DAY PITNEY LLP

July 11, 2011

SEC Adopts Rules Implementing Dodd-Frank Investment Adviser Registration and Exemption Requirements

The Securities and Exchange Commission ("SEC") recently issued final rules and rule amendments implementing certain provisions of Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") that amend the Investment Advisers Act of 1940, as amended ("Advisers Act"). The new rules are of particular importance to private fund managers and others evaluating whether they must register as investment advisers with the SEC or whether they can rely on an exclusion from the definition of "investment adviser" in the Advisers Act or on certain exemptions from registration created by Dodd-Frank.

The final rules are described in two adopting releases issued by the SEC. The "Registration Release" sets forth final rules implementing certain amendments to the Advisers Act required by Dodd-Frank, including:

- increasing the statutory threshold for SEC registration, which will generally be $100 million in assets under management ("AUM") for most U.S. advisers;
- establishing new reporting and record-keeping requirements for certain advisers exempt from registration ("exempt reporting advisers");
- amending the SEC's "pay-to-play" rule, which reflects changes made by Dodd-Frank; and
- detailing various changes made to Form ADV in order to conform to the new rules.

The related release (the "Exemption Release") sets forth final rules implementing new exemptions, created by Dodd-Frank, from the registration requirements of the Advisers Act, including:

- defining "venture capital fund" for purposes of the new Advisers Act exemption for advisers to venture capital funds;
- exempting from registration certain private fund advisers with less than $150 million in private fund AUM in the United States; and
- clarifying the meaning of certain terms used in the new exemption for foreign private advisers.

In addition, the SEC issued a final rule implementing the definition of "family office" as required by Dodd-Frank. Such family offices are excluded from the definition of "investment adviser" and are thereby exempt from regulation under the Advisers Act. Dodd-Frank had tasked the SEC with providing a definition of "family office" that is consistent with past SEC exemptive orders. The definition

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contained in the final rule, as required by Dodd-Frank, also contains a grandfathering provision that includes in the definition of “family office” persons not registered or required to be registered under the Advisers Act on January 1, 2010, but would be so required under the new “family office” definition.

The SEC further announced **that the deadline for investment adviser registration for advisers previously relying on former section 203(b)(3) of the Advisers Act** (also known as the “private adviser” or “fewer than 15 clients” exemption), which is repealed by Dodd-Frank effective July 21, 2011, **is extended to March 30, 2012**. Insofar as the repeal of the private adviser exemption is effective as of July 21, 2011, advisers formed after July 20, 2011, may not avail themselves of the March 30, 2012, registration extension. The SEC further indicated that because the initial applications for registration can take up to 45 days to be approved, advisers relying on the Rule 203-1(e) transition provisions should file a complete application — both Part 1 and a brochure(s) meeting the requirements of Part 2 of Form ADV — no later than **February 14, 2012**.

The SEC did not provide an exemption for advisers to private equity firms similar to the exemption to advisers to venture capital firms. However, the House Financial Services Committee passed legislation in H.R. 1082 that would exempt advisers to private equity funds from the investment adviser registration and reporting requirements. The bill was amended to clarify that the exemption would apply only for funds that have not borrowed a principal amount in excess of twice their funded commitments. The full House of Representatives is not expected to consider H.R. 1082 until after Labor Day. Accordingly, for the time being, advisers to private equity funds remain subject to the provisions of the final rules.

The issuance of these final rules and the adoptive releases addresses many of the open questions arising from the rules first proposed by the SEC in October and November 2010, although many other issues will need to be clarified by the SEC in future guidance. This Alert provides a summary of the final rules and certain notable guidance provided by the SEC staff in the adopting releases.

Registration Eligibility — Increase of Threshold

Effective July 21, 2011, the minimum AUM threshold for SEC registration for most U.S. investment advisers (that do not manage registered investment companies or business development companies) will be:

- $100 million in general, but
- $25 million for advisers that are not subject to registration and examination in the state in which they maintain their principal offices and places of business or that otherwise would be required to register with 15 or more states.[1]

Investment advisers must indicate their eligibility to register with the SEC on Item 2.A. of Form ADV. An adviser may register with the SEC if it (i) falls into the category of a “large adviser” and has $100 million or more of AUM (or $90 million or more if an adviser is filing its most recent annual updating amendment and is already registered with the SEC); (ii) is what is referred to as a mid-sized adviser (those with AUM between $25 million and $100 million) that does not meet the criteria for state registration or is not subject to examination by the state; (iii) has its principal place of business in Wyoming or outside the United States; (iv) meets the requirements of one or more of the revised exemptive rules under section 203A of the Advisers Act; (v) is an adviser (or sub-adviser) to a registered investment company; or (vi) received an order permitting the adviser to register with the SEC.

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New Rule 203A-1 under the Advisers Act creates a "buffer" for mid-sized advisers that provides some flexibility for advisers when determining their registration status. The new Rule raises the threshold above which a mid-sized investment adviser must register with the SEC to $110 million from $100 million; but, once registered with the SEC, an adviser need not withdraw its registration unless and until it has less than $90 million of AUM.

Transition of Mid-Sized Advisers

Under Dodd-Frank, Congress transferred most of the regulatory burden of monitoring many smaller advisers to the states by increasing the threshold for SEC registration. To effectuate the transition of mid-sized advisers (those with AUM between $25 million and $100 million) pursuant to Dodd-Frank, the SEC adopted new Rule 203A-5 under the Advisers Act, which provides for the transition of mid-sized advisers to the appropriate regulatory body. Pursuant to the new Rule, until July 21, 2011, investment advisers applying for registration with the SEC that qualify as mid-sized advisers under section 203A(a)(2) of the Advisers Act may register with either the SEC or the appropriate state securities authority. Thereafter, all such mid-sized advisers are prohibited from registering with the SEC and must register as investment advisers with the appropriate state securities authority. Mid-sized advisers registered with the SEC as of July 21, 2011, must remain registered with the SEC (unless an exemption is available) until January 1, 2012.

Furthermore, new Rule 203A-5 under the Advisers Act requires all investment advisers registered with the SEC on January 1, 2012, to file an amendment to the adviser's Form ADV no later than March 30, 2012. This will identify those mid-sized advisers that are no longer eligible to remain registered with the SEC. Mid-sized advisers that are no longer eligible for SEC registration must withdraw their registration with the SEC by filing Form ADV-W within 90 days of filing their amended Form ADV. Accordingly, a mid-sized adviser no longer eligible for SEC registration must withdraw from registration by filing Form ADV-W no later than June 28, 2012.

Venture Capital Exemption

Section 203(l) of the Advisers Act, which was created by Dodd-Frank, provides an exemption from registration for venture capital fund advisers. In new Advisers Act Rule 203(l)-1, the SEC defines a "venture capital fund" as a private fund that:

> (i) Holds no more than 20 percent of the fund's capital commitments in "non-qualifying investments";
> (ii) Does not incur leverage in excess of 15 percent of its committed capital or for a term longer than 120 days;
> (iii) Does not offer redemption of investor interests except in extreme circumstances;
> (iv) Represents itself as pursuing a venture capital strategy to its investors and prospective investors; and
> (v) Is not registered under the Investment Company Act of 1940 or elected to be treated as a business development company.

The definition of "venture capital fund" includes a fund that invests a portion of its capital in investments that would not otherwise satisfy all the elements of Advisers Act Rule 203(l). The SEC stated that this 20 percent "non-qualifying basket" is intended to provide the flexibility sought by many venture capital funds while precluding an adviser relying on the exemption from altering the character of the fund's investments to such an extent that the fund could no longer be viewed as a venture capital fund.

A "qualifying investment" is defined by the SEC as:

(i) Any equity security issued by a qualifying portfolio company that is directly acquired by the private fund from the portfolio company;
(ii) Any equity security issued by a qualifying portfolio company in exchange for directly acquired equity issued by the same qualifying portfolio company; and
(iii) Any equity security issued by a company of which a qualifying portfolio company is a majority-owned subsidiary, or a predecessor, and is acquired by the fund in exchange for directly acquired equity.

Advisers Act Rule 203(l)-1 incorporates the definition of “equity security” from section 3(a)(11) of the Securities Exchange Act of 1934 and Rule 3a11-1 thereunder. Accordingly, “equity security” includes common stock, preferred stock, warrants and other securities convertible into common stock, in addition to limited partnership interests.

Additionally, Advisers Act Rule 203(l)-1 grandfathers as a venture capital fund any pre-existing private fund that (i) represented to investors and potential investors at the time the fund offered its securities that it pursues 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 securities in its fund to, including accepting any additional capital commitments from, any person after July 21, 2011. Advisers may rely on the Advisers Act section 203(l) venture capital exemption only if they exclusively advise venture capital funds that satisfy all the elements in the definition of “venture capital fund” or meet the requirements of the grandfathering provision.

Private Fund Adviser Exemption

Section 203(m) of the Advisers Act, enacted by Dodd-Frank, requires the SEC to provide an exemption from registration to any investment adviser that acts solely as an adviser to private funds[2] and has AUM in the United States of less than $150 million. New Advisers Act Rule 203(m)-1 implements this private fund adviser exemption and provides that an adviser may advise an unlimited number of private funds, as long as the aggregate value of the AUM of the private funds is less than $150 million, without triggering the requirement to register as an investment adviser with the SEC. Importantly, advisers with a principal office and place of business outside of the United States may avail themselves of the exemption as long as all the adviser’s clients that are U.S. persons are qualifying private funds. A non-U.S. adviser may take advantage of the exemption without regard to the type or number of its non-U.S. clients or the amount of AUM it manages outside of the United States.

New Advisers Act Rule 203(m)-1 requires that advisers annually measure and report their AUM on the adviser’s updated Form ADV. The methodology used to measure AUM now follows the uniform standards set forth in the newly adopted Form ADV. Advisers must include in their calculations proprietary assets and assets managed without compensation, as well as uncalled capital commitments. Additionally, advisers may not deduct liabilities, such as accrued fees and expenses or the amount of any borrowing. Advisers relying on the private fund adviser exemption that report AUM in excess of $150 million on their annual updating amendment have 90 days following such annual updating report to register as an investment adviser with the SEC.

Foreign Private Adviser Exemption

Section 403 of Dodd-Frank replaced the private adviser exemption provided by section 203(b)(3) of the Advisers Act with a new “foreign private adviser exemption.” Pursuant to section 202(a)(30) of the Advisers Act, a foreign private adviser is any 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 AUM attributable to clients in the United States in private funds advised by the investment adviser of less than $25 million; and (iv) does not hold itself out to the public in the United States as an investment adviser. Section 202(a)(30) of the Advisers Act also authorizes the SEC to increase the $25 million threshold "in accordance with the purposes of this title."

Additionally, Advisers Act section 202(a)(30) provides that foreign private advisers cannot have more than 14 clients or "other investors in the United States in private funds" advised by the foreign private adviser. An "investor" in a private fund is any person who would be included in determining the number of beneficial owners of the outstanding securities of a private fund owned exclusively by qualified purchasers under section 3(c)(7) of the Investment Company Act of 1940. In order to avoid double-counting, Advisers Act Rule 203(a)(30)-1 clarifies that an adviser may treat as a single investor any person who is an investor in two or more private funds advised by the foreign private adviser. Unlike the initial Proposed Rule, Rule 202(a)(30)-1 does not treat as investors those beneficial owners who are "knowledgeable employees" with respect to the private fund. Additionally, Rule 202(a)(30)-1 requires advisers to count as investors all holders of debt securities of the fund, including holders of short-term paper.

Exempt Reporting Advisers

New Advisers Act Rule 204-4 creates certain record-keeping and reporting requirements for (i) advisers to venture capital funds and (ii) private fund advisers with less than $150 million in AUM who are relying on Advisers Act sections 203(l) and 203(m) for exemptions from the registration requirements. Also referred to as "exempt reporting advisers," these advisers are required to submit to the SEC, and to periodically update, reports that consist of a limited subset of disclosure items on Form ADV. The exempt reporting advisers must submit their initial reports on Form ADV within 60 days of relying on the exemption from registration under either section 203(l) or 203(m) of the Advisers Act. Exempt reporting advisers must file their first reports on Form ADV through the Investment Adviser Registration Depository ("IARD") between January 1 and March 30, 2012. Such exempt reporting advisers must complete the following items of Part 1A of Form ADV: 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).

The SEC also amended Rule 204-1 under the Advisers Act to require exempt reporting advisers to amend their reports on Form ADV at least annually, within 90 days of the end of the adviser's fiscal year and more frequently if required by the instructions to Form ADV. Additionally, General Instruction 4 to Form ADV requires an exempt reporting adviser to update promptly Items 1 (Identifying Information), 3 (Form of Organization) and 11 (Disclosure Information) if they become inaccurate in any way and to update Item 10 (Control Persons) if such information becomes materially inaccurate.

The SEC indicated that although it does not intend to routinely examine exempt reporting advisers (including venture capital fund managers), it will maintain the authority to do so. The SEC has also directed its staff to consider and report on the adequacy of the level of reporting by exempt reporting advisers after one year following the submission of the first reports by such advisers.

Pay-to-Play Rule

The SEC also amended the pay-to-play rule[3] to provide that registered municipal advisers may act as solicitors for registered investment advisers that seek business from state and local governments. Amended Rule 206(4)-5, the pay-to-play rule, permits any "regulated person," which includes registered broker-dealers and investment advisers in addition to registered municipal advisers, to engage in third-party solicitation as long as the regulated person is subject to restrictions at least as stringent as those set forth in the pay-to-play rule. Additionally, the SEC amended the pay-to-play rule so that it continues to apply to advisers that previously relied on the private adviser exemption, including exempt reporting advisers and foreign private advisers.

Family Office Exclusion

Section 409(b) of Dodd-Frank required the SEC to define the term “family office.” Family offices are entities established by wealthy families to manage their wealth, plan for their families’ financial future, and provide other services to family members. Many family offices relied on the private adviser exemption from registration as an investment adviser with the SEC. As discussed, Dodd-Frank eliminated the private adviser exemption, effective July 21, 2011. Pursuant to Dodd-Frank’s section 409(b) mandate and new Rule 202(a)(11)(G)-1 of the Advisers Act, a “family office” will not be considered an investment adviser for purposes of the Advisers Act. This exclusion provides that family offices will not be subject to any of the registration, reporting, record-keeping or other compliance provisions required by the Advisers Act.

New Advisers Act Rule 202(a)(11)(G)-1 defines “family office” as an entity providing investment advisory services that (i) has only clients that are “family clients” (ii) is wholly owned by family clients and controlled by family members; and (iii) does not hold itself out to the public as an investment adviser. Rule 202(a)(11)(G)-1 also incorporates a grandfathering provision, as required by section 409(b) of Dodd-Frank.

Under new Rule 202(a)(11)(G)-1, “family clients” includes current and former family members, certain key employees of the family office and certain alter-ego entities formed for tax, charitable or estate-planning purposes. The Rule defines “family members” to include all lineal descendants of a common ancestor, as well as current and former spouses or spousal equivalents of those descendants, provided the common ancestor is no more than 10 generations removed from the youngest generation of family members.[4] These definitions permit a family office to provide investment advisory services to certain key employees and also to allow equity ownership by such key employees. The Rule does not, however, allow key employees to control the family office; the family office must be controlled solely by “family members.”

New Adviser Act Rule 202(a)(11)(G)-1 treats as “family clients” any nonprofit organization, charitable foundation, charitable trust or other charitable organization funded exclusively by one or more family clients. Family offices currently advising charitable or nonprofit organizations that have accepted funding from non-family clients have a transition period until December 31, 2013, before they must comply with this aspect of the exclusion. Accordingly, if the only reason the family office would not meet the exclusion is because it advises a nonprofit or charitable organization that currently holds non-family client funding, the family office may rely on the exclusion until December 31, 2013. In order for the exclusion to apply, however, a nonprofit or charitable organization advised by a family office cannot accept additional funding from non-family clients after August 31, 2011, unless the funding is the fulfillment of a pledge made prior to August 31, 2011.

As required by section 409(b) of Dodd-Frank, paragraph (e) of Rule 202(a)(11)(G)-1 provides that family offices that are exempt from registration under the Advisers Act on July 20, 2011, in reliance of the 203(b)(3) private adviser exemption and that do not meet the new family office exclusion are not required to register with the SEC until **March 30, 2012**. Additionally, the SEC noted in the release to Rule 202(a)(11)(G)-1 that it will not rescind exemptive orders issued previously to family offices under section 202(a)(11)(G) of the

Advisers Act. Accordingly, family offices currently operating under such exemptive orders may continue to rely on them.

The Family Office Rule will become effective on August 29, 2011.

Conclusion

The newly adopted SEC rules implementing the investment adviser amendments under Dodd-Frank create significant new compliance and regulatory issues for investment advisers. Now that the SEC has promulgated final exemptive rules and provided firm compliance deadlines, investment advisers must reexamine their registration requirements, potential exemption eligibility and the possibility of restructuring to satisfy the compliance requirements of the Advisers Act. In addition, the analysis does not end if it is determined that the adviser is exempt from registration because there are new filing and reporting requirements for exempt reporting advisers.

Please contact any of the attorneys listed to the right for guidance and instruction with respect to the new regulatory regime for investment advisers.

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[1] Notably, after conducting a 50-state survey, the SEC determined that Minnesota does not subject investment advisers to examination, and New York failed to respond to the survey. The SEC stated that it will treat New York as not subjecting investment advisers to examination. Therefore, investment advisers with their principal offices and places of business in Minnesota, New York or Wyoming (which does not regulate investment advisers) with AUM between $25 million and $100 million will now be required to register with the SEC.

[2] Section 202(a)(29) of the Advisers Act defines “private fund” as “an issuer that would be an investment company, as defined in section 3 of the Investment Company Act of 1940, but for section 3(c)(1) or 3(c)(7) of that Act."

[3] For a detailed discussion of the pay-to-play rule, please see the following Day Pitney Investment Management Compliance Update.

[4] Rule 202(a)(11)(G)-1 permits the family office to choose the common ancestor and to redesignate the common ancestor over time.

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