BUTZEL LONG
ATTORNEYS AND COUNSELORS

Investment Management E-news

November 29, 2010

SEC Proposes Rules to Clarify Investment Adviser Exemptions

On November 19, 2010, the Securities and Exchange Commission (the "SEC") issued proposed rules (the "Proposed Rules") to implement certain provisions of The Private Fund Investment Advisers Registration Act of 2010 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") relating to private fund managers and other investment advisers. The Proposed Rules are available at http://www.sec.gov/rules/proposed/2010/ia-3110.pdf and http://www.sec.gov/rules/proposed/2010/ia-3111.pdf.

The Proposed Rules would, among other things:

- Facilitate registration of advisers to hedge funds and other private funds with the SEC;
- Implement the Dodd-Frank Act's mandate to require reporting by certain advisers that are exempt from SEC registration;
- Increase the asset threshold for advisers to register with the SEC; and
- Define "venture capital fund" and provide clarity regarding certain exemptions to investment adviser registration.

Reporting Requirements for Hedge Fund and Other Investment Advisers

Effective as of July 21, 2011, the Dodd-Frank Act eliminates the existing exemption from SEC registration for investment advisers that have fewer than 15 clients during the course of the preceding 12 months and do not hold themselves out to the public as investment advisers. As a result, most advisers to private funds will be required to register with the SEC. Under the Proposed Rules, advisers to private funds that will not have to register will nevertheless be required to file Form ADV with the SEC and also to file reports about their business activities.

Under the proposed rules, advisers to private funds would have to provide:

- Basic organizational and operational information about the funds they manage, such as information about the amount of assets held by the fund, the types of investors in the fund, and the adviser's services to the fund.
- Identification of five categories of "gatekeepers" that perform critical roles for advisers and the private funds they manage (i.e., auditors, prime brokers, custodians, administrators and marketers).

In addition, the SEC proposed other amendments to Form ADV. These amendments would require all registered advisers to provide more information about their advisory business, including information about:

- The types of clients they advise, their employees, and their advisory activities.
- 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).

The proposal also would require advisers to provide additional information about their non-advisory activities and their financial industry affiliations.

Reporting Requirements for Exempted Advisers

Some advisers will be able to rely upon three new exemptions from SEC registration created by the Dodd-Frank Act applicable to:

- Advisers solely to venture capital funds.
- Advisers solely to private funds with less than $150 million in assets under management in the U.S.
- Certain foreign advisers without a place of business in the U.S.

The Dodd-Frank Act allows the SEC to impose certain reporting requirements upon advisers relying upon either of the first two of the above exemptions ("exempt reporting advisers").

Under the Proposed Rules, exempt reporting advisers would be required to file, and periodically update, Form ADV but rather than completing all of items on the form, exempt reporting advisers would fill out a limited subset of items, including:

- Basic identifying information for the adviser and the identity of its owners and affiliates.
- Information about the private funds the adviser manages and about other business activities that the adviser and its affiliates are engaged in that present conflicts of interest that may suggest significant risk to clients.
- The disciplinary history of the adviser and its employees that may reflect on their integrity.

These abbreviated Form ADVs would be filed on the SEC's investment adviser electronic filing system (IARD), and these reports would be publicly available on the SEC's website.

Reallocation of Regulatory Responsibility

Under current law, as a general rule, only investment advisers managing at least $25 million in assets under management ("AUM") may *opt* to register with the SEC and advisers managing at least $30 million in AUM are *required* to register with the SEC, in each case absent an exemption. The Dodd-Frank Act changes the existing allocation of registration authority between the SEC and the states, so that, effective July 21, 2011, SEC registration will be prohibited for an adviser that:

- is required to be registered with the state securities regulator in the state where it maintains its principal office and place of business[1], and

- if registered, would be subject to examination as an investment adviser by such regulator; and
- has more than $25 million but less than $100 million (so-called "mid-sized advisers") in AUM.

All three prongs of the above test will need to be met to avoid SEC registration. So, for example, a mid-sized adviser to managed accounts and private funds[2] that is exempt from registration under state law (for example, because all of its clients are institutional investors), will be required to register with the SEC unless an exemption at the federal level is otherwise available.

The SEC proposes to define AUM as the securities portfolios over which an adviser provides "continuous and regular supervisory or management services." These assets would include proprietary assets, assets managed without receiving compensation, assets of foreign clients and accrued unpaid liabilities in an adviser's AUM calculations. An Adviser to a private fund would have to include in its regulatory assets under management the value of any private fund over which it exercises continuous and regular supervisory or management services, regardless of the nature of the assets held by the fund;[3] and any uncalled capital commitments made to the fund; and would be required to use the fair value of private fund assets. A foreign adviser would have to meet the conditions with respect to its assets under management attributable to U.S. clients and private funds, but generally not with respect to its assets managed from abroad. Assets would be valued no less often than quarterly.

Under the Proposed Rules, advisers would have until August 20, 2011 (a 30 day grace period after the effective date of the applicable provisions under the Dodd-Frank Act) to file an amended Form ADV which would report the adviser's AUM determined within 30 days of the filing and would state whether or not the adviser remains eligible for SEC registration. Advisers with less than the amount of AUM required for SEC registration would then have a further 60 day grace period, or until October 19, 2011, to file Form ADV-W to withdraw from registration with the SEC as part of the adviser's transition to state registration.

The SEC estimates that as a result of this amendment to the Investment Advisers Act, about 4,100 of the current 11,850 registered advisers will switch from registration with the SEC to registration with the states. These advisers will continue to be subject to the Advisers Act's general anti-fraud provisions. In the meantime, to avoid the necessity for an adviser to register for several months and then deregister, the SEC has stated that it will not require SEC registration by advisers who report on their Form ADV after January 1, 2011 AUM in excess of $30 million but under $100 million and who are required to be registered with, and are subject to examination by a state.

Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers

The SEC proposes to define a venture capital fund as a private fund that meets each of the following six criteria:

- Represents itself to investors as being a venture capital fund.

- Only invests in equity securities of private operating companies to provide primarily operating or business expansion capital (not to buy out other investors), U.S. Treasury securities with a remaining maturity of 60 days or less, or cash.
- Is not leveraged and its portfolio companies may not borrow in connection with the fund's investment.
- Offers to provide a significant degree of managerial assistance, or controls its portfolio companies.
- Does not offer redemption rights to its investors.

A "portfolio company" is defined as any company that: (i) is not publicly traded; (ii) does not incur leverage in connection with the investment by the private fund; (iii) uses the capital provided by the fund for operating or business expansion purposes rather than to buy out other investors; and (iv) is not itself a fund (i.e., is an operating company).

Under a proposed grandfathering provision, existing funds that make venture capital investments would generally be deemed to meet the proposed definition, as long as they have represented themselves as venture capital funds. The SEC states that it is proposing this approach because it could be difficult or impossible for advisers to conform existing funds, which generally have terms in excess of 10 years, to the new definition.

The Dodd-Frank Act also amended the Advisers Act to provide for an exemption from registration for foreign advisers that do not have a place of business in the United States, and have:

- Less than $25 million in aggregate AUM from U.S. clients and private fund investors.
- Fewer than 15 U.S. clients and private fund investors.

The SEC is proposing to define certain terms included in the statutory definition of "foreign private adviser" in order to clarify the application of the foreign private adviser exemption.

Under Proposed Rule 202(a)(30)-1, a natural person and his or her minor children, relatives and/or spouse living at the same principal residence, and related accounts will generally be treated as one client for purposes of the rule. Multiple legal entities with identical owners will be considered one client. Accounts that are not charged fees must still be counted as "clients" for purposes of the foreign private adviser exemption.

"Investor" would generally be defined as any person who would be included in determining the number of beneficial owners of a private fund under Section 3(c)(1) of the Company Act, or in determining that the outstanding securities of a private fund are owned exclusively by qualified purchasers under Section 3(c)(7) of the Company Act. For purposes of the 15 client threshold, (i) identical investors in two or more funds only need to be counted once and (ii) if an adviser has already counted a U.S. investor in a non-U.S. fund, it does not need to "double count" the fund.

The Proposed Rules define the phrase "in the United States" generally by incorporating the definition of a "U.S. person" and "United States" that appear under Regulation S.

Changes to Pay-to-Play Rule

The Proposed Rules include an amendment to the investment adviser "pay-to-play" rule in response to changes made by the Dodd-Frank Act. The pay-to-play rule prohibits advisers from engaging in pay to play practices.

Under the proposed amendment, an adviser would be permitted to pay a registered municipal adviser, instead of a "regulated person," to solicit government entities on its behalf if the municipal adviser is subject to a pay-to-play rule adopted by the MSRB that is at least as stringent as the investment adviser pay-to-play rule. The MSRB received new authority over municipal advisors under the Dodd-Frank Act.

Comments

Comments on the proposal should be received by the SEC within 45 days after publication in the Federal Register.

For more information, please feel free to contact your Butzel attorney, the authors listed below or other attorneys of the Investment Management Practice Group.

Robert A. Hudson
313 225 7019
hudson@butzel.com

Robert I. Jones
212 818 1872
jones@butzel.com

Jennifer E. Powell
248 593 3023
powell@butzel.com

[1] Wyoming is the only state that does not regulate investment advisers.

[2] Advisers only to private funds with less than $150 million AUM will be exempt from SEC registration regardless of whether they are exempt from registration at the state level or not.

[3] A sub-adviser to a private fund would include in its assets under management only that portion of the value of the portfolio for which it provides sub-advisory services.