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SEC Adopts Significant Implementing Rules For Investment Advisers Under Dodd-Frank Act

Introduction

On June 22, 2011, the Securities and Exchange Commission (the "SEC") adopted rules, rule amendments and amendments to Form ADV (the "New Rules") under the Investment Advisers Act of 1940 (the "Advisers Act") to implement Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").

The New Rules were not adopted without some controversy. Two of the five SEC Commissioners voted against adopting new rules and amendments to register hedge fund and private fund advisers, and to impose reporting requirements on funds exempt from registration, arguing that the regulatory burdens of the new reporting requirements on venture capital advisers who are exempt from registration are too heavy, are contrary to congressional intent and would negatively impact capital formation. The SEC Commissioners unanimously voted to adopt rules to implement registration exemptions for venture capital fund advisers, advisers to private funds with less than $100 million in assets under management ("AUM") in the United States, and certain foreign advisers. The SEC Commissioners also unanimously voted to adopt a new rule defining "family offices" that are exempt from registration under the Advisers Act.

The SEC previously proposed rules for exemptions and implementation under the Dodd-Frank Act on November 19, 2010. Generally, the New Rules follow the SEC's rule proposals, but they do further clarify certain key definitions and other aspects of the provisions. The New Rules are extensive and the following is a summary of certain of their key provisions.

Extension of Private Adviser Exemption

The existing exemption from registration for an investment adviser having fewer than 15 clients during the course of the preceding 12 months and that does not hold itself out to the public as an investment adviser was scheduled to expire on July 21, 2011. Under the New Rules, advisers who are currently registered with the SEC will have to file by March 30, 2012, an updated Form ADV which provides the basis for their continued registration with the SEC. The SEC recommends filing such application by February 14, 2012 to meet that deadline. Advisers who will not be eligible for SEC registration under the new registration thresholds must file a Form ADV-W withdrawing that registration by June 28, 2012 and will be transferred to state regulation. The SEC estimates that approximately 3,200 advisers will no longer qualify to be registered with the SEC and will be required to register with the state in which they maintain their principal office and place of business.

Observation: Many states have exemptions from registration for investment advisers that are coordinated with the SEC's rules. While some states have already extended their own private adviser exemption to coincide with the New Rules' extension date of March 30, 2012, if a state does not do so by July 21, 2011, advisers relying on that state's exemption could be required to register with the state.

Increased Threshold for SEC Registration for Mid-Sized Advisers

Previously, absent an exemption, an adviser with under $25 million in AUM was required to register with the appropriate state securities authority while an adviser with over $30 million in AUM was required to register with the SEC, and an adviser with AUM of between $25 million and $30 million could opt to register with the appropriate state securities authority or the SEC. Under the New Rules, absent an exemption, an adviser with between $25 million and $100 million in regulatory AUM (a "mid-sized adviser") that is 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 is excluded from the definition of investment adviser, and if registered, would be subject to examination as an investment adviser, will have to switch from SEC registration to registration in the state where it maintains its principal office and place of business. Currently, Minnesota and New York have advised that they do not intend to subject their advisers to examination and Wyoming has no investment adviser law. 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. For purposes of applying the New Rules, AUM must be those that receive continuous and regular management and are calculated quarterly using fair-value and not cost-basis accounting.

In addition, amended rule 203A-2(d) under the Advisers Act permits all investment advisers who are required to register as an investment adviser with 15 or more states to register with the SEC.

Exemption for Private Fund Advisers with Less than $150 Million in AUM

The New Rules implement the Dodd-Frank Act's requirement to provide an exemption from registration for an adviser that acts solely as an adviser to private funds and has less than $150 million in AUM. This exemption requires that the private fund adviser is otherwise subject to SEC registration. A "private fund" is defined as an issuer that would qualify as an "investment company" under Section 3 of the Investment Company Act but for the exceptions under that section. Such exempt private fund advisers are still required to maintain records and provide annual or other reports, as required by the SEC.

Venture Capital Fund Exemption

The Dodd-Frank Act includes an exemption from registration with the SEC for investment advisers to one or more "venture capital funds." The New Rules implement this exemption and further define a venture capital fund as a private fund that:

- invests primarily in "qualifying investments" (generally, private operating companies that do not distribute proceeds from debt financings in exchange for the fund's investment in the company); may invest in a "basket" of non-qualifying investments of up to 20 percent of its committed capital; and may hold certain short-term investments;
- is not leveraged except for a minimal amount on a short-term basis;
- does not offer redemption rights to its investors; and
- represents itself to investors as pursuing a venture capital strategy.

Under a grandfathering provision, funds that began raising capital by the end of 2010 and represented themselves as pursuing a venture capital strategy would generally be considered venture capital funds. Advisers to venture capital funds will be required to maintain records and provide reports as discussed below and will further be subject to SEC examination.

Observation: Venture capital funds should review their agreements and disclosures and consider revising them as necessary to comply with the new definition of "venture capital fund."

Foreign Private Advisers

The Dodd-Frank Act included an exemption from registration for "foreign private advisers," as defined in Section 202(a)(30) of the Advisers Act. The New Rules require an adviser with no place of business in the United States to register with the SEC if, among other things: (i) it holds itself out to the public in the United States as an investment adviser; or (ii) (a) it has 15 or more clients and private fund investors in the United States, or (b) it has $25 million or more of AUM from clients and private fund investors in the United States, regardless of the number of clients or investors. The SEC noted that it was not withdrawing any relief previously given under the Unibanco line of no-action letters under which certain non-U.S. affiliates of registered investment advisers that advise only U.S. clients are exempt from registration.

Family Offices

The Dodd-Frank Act included the requirement that the SEC define "family offices" in order to exempt them from regulation under the Advisers Act.

New Rule 202(a)(11)(G)-1 ("the Family Office Rule") contains three general conditions. First, the exclusion is limited to family offices that provide advice about securities only to certain "family clients." Second, it requires that family clients wholly own the family office and family members and/or family entities control the family office. Third, it precludes a family office from holding itself out to the public as an investment adviser.

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

"Family members" are defined to include all lineal descendants (including descendants by adoption, stepchildren, foster children, and, in some cases, descendants by legal guardianship) of a common ancestor (who is no more than ten generations removed from the youngest generation of family members), and such lineal descendants' spouses or spousal equivalents.

The Family Office Rule allows key employees of the family office to be clients of the family office. Any company, including a pooled investment vehicle that is wholly owned, directly or indirectly, by one or more family clients and operated for the sole benefit of family clients, will be treated as a family client.

Certain family offices will not be precluded from meeting the new exclusion solely because they provide investment advice (and provided that advice prior to January 1, 2010) to:

- officers, directors, or employees of the family office who are accredited investors, as defined in Regulation D under the Securities Act of 1933;
- any company owned exclusively and controlled by one or more family members; and
- certain SEC-registered investment advisers that provide advice and identify investment opportunities for the family office and invest in these opportunities on the same terms as the family office and whose assets as to which the family office directly or indirectly provides investment advice represent no more than five percent of the value of the total assets as to which the family office provides investment advice.

Observation: Family offices, which until now have generally relied on the private adviser exemption, should confirm that they meet the new exemption requirements for family offices.

Revision of Form ADV

The New Rules revise Form ADV to required expanded disclosure including information about each private fund advised and private fund service providers and additional information about the adviser's advisory and non-advisory business activities and financial industry affiliations.

Reporting Requirements

The Dodd-Frank Act authorizes the SEC to require non-SEC-registered advisers to maintain records and provide reports with respect to the private funds that they advise. The New Rules require exempt advisers annually to file reports electronically consisting of certain items of Form ADV. The reports will be available to the public on the SEC's website.

Amendment of Pay to Play Rule

The SEC also amended Rule 206(4)-5 under the Advisers Act (the "Pay-to-Play Rule") to permit registered municipal advisers to act as solicitors for registered investment advisers that seek business from state and local governments. Registered broker-dealers and investment advisers are also allowed to act as solicitors, provided that they are subject to "pay to play" rules.

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