DAY PITNEY LLP

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SEC Proposes Rules on Investment Adviser Registration

The SEC recently issued proposed rules and rule amendments under the Investment Advisers Act of 1940 (the "Advisers Act") that would give effect to certain provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). The proposed rules were set forth in two releases. In one release, the SEC proposed rules for the reallocation of responsibility for the oversight of certain mid-sized investment advisers between the states and the SEC, changes to Form ADV, reporting requirements for exempt private advisers, and amendments to the SEC's "pay-to-play" rules. In the other release, the SEC proposed rules to implement the new venture capital, private fund adviser, and foreign private adviser exemptions from investment adviser registration. The key provisions of these proposed rules and rule amendments are summarized below.

Implementation of Amendments to the Advisers Act

Eligibility for SEC Registration

The Dodd-Frank Act raises the threshold for SEC registration of investment advisers to $100 million in assets under management, and creates a new category of "mid-sized advisers" for advisers with assets under management between $25 million and $100 million. Under the Dodd-Frank Act, mid-sized advisers are not permitted to register with the SEC, unless the adviser:

- is not required to be registered as an investment adviser with the regulator of the state in which it maintains its principal office and place of business;
- would not be subject to examination if registered with the state regulator;
- is an adviser to an investment company registered under the Investment Company Act of 1940 (the "Investment Company Act") or a "business development company" pursuant to Section 54 of the Investment Company Act; or
- would be required to register in 15 or more states.

Related practice areas:

Private Equity and Investment Funds

Broker-Dealers, Investment Advisers and Commodities Firms

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The SEC has proposed rules and rule amendments to clarify the application of the new statutory provisions, modify certain SEC exemptions from the prohibition on registration, and provide for a transitional process for advisers no longer eligible for SEC registration. The SEC has also proposed amendments to Form ADV to identify advisers that must transition to state regulation.

Notably, a mid-sized adviser that relies on an exemption from registration under the law of the state in which it has its principal office and place of business is deemed to be “not required to be registered” with the state. Accordingly, such an adviser would be required to register with the SEC unless the adviser qualifies for another exemption from federal registration. With respect to the examination requirement, the SEC intends to request certification from each state’s securities regulator as to whether an adviser registered in the state would be subject to examination, and incorporate a list of states that do not provide for an examination into the Investment Adviser Registration Depository (“IARD”).

To determine its eligibility for SEC registration based on its “regulatory assets under management,” an adviser must calculate the securities portfolios with respect to which the adviser provides “continuous and regular supervisory or management services.” Currently, instructions to Form ADV provide guidance in applying the provision. The SEC proposes to modify the instructions to establish a uniform method in how assets under management are calculated for various regulatory purposes. Changes from the current calculation method are:

- the mandatory inclusion of proprietary assets, assets managed without receiving compensation, and assets of foreign clients;
- the prohibition on subtracting outstanding indebtedness and other accrued but unpaid liabilities that remain in a client’s account and are managed by the adviser;
- the inclusion of the value of any private fund, regardless of the nature of the assets held by the fund, and any uncalled capital commitments made to the fund; and
- the requirement that the fair value, not the cost basis, of private fund assets be used.

Additionally, the SEC proposes to amend Form ADV to require an investment adviser to indicate its basis for registration with the SEC and to report annually its eligibility to remain so registered.

The proposed rules would require advisers that are no longer eligible for SEC registration to withdraw their registrations. Advisers registered with the SEC as of July 21, 2011 would have a 90-day transition period during which (1) to file an amendment to their Form ADV no later than August 20, 2011 to report the market value of their assets under management determined within 30 days prior to the filing; and (2) if no longer eligible to be registered with the SEC, to withdraw their registration with the SEC and register with the applicable state regulators by October 19, 2011, unless they are eligible for a state exemption.

Amendments to Form ADV

The SEC proposes to amend Form ADV to require additional information about an adviser's operations in an effort to enhance the SEC's ability to oversee investment advisers. The amendments would expand the information required to be disclosed with respect to the following:

- Identifying information for private funds managed by such adviser, including basic organizational, operational and investment characteristics of the fund, the amount of assets held by the fund, the nature of the investors in the fund, and the fund's "gatekeepers" (i.e., primary service providers)
- The adviser's employees, the composition of the adviser's clients and the nature and scope of services the adviser provides
- The adviser's other business activities and financial industry affiliations
- The adviser's participation in client transactions, including broker-dealer relationships, use of "soft dollars," and referral compensation

The amended Form ADV would also require advisers to indicate whether the adviser had $1 billion or more in assets in the prior fiscal year and, therefore, would be subject to the excessive incentive-based compensation regulations of the Dodd-Frank Act. Form ADV information would be publicly available, and the SEC expects it would be used by investors to supplement their due diligence efforts.

Requirements for Exempt Reporting Advisers

The Dodd-Frank Act directs the SEC to create new exemptions for venture capital fund and certain other private fund advisers (discussed below) and subject such "exempt reporting advisers" to recordkeeping and reporting requirements as the SEC determines to be necessary or appropriate in the public interest. The SEC has proposed to require exempt reporting advisers to file, and update, reports electronically on Form ADV that would provide the SEC with the following:

- Basic organizational and ownership information
- Information regarding other business activities of the adviser and its affiliates that may pose conflicts of interest and significant risks to clients
- The disciplinary history of the adviser and its employees

- With respect to each private fund the adviser manages, information about its ownership, service providers and total and net assets

Initial reports would be required to be filed with the SEC no later than August 20, 2011.

Pay-to-Play Rules

As a result of the Dodd-Frank Act, the SEC determined that the "pay-to-play" rule adopted last July should be amended, and has proposed rules to (1) broaden the scope of the rule to apply to exempt reporting advisers and foreign private advisers and (2) permit an adviser to pay a municipal adviser, registered under the Securities Exchange Act and subject to the pay-to-play rules adopted by the Municipal Securities Rulemaking Board, to solicit government entities.

New Exemptions from Investment Adviser Registration

The Dodd-Frank Act eliminates the "private adviser exemption" contained in Section 203(b)(3) of the Advisers Act upon which many hedge fund and other private fund advisers have historically relied. Under the private adviser exemption, an adviser that advised fewer than 15 clients on a rolling 12-month basis and neither held itself out to the public as an adviser nor acted as an adviser to a registered investment company was exempt from registration as an investment adviser.

While removing the private adviser exemption, the Dodd-Frank Act creates new exemptions for private fund advisers, advisers to venture capital funds, and foreign private advisers. The SEC has now proposed rules to implement these new exemptions. The exemptions are not mandatory and an adviser that qualifies for an exemption can still choose to register (unless the adviser is otherwise prohibited from registering with the SEC). However, an adviser that avails itself of one of these federal exemptions may still be subject to state registration. In addition to the exemptions described below, the Dodd-Frank Act also provides exemptions for advisers to family offices and small business investment companies regulated by the Small Business Administration. The SEC previously proposed a rule in a separate release with respect to the family office exemption.

Private Fund Adviser Exemption

The Advisers Act, as amended by the Dodd-Frank Act, directs the SEC to provide an exemption from registration under the Advisers Act to an investment adviser that solely advises "private funds" and has less than $150 million in assets under management in the United States. The Dodd-Frank Act defines the term "private fund" to mean an issuer that would be an investment company under the Investment Company Act, but for section 3(c)(1) or 3(c)(7) of the Investment Company Act.

Under the SEC's proposed rule, an investment adviser with its principal office and place of business in the United States would be exempt from registration if the adviser acts solely as an investment adviser to qualifying private funds and manages private fund assets of less than $150 million. For purposes of the exemption, an adviser would have to aggregate the value of the assets of all the private funds it manages in the United States, including any uncalled capital commitments with respect to such funds, on a quarterly basis using the new calculation method provided in Form ADV. All the private fund assets of a U.S. adviser would be included, even if the adviser has offices outside the United States.

The exemption would also be available to non-U.S. advisers who have their principal office and place of business outside of the United States, as long as all the adviser's clients that are United States persons (in general, as defined in Regulation S of the Securities Act of 1933 (the "Securities Act") are qualifying private funds. A non-U.S. adviser would only need to count private fund assets it manages from a place of business in the United States toward the $150 million threshold.

The proposed rule provides a transition period of one calendar quarter to register with the SEC after becoming ineligible to rely on the private fund adviser exemption. The safe harbor transition period would only be available to investment advisers who have complied with all applicable reporting requirements.

Venture Capital Fund Exemption

An investment adviser that solely advises venture capital funds is exempt from registration under the Advisers Act. The SEC's proposed rule defines the term "venture capital fund" as a private fund that:

- owns solely (i) equity securities of one or more "qualified portfolio companies," and at least 80% of each qualified portfolio company's securities owned by the fund was acquired directly from the qualifying portfolio company and (ii) cash and cash equivalents and U.S. Treasuries with a remaining maturity of 60 days or less;
- offers or provides significant managerial assistance to, or controls, the qualifying portfolio companies;
- does not borrow or otherwise incur leverage (i) in excess of 15% of the fund's aggregate capital contributions and uncalled committed capital and (ii) for a nonrenewable term of more than 120 calendar days;
- issues securities that do not provide its investors redemption or other similar liquidity rights except in extraordinary circumstances (but may entitle investors to *pro rata* distributions);
- represents itself as a venture capital fund to investors; and

- is not registered under the Investment Company Act of 1940 and has not elected to be treated as a “business development company” as defined thereunder.

A “qualifying portfolio company” is any company that (i) is not publicly traded, (ii) does not incur leverage in connection with the investment by the fund, (iii) uses the capital provided by the fund exclusively for operating or business expansion purposes rather than to buy out other investors, and (iv) is not itself a fund.

The proposed rule includes a grandfathering provision that includes within the definition of “venture capital fund” any private fund that (i) has sold securities to investors not affiliated with any investment adviser of the fund prior to December 31, 2010, (ii) does not sell any securities to (including accepting any capital commitments from) investors after July 21, 2011, and (iii) represented to investors and potential investors at the time of offering that it is a venture capital fund.

Foreign Private Adviser Exemption

The Dodd-Frank Act creates a new foreign private adviser exemption for an investment 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 Sates as an investment adviser. The Dodd-Frank Act grants the SEC authority to raise the $25 million threshold for such exemption, but the SEC did not modify such threshold in its proposed rule.

In its proposed rule, the SEC has provided the following definitions and safe harbors for several of the terms set forth in the new statutory exemption:

- A safe harbor rule for counting clients that is substantially similar to the client counting rules currently in effect
- A definition for “investor” that largely references determinations made under sections 3(c)(1) and 3(c)(7) of the Investment Company Act, but notably would include “knowledgeable employees” with respect to the private fund and certain other persons related to such employees
- A definition for “in the United States” that generally incorporates the definitions under Regulation S of the Securities Act
- A definition for “place of business,” which means a location or office held out to the public as a location at which the adviser regularly provides investment advisory services or otherwise communicates with clients

- A definition for “assets under management,” which means the assets under management determined in accordance with new Form ADV (see discussion of Form ADV amendments above)
- A safe harbor for “holding out,” such that an adviser will not be deemed to be holding itself out as an investment adviser solely because the adviser participates in a nonpublic offering in the United States of securities issued by a private fund under the Securities Act

These proposed rules and rule amendments were issued by the SEC on November 19, 2010 and published in the Federal Register on December 10, 2010. The period for submitting comments to the SEC on the proposals will run until January 24, 2011. Day Pitney team members actively monitor legislation that affects our clients and will continue to monitor developments in this area.

To view the full text of the releases, follow the links below:

Release No. IA-3110

Release No. IA-3111

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