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SEC Adopts Final Rules Regarding Investment Adviser Registration

On June 22, 2011, the Securities and Exchange Commission (the "SEC") adopted final rules[1] which implement certain provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). Among other things, the final rules adopted by the SEC: (i) provide an extension to the SEC registration deadline for advisers currently relying on the "private adviser exemption," including hedge fund and private equity fund advisers, until March 30, 2012, (ii) implement exemptions from SEC registration for certain venture capital fund advisers, private fund advisers and foreign private advisers, (iii) reallocate regulatory oversight of investment advisers among the SEC and the individual states, (iv) expand disclosure obligations, (v) define the term "family offices" that are to be excluded from SEC regulation and (vi) revise the "pay-to-play" rule. Set forth below is a high-level summary of the final rules.

Extension of Registration Deadline

Prior to the Dodd-Frank Act, investment advisers commonly relied on an exemption from registration with the SEC under Section 203(b)(3) of the Investment Advisers Act of 1940 (the "Investment Advisers Act"), which is commonly referred to as the "private adviser exemption." This exemption exempted from SEC registration an investment adviser that did not hold itself out to the public as an investment adviser, had fewer than 15 clients during the preceding twelve months and was not an adviser to a registered investment company or a company that elected to be a business development company. Effective July 21, 2011, the Dodd-Frank Act will eliminate this exemption and many previously unregistered investment advisers will be required to register with the SEC. The rules adopted by the SEC provide that advisers that are relying on, and are entitled to rely on, the private adviser exemption on July 20, 2011, may delay registering with the SEC until March 30, 2012. Because initial applications for registration can take up to 45 days to be approved by the SEC, the SEC recommends that advisers relying on this transition provision to remain unregistered until March 30, 2012 file a complete application on Form ADV by February 14, 2012.

Exemptions for Venture Capital Fund and Private Fund Advisers

The final rules implement exemptions from SEC registration for certain venture capital fund advisers and private fund advisers which were mandated by the Dodd-Frank Act. Although exempt from registration with the SEC as described below, the Dodd-Frank Act requires these advisers to maintain certain records and file reports with the SEC. In addition, such investment advisers must still comply with any applicable state investment adviser registration requirements even though they are not required to register with the SEC.

Venture Capital Fund Advisers

The final rules provide that investment advisers that act solely as an adviser to venture capital funds are exempt from SEC registration. In summary, the SEC's final rules define a "venture capital fund" as a fund 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 borrowings (excluding certain guarantees of qualifying portfolio company obligations by the fund);

- does not offer redemption rights or other similar liquidity rights to its investors 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 and has not elected to be treated as a business development company.

The final rules also grandfather any existing fund as a venture capital fund if the fund: (i) represented to investors and potential investors at the time the fund offered its securities that it was pursuing a venture capital strategy, (ii) prior to December 31, 2010, sold securities to one or more investors that are not related persons of any investment adviser of the venture capital fund and (iii) does not sell any securities to, including accepting any additional capital commitments from, any person after July 21, 2011. An adviser is eligible to rely on the venture capital exemption only if it solely advises venture capital funds that meet all of the elements of the definition or funds that have been grandfathered.

Private Fund Advisers

The final rules provide that investment advisers that act solely as an adviser to "private funds" and have assets under management in the United States of less than $150 million are exempt from SEC registration. The final rules treat U.S. advisers (advisers with a principal office and place of business in the United States) differently than non-U.S. advisers. Under the final rules, all of the private fund assets of a U.S. advisor 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.[2]

A private fund is defined as any private fund that is not registered under Section 8 of the Investment Company Act of 1940 and has not elected to be treated as a business development company. An adviser that has one or more clients that are not private funds is not eligible for the exemption and must register under the Investment Advisers Act unless another exemption is available.[3] A private fund adviser may advise an unlimited number of private funds and still qualify for the exemption, provided that the assets under management are below the threshold, which is measured annually.

Reporting Requirements for Exempt Reporting Advisers

Advisers exempt from SEC registration under the venture capital and private fund exemptions are referred to herein as "exempt reporting advisers." Although exempt from registration with the SEC as described above, the final rules require these exempt reporting advisers to submit to the SEC, and to periodically update, reports that consist of a limited subset of items contained in Form ADV. Such reports must include information such as business description and ownership, funds under management, conflicts of interest and the disciplinary history of the adviser and its employees. Exempt reporting advisers are required to file an initial Form ADV with the SEC between January 1, 2012 and March 30, 2012.

During the open meeting in which the final rules were adopted, SEC Chairman Mary L. Schapiro indicated that although the SEC does not intend to routinely examine exempt reporting advisers, the SEC will maintain authority to do so. In addition, the SEC has asked its staff to consider and report on the adequacy of the level of reporting by these exempt reporting advisers after review of the first year's filings.

Recordkeeping requirements for exempt reporting advisers will be addressed in a future release.

Reallocation of Regulatory Oversight; Mid-Sized Advisers

Regulatory oversight for investment advisers is divided between the SEC and the states, primarily based on the amount of money an adviser manages for its clients. Prior to the Dodd-Frank Act, advisers generally could not register with the SEC unless they had at least $25 million in assets under management. The Dodd-Frank Act raised this threshold to $100 million and created a new category of advisers called "mid-sized advisers."

A mid-sized adviser is an investment adviser that (i) manages between $25 million and $100 million in assets, (ii) is required to be registered in the state where it maintains its principal office and place of business and (iii) would be subject to examination by that state, if required to register (all states, other than Wyoming, Minnesota and New York, have confirmed to the SEC that they will subject advisers registered with them to examination). Effective July 21, 2011, mid-sized advisers will generally be prohibited from registering with the SEC and will instead be regulated by the states. However, advisers with between $25 million and $100 million in assets under management and which have their principal offices and places of business in Wyoming, New York or Minnesota will have to register with the SEC, unless an exemption from registration is applicable.

Most mid-sized advisers currently registered with the SEC will need to withdraw their registration and register with one or more state securities authorities. The rules provide that all SEC registered advisers must file an amended Form ADV by March 30, 2012, in which they will indicate whether they are eligible to remain registered with the SEC. If an adviser is no longer eligible, it must withdraw its SEC registration by June 28, 2012 by filing a form ADV-W. Mid-sized advisers registered with the SEC as of July 21, 2011, must remain registered with the SEC (unless an exemption from SEC registration is available) until January 1, 2012.

Changes to Form ADV

Investment advisers required to register as a result of the Dodd-Frank Act must file Form ADV with the SEC, which is the investment adviser registration form. The final rules amended Form ADV to require inclusion of certain additional information. The amended Form ADV will require:

- basic organizational and operational information about each private fund the investment adviser manages, such as the type of fund (i.e., hedge, private equity or liquidity), general information about the size and ownership of the fund, general fund data, and the adviser's services to the fund; and
- identification of five categories of "gatekeepers" that perform critical roles for investment advisers and the private funds they manage (i.e., auditors, prime brokers, custodians, administrators and marketers).

The SEC indicated that these expanded reporting requirements are designed to help identify practices that may harm investors, deter fraud and facilitate earlier discovery of potential misconduct. The SEC also stated that this information will provide important statistical data regarding the asset management industry.

Form ADV was also amended to require that all registered advisers provide more information regarding their advisory business, including information about:

- the types of clients they advise, their employees, and their advisory activities; and
- their business practices that may present conflicts of interest.

In addition, the amendments to the Form ADV will require registered advisers to disclose additional information regarding their non-advisory activities and their financial industry affiliations.

Other Rules Adopted

Foreign Private Adviser Exemption

The Dodd-Frank Act amended the Investment Advisers Act to provide an exemption from registration with the SEC for "foreign private advisers." The final rules clarify when a foreign adviser must register with the SEC. The exemption from registration is available to a foreign adviser that: (i) has no place of business in the United States, (ii) 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, (iii) 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 (iv) does not hold itself out generally to the public in the United States as an investment adviser.

Family Office Rule

The final rules also create an exemption from registration with the SEC for "family offices." A family office is an entity which: (i) provides investment advisory services only to clients who are "family clients," (ii) is wholly-owned by family clients and is exclusively controlled by "family members," and/or "family entities" and (iii) does not hold itself out as an investment adviser.

Pay-to-Play Rule

The final rules amend the existing investment adviser "pay-to-play" rule in order to permit an adviser to pay a registered municipal advisor to act as a placement agent to solicit government entities on its behalf, if the municipal advisor is subject to a pay-to-play rule adopted by the Municipal Securities Rulemaking Board that is at least as stringent as the investment adviser pay-to-play rule. The rules also extended the date by which advisers must comply with the ban on third-party solicitation from September 13, 2011 to June 13, 2012. In addition, the amendments provide that the "pay-to-play" rule is applicable to exempt reporting advisers and foreign private advisers.

Conclusion

The final rules significantly change the regulatory environment for investment advisers. Although the final rules provide some certainty, the practical implications of the rules for investment advisers and their business practices remain to be seen. Fund managers advising existing funds, as well as contemplated funds, should assess with counsel to what extent the final rules will require registration and/or reporting with the SEC or with state securities commissions. We will be working closely with our clients to determine the impact of the new rules and assist with compliance. Please contact the attorneys listed here with any questions or concerns.

1. See Investment Advisers Act Release No. 3220 (June 22, 2011), available at http://sec.gov/rules/final/2011/ia-3220.pdf; Investment Advisers Act Release No. 3221 (June 22, 2011), available at http://sec.gov/rules/final/2011/ia-3221.pdf; Investment Advisers Act Release No. 3222 (June 22, 2011), available at http://sec.gov/rules/final/2011/ia-3222.pdf.

2. Any assets managed at a place of business in the United States for clients other than private funds would make the exemption unavailable.

3. In the case of a non-U.S. adviser, the exemption is available as long as *all* of the adviser's clients that are "United States persons" are private funds. As a consequence, a non-U.S. adviser may enter the U.S. market and take advantage of the exemption without regard to the type or number of its non-U.S. clients or the amount of assets it manages outside the United States.

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