicable reporting requirements of exempt reporting advisers as such (as opposed to all Commission reporting requirements). If an investment adviser is registered with the Commission and files an annual updating amendment to its Form ADV reporting that it is not eligible for Commission registration and is not relying on an exemption from registration under Sections 203(l) or 203(m) of the Advisers Act, it must file Form ADV-W to withdraw its Commission registration within 180 days after its fiscal year end (unless it is then eligible for Commission registration).[54] During the period while an investment adviser is registered with both the Commission and one or more state securities authorities, both the Advisers Act and applicable State law will apply to its advisory activities.

Exemptions from the Prohibition on Registration with the Commission

The Commission adopted amendments to three of the exemptions in Rule 203A-2 from the prohibition on Commission registration in Section 203A to reflect developments since their original adoption, including the enactment of the Dodd-Frank Act. Each of the exemptions in Rule 203A-2 also applies to mid-sized advisers, exempting them from the prohibitions on registering with the Commission if they meet the requirements of Rule 203A-2. Advisers may rely on the Commission's amendments to Rule 203A-2 beginning on September 17, 2011.

First, the Commission eliminated the exemption in Rule 203A-2(a) from the prohibition on Commission registration for nationally recognized statistical rating organizations (NRSROs).[55] The Commission eliminated this exemption because the Advisers Act was amended to exclude certain NRSROs from the definition of "investment adviser." Congress has provided for a separate regulatory regime for NRSROs under the Securities Exchange Act of 1934 (Exchange Act).

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.[56] As a result of this amendment, advisers currently relying on the pension consultant exemption advising plans with assets of less than $200 million may be required to withdraw from Commission registration and register with one or more states.[57]

Third, the Commission amended 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.[58] 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. An adviser relying on the rule must withdraw from registration with the Commission when it is no longer required to be registered with 15 states.[59]

To rely on multi-state adviser exemption, an adviser must continue to: (1) include a representation on Schedule D of Form ADV that the investment adviser has concluded, after reviewing applicable State and Federal laws, that, in the case of an application for registration with the Commission, it must register as an investment adviser with the required number of states, or in the case of an amendment to Form, it would be required by the laws of the required number of states to register within 90 days prior to the date of filing Form ADV; (2) undertake to withdraw from registration with the Commission if the adviser indicates on an annual updating amendment to Form ADV that it would be required by the laws of fewer than 15 states to register as an investment adviser with the state, and that the adviser would be prohibited by Section 203A(a) of the Advisers Act from registering with the Commission; and (3) maintain a record of the states in which the investment adviser has determined it would, but for the exemption, be required to register.[60] The Commission stated that the adviser may not include in the number of states those in which it is not required to register because of applicable state laws or the national *de minimis* standard of Section 222(d) of the Advisers Act.

Amended Rule 203A-2(d) permits an adviser otherwise eligible to rely on the multi-state adviser exemption to choose to maintain its state registrations and not switch to SEC registration.[61]

Elimination of Safe Harbor

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. The Commission rescinded the rule because it believed the safe harbor was designed for smaller advisory businesses with assets under management of less than $30 million, which may not employ the same tools or otherwise have a need to calculate assets as precisely as advisers with greater assets under management. The Commission also believed that the Form ADV's uniform method for advisers to calculate assets under management will reduce confusion among investment advisers.

Mid-Sized Advisers

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: (1) 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 (2) is not subject to examination as an adviser by that state.[62] The Commission provided an explanation of what "required to registered" and "subject to examination" means. The instruction explains that a mid-sized adviser "is not required to be registered" with the state securities authority and must register with the Commission (unless an exemption from registration with the Commission otherwise is available) if the adviser is exempt from registration under the law of the state in which it has its principal office and place of business, or is excluded from the definition of investment adviser in that state.

Exempt Reporting Advisers

The Dodd-Frank Act adds some new exemptions to the Advisers Act. First, it added Section 203(l), which exempts from the registration requirements investment advisers that advise solely one or more venture capital funds. Second, it added Section 203(m) of the Advisers Act, which exempts from the registration requirements investment advisers that act solely as an investment adviser to "private funds"[63] and that has assets under management in the United States of less than $150 million.[64]

To implement new Sections 203(l) and 203(m) of the Advisers Act, the SEC adopted a new rule, Rule 204-4, that requires advisers relying on those exemptions (exempt reporting advisers) to submit to the Commission, and to periodically update, reports that consist of a limited subset of items on Form ADV. The Commission stated that these reports would both: (1) provide the Commission with information as to whether these advisers or their activities might present sufficient concerns to warrant the Commission's further attention in order to protect clients, investors, and other market participants, and (2) provide the public with some basic information about these advisers and their businesses. At the Commission meeting adopting this rule, one Commissioner questioned its value, arguing that it eliminates the distinction between an exempt reporting adviser and a registered adviser.[65]

Reporting Required. Rule 204-4 requires exempt reporting advisers to file reports with the Commission electronically on Form ADV through IARD using the same process used by registered investment advisers.[66] Information on how to file with IARD is available on the Commission's Web site at *www.sec.gov/iard*. An exempt reporting adviser must submit its initial Form ADV within 60 days of relying on the exemption from registration under either Section 203(l) or Section 203(m) of the Advisers Act.[67] Each Form ADV is considered filed with the Commission upon acceptance by IARD.[68] An exempt reporting adviser unable to file electronically as a result of unanticipated technical difficulties may, like a registered adviser, request a temporary hardship exemption of up to seven business days after the filing was due, but the application must be filed in paper format no later than one business day after the filing is due.[69] Advisers filing the form must pay a filing fee.[70] The Commission stated that it anticipates that filing fees will be the same as those for registered investment advisers, which currently range from $40 to $225 based on the amount of assets an adviser has under management.[71]

Information in Reports. The Commission made its changes to Form ADV to accommodate its use by exempt reporting advisers as follows. First, the Commission retitled the form to reflect its dual purpose. Second, the Commission revised the cover page to require exempt reporting advisers to indicate the type of report they are filing. An exempt reporting adviser must indicate whether it is submitting an initial report, an annual updating amendment, an other-than-annual amendment, or a final report. Finally, the Commission amended Item 2 of Part 1A, which requires advisers to indicate their eligibility for SEC registration, to add a new subsection B that requires an exempt reporting adviser to identify the exemption(s) on which it is relying to report, rather than register, with the Commission.

An exempt reporting adviser must check that it qualifies for an exemption from registration: (1) as an adviser solely to one or more venture capital funds; and/or (2) because it acts solely as an adviser to private funds and has assets under management in the United States of less than $150 million.[72] An exempt reporting adviser relying on the latter exemption, for private fund advisers, must also indicate the amount of private fund assets it manages in Section 2.B. of Schedule D to Form ADV, Part 1A.

Exempt reporting advisers must complete seven items of Form ADV: Items 1 (Identifying Information), 2.B. (SEC Reporting by Exempt Reporting Advisers), 3 (Form of Organization), 6 (Other Business Activities), 7 (Financial Industry Affiliations and Private Fund Reporting), 10 (Control Persons), and 11 (Disclosure Information). Exempt reporting advisers also must complete corresponding Sections of Schedules A, B, C, and D.

Public Availability of Reports. The Commission determined to make the reports of exempt reporting advisers publicly available. It stated that doing so would provide a level of transparency that will help the Commission to identify practices that may harm investors, aid investors in conducting their own due diligence, deter advisers' fraud and facilitate earlier discovery of potential misconduct.

Updating Requirements. As amended, Rule 204-1 requires an exempt reporting adviser, like a registered adviser, to amend its reports on Form ADV: (1) at least annually, within 90 days of the end of the adviser's fiscal year; and (2) 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.

Final Reports. When an adviser ceases to be an investment adviser, an exempt reporting adviser or when it applies for registration with the Commission, new Rule 204-4 requires the adviser to file an amendment to its Form ADV to indicate that it is filing a final report.[73] Final report filings will allow the Commission to distinguish such a filer from one that is failing to meet its filing obligations. An adviser that failed to file a final report would violate Rule 204-4(f). 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.[74]

While an application is pending, but before it is approved, an adviser may continue to operate as an exempt reporting adviser in accordance with the terms of the relevant exemption.[75] The Commission noted during this pendency period, an adviser transitioning from exempt reporting to registered would violate the Advisers Act registration requirement if it provides advisory services to a client that is not a private fund before the Commission approves its application for registration.

The Commission stated that an adviser that has complied with all of its reporting obligations as an exempt reporting adviser may continue advising private fund clients for up to 90 days after filing an annual updating amendment indicating that it has private fund assets of $150 million or more before filing its final report and application for registration.[76] The transition period is not available to advisers relying on the "venture capital adviser" exemption in Section 203(l) of the Advisers Act. Advisers seeking to rely on that exemption may not accept a client that is not a venture capital fund without first registering under the Adviser Act.[77]

Compliance Dates. Exempt reporting advisers must file their first reports on Form ADV through IARD between January 1 and March 30, 2012.

Examinations. The Commission indicated that it does not anticipate that the staff will conduct compliance examinations of exempt reporting advisers on a regular basis. Nonetheless, the Commission has the authority under Section 204(a) of the Advisers Act to examine records of exempt reporting advisers and would do so if it receives indications of wrongdoing, *e.g.,* those examinations prompted by tips, complaints, and referrals.

Form ADV

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 required advisers to provide additional information about private funds they advise.[78] Second, the Commission expanded the data advisers must 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 required additional information about advisers' non-advisory activities and their financial industry affiliations. Some additional changes to Form ADV 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

Rule 206(4)-5 contains the SEC's pay to play rule, which prior to the rules, generally applied only to registered investment advisers. The SEC's pay to play had several restrictions relating to, among other things, payments to government officials or political parties, as well as restrictions on an investment adviser's ability to use placement agents with respect to government entities.

The Commission amended Rule 206(4)-5 to address certain consequences arising from the Dodd-Frank Act's amendments to the Advisers Act and the Exchange Act. First, 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.[79] 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.[80]

Second, the SEC amended the rule to add municipal advisers 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.[81] To qualify as a "municipal adviser" (and thereby a "regulated person"), a solicitor must be registered under Section 15B of the Exchange Act and subject to pay to play rules adopted by the Municipal Securities Rulemaking Board (MSRB).[82] Notably, for municipal advisers to qualify as "regulated persons," the Commission must find that applicable MSRB pay to play rules: (1) impose substantially equivalent or more stringent restrictions on municipal advisers than the pay to play rule imposes on investment advisers; and (2) are consistent with the objectives of the pay to play rule.[83] The amended rule retains the approach of the current rule by permitting advisers to compensate persons that are "regulated persons" for soliciting government entities if they are subject to restrictions at least as stringent as the pay to play rule.

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 also adopted amendments to Rule 204-2 under the Advisers Act, the "books and records" rule. The amendments, among other things, update 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 "private advisers" exemption is eliminated. The Commission will require these investment advisers, as discussed above, to register by March 30, 2012. Upon registration, these advisers will become subject to the recordkeeping requirements of the Advisers Act, including the requirement to keep records relating to performance.[84] The amendment clarifies that these advisers are not obligated to keep performance-related records for any period when they were not registered with the Commission; however, to the extent that these advisers preserved these performance-related records even though they were not required to keep them, they must continue to preserve them.[85]

Conclusion

The Dodd-Frank Act eliminates the "private advisers" exemption in Section 203(b)(3). While it eliminates this "private advisers" exemption, it generally raises the floor for Advisers Act registration and creates certain new additional exemptions. Accordingly, certain investment advisers that previously did not have to register will now be required to register, while other investment advisers that previously were required to register will now be ineligible to register. Part II of this article will focus on the new Advisers Act exemptions.

NOTES

1. The exemption did not apply to advisers to registered investment companies and "business development companies."
2. Rule 203-1(e); Release No. IA-3221, Rules Implementing Amendments to the Investment Advisers Act of 1940.
3. Dodd-Frank Act, Section 407.
4. Dodd-Frank Act, Section 408.
5. Dodd-Frank Act, Section 409.
6. Advisers Act, Section 203A(b).
7. *See* 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. Note that we previously discussed the proposed exemptions release in Kenneth Muller and Seth Chertok: *Registration of Private Equity Advisers*, INSIGHTS, VOL. 25 NUMBER 1 (January 2011).
8. Release No. IA-3220, Family Offices.
9. Note that we previously discussed the proposed implementing release in Kenneth Muller and Seth Chertok: *Registration of Private Equity Advisers*, INSIGHTS, VOL. 25 NUMBER 1 (January 2011).
10. Release No. IA-3221, Rules Implementing Amendments to the Investment Advisers Act of 1940. Note that we previously discussed the proposed family offices release in Kenneth Muller and Seth Chertok: *The SEC's Proposed Rule Regarding the Family Offices Exemption*, BLOOMBERG LAW REPORTS—SECURITIES LAW, VOL. 4 NO. 50 (December 13, 2010). In the final release, the SEC adopted the relevant Rules substantially as proposed but also made several modifications.

11. *See* 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.

12. *See, e.g.*, The National Mutual Group, 1993 SEC No-Act. LEXIS 384 (March 8, 1993).

13. Advisers Act, Section 203.

14. Protecting Investors: A Half Century of Investment Company Regulation, 1992 SEC LEXIS 3489 (May, 1992); Gim-Seong, SEC No-Action Letter, 1987 SEC No-Act. LEXIS 2789 (Nov. 30, 1987).

15. *Id*.

16. *Id*.

17. Murray Johnstone Holdings Limited; Murray Johnstone Limited; Murray Johnstone International Limited, 1994 SEC No-Act. LEXIS 734 (Oct. 7, 1994).

18. The National Mutual Group, 1993 SEC No-Act. LEXIS 348 (March 8, 1993).

19. Royal Bank of Canada, Royal Bank of Canada Investment Management (US) Limited, Royal Bank of Canada Investment Management (USA) Limited, 1998 SEC No-Act. LEXIS 620 (June 3, 1998).

20. Uniao de Bancos de Brasileiros S.A., SEC Staff No-Action Letter (Jul. 28, 1992).

21. Dodd-Frank, Section 410; Advisers Act, Section 203A(a)(2)(B).

22. Form ADV, Part 1A, Items 2.A.(3), 2.A.(4).

23. Rule 203A-5(a).

24. Rule 203A-1(a)(1). This provision does not apply if the investment adviser is an investment adviser to a registered investment company or a BDC, or if the investment adviser is eligible for an exemption in Rule 203A-2. Rule 203A-1(a)(2). In addition, advisers that rely on amended Rule 203A-2(c) to register with the SEC (because they expect to be eligible for registration within 120 days) cannot rely on the buffer and must have $100 million of assets under management within 120 days to remain registered with the SEC. *See* Form ADV: Instructions for Part 1A, instrs. 2.a., 2.g. *See also* amended Rule 203A-1(a)(2)(ii); amended Rule 203A-2(c).

25. Advisers Act, Section 203A(a)(1).

26. U.S. jurisdictional means in discussed in “Non-U.S. Advisers” below.

27. Rule 203A-1(a); Advisers Act, Section 202(a)(11); Dodd-Frank Act, Section 410.

28. Dodd-Frank, Section 410; Advisers Act, Section 203A(a)(2)(B). A mid-sized adviser that relies on an exemption from registration with its home state would not be considered to be “required to be registered” with its home state. *See* Form ADV: Instructions for Part 1A, instr. 2.b.

29. U.S. jurisdictional means in discussed in “Non-U.S. Advisers” below.

30. Release No. IA-3221, Rules Implementing Amendments to the Investment Advisers Act of 1940, at fn. 106.

31. Section 203A(a)(2)(A) of the Advisers Act provides as follows: “No investment adviser described in subparagraph (B) shall register under Section 203, unless the investment adviser is an adviser to an investment company registered under the Investment Company Act of 1940, or a company that has elected to be a business development company pursuant to Section 54 of the Investment Company Act of 1940, and has not withdrawn the election, except that, if by effect of this paragraph an investment adviser would be required to register with 15 or more States, then the adviser may register under Section 203.

32. Rule 203A-1(a).

33. Advisers Act, Section 203A; Section 202(a)(11); Rule 203A-1(a).

34. Form ADV, Part 1A, Item 2.A.(12).

35. Rule 203A-5(b). The Commission stated that after this period, it expected to cancel the registration of advisers no longer eligible to register with the Commission that fail to file an amendment or withdraw their registrations in accordance with the Rule. *See* Advisers Act, Section 203(h).

36. The Commission stated that advisers will report the current market value of their assets under management determined within 90 days of the filing.

37. Rule 203A-5(b).

38. Rule 203A-5(c)(1). During this period while an investment adviser is registered with both the Commission and one or more state securities authorities, the Advisers Act and applicable State law will apply to the investment adviser’s activities. *Id*. If, prior to the effective date of the withdrawal from registration of an investment adviser on Form ADV-W, the Commission has instituted a proceeding pursuant to Section 203(e) of the Advisers Act to suspend or revoke registration, or pursuant to Section 203(h) to impose terms or conditions upon withdrawal, the withdrawal from registration shall not become effective except at such time and upon such terms and conditions as the Commission deems necessary or appropriate in the public interest or for the protection of investors. Rule 203A-5(c)(2).

39. Rule 203A-5(a).

40. Advisers Act, Section 203A(a)(2).

41. Advisers Act, Section 203A(b).

42. Form ADV: Instructions for Part 1A, instr. 5.b.

43. *See* Form ADV: Instructions for Part 1A, instr. 5.b.

44. *See* Form ADV: Instructions for Part 1A, instr. 5.b

45. Rule 203A-3(d).

46. Form ADV: Instructions for Part 1A, instr. 5.b.(1).

47. *See* Form ADV: Instructions for Part 1A, instr. 5.b.(2).

48. Advisers that have discretionary authority over fund assets, or a portion of fund assets, and that provide ongoing supervisory or management services over those assets would exercise continuous and regular supervisory or management services. *See* Form ADV: Instructions for Part 1A, instr. 5.b.(3).

49. *See* Form ADV: Instructions for Part 1A, instr. 5.b.(1).
50. *See* Form ADV: Instructions for Part 1A, instr. 5.b.(1).
51. *See* Form ADV: Instructions for Part 1A, instr. 5.b.(4). This valuation requirement is described in terms similar to the definition of "value" in the Investment Company Act, which looks to market value when quotations are readily available and, if not, then to fair value. *See* Investment Company Act, Section 2(a)(41).
52. Rule 203A-1(b)(2).
53. Rule 203A-1(b)(1).
54. Rule 203A-1(b)(2).
55. *See* Rule 203A-2(a).
56. Rule 203A-2(a).
57. An adviser currently relying on the exemption, but that advises plan assets of less than $200 million and files an annual updating amendment to its Form ADV following the compliance date of the amended Rule, will be required to withdraw from Commission registration within 180 days of the adviser's fiscal year end (unless the adviser is otherwise eligible for SEC registration). *See* Rule 203A-1(b)(2).
58. Rule 203A-2(d).
59. Rule 203A-2(d).
60. Rule 203A-2(d)(2)-(3).
61. Rule 203A-2(d)(2).
62. *See* Form ADV, Part 1A, Item 2.A.(2).
63. "Private fund" is defined as an issuer that would be an investment company, as defined in Section 3 of the Investment Company Act, but for Section 3(c)(1) or 3(c)(7) of that Act. The Commission stated that a "private fund" includes a private fund that invests in other private funds.
64. Dodd-Frank Act, Section 408.
65. *See,* eg., Statement of Commissioner Kathleen L. Casey, Statement at SEC Open Meeting—Rules Implementing Amendments to the Investment Advisers Act of 1940; Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers (June 22, 2011), available at *http://www.sec.gov/news/speech/2011/spch062211klc-items1-2.htm* ("To be clear, my disagreement with the reporting requirements is not a mere quibble with which and how many Form ADV items are being required. Instead, I am deeply concerned by the wholesale lack of any principled, meaningful distinction drawn in the release between exempt advisers and registered advisers. Indeed, I believe it is not simply a function of degree, but of design. That is to say, I believe that the adoption of the current reporting requirements is only the first step in what will surely be an ongoing process of emptying the distinction between an 'exempt reporting adviser' and a "registered' adviser of all meaning.").
66. Rule 204-4(b).
67. *See* Form ADV: General Instruction 13.
68. Rule 204-4(c).
69. *See* Rule 204-4(e).
70. Rule 204-4(d).
71. The current fee schedule applicable to advisers applying for registration may be found on the Commission's Web site at *http://www.sec.gov/divisions/investment/iard/iardfee.shtml.*
72. *See* Form ADV, Part 1A, Item 2.B, questions 1 and 2.
73. Rule 204-4(f).
74. *See* Form ADV: General Instruction 15.
75. *See* Form ADV: General Instruction 15.
76. *See* Form ADV: General Instruction 15.
77. *See* Form ADV: General Instruction 15.
78. Note that real estate funds relying upon Section 3(c)(5)(C) of the Investment Company Act and investment companies not relying upon Section 3(c)(1) or Section 3(c)(7) would not fall within the definition of "private funds" and therefore would not be subjected to "private funds' information requirements.
79. Rule 206(4)-5.
80. Rule 206(4)-5(a).
81. Rule 206(4)-5(a)(2)(i)(A), (f)(9).
82. Rule 206(4)-5(f)(9)(iii).
83. Rule 206(4)-5(f)(9)(iii).
84. Rule 204-2(a)(16).
85. Rule 204-2(e)(3)(ii).