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INVESTMENT ADVISERS

SEC Finalizes Investment Adviser Registration Exemptions And Grants Extension to New Registrants



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On June 22, 2011, the Securities and Exchange Commission (the ''SEC'' or the ''Commission'') voted to adopt final rules to implement amendments to the Investment Advisers Act of 1940 (the ''Advisers Act'') contained in Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act (''Dodd-Frank'').[1] Title IV of Dodd-Frank repeals the ''private adviser'' exemption to the investment adviser registration requirements, which is currently available to private fund advisers who have fewer than 15 clients over the preceding 12 months and do not hold themselves out generally to the U.S. public as investment advisers.[2] As a result, many private fund advisers that relied on this exemption will now have to comply with the registration and compliance requirements of the final rules implementing Title IV of Dodd-Frank if they do not qualify for any of the new related exemptions. Im-

[1] Pub.L 111-203, H.R. 4173.

[2] Under the Advisers Act, each private investment fund is generally counted as one client, regardless of the number of investors in the fund. Consequently, many private fund advisers have been able to rely on this exemption, even though dozens or hundreds of investors may participate in the funds.

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portantly, the Commission also extended from July 21, 2011 to March 30, 2012 the deadline for registration for private fund advisers previously exempt under the ''private adviser'' exemption.

The final rules can be broken down into three main categories. First, the rules address provisions of Dodd-Frank that delegate responsibility for mid-sized investment advisers away from the Commission to state regulatory authorities. Second, the rules address the new exemptions from registration enacted in Dodd-Frank in connection with Dodd-Frank's repeal of the ''private adviser'' exemption. Third, the Commission adopted amendments to Form ADV to reflect the new registration requirements.

I. Mid-Sized Advisers

Previously under the Advisers Act, investment advisers that were subject to registration in the state in which they maintained their principal office and place of business were prohibited from registering with the Commission if they had less than $25 million of assets under management, with certain exceptions. Section 410 of Dodd-Frank increases this threshold, effectively creating a new prohibition from registration for so-called ''mid-sized advisers'' and shifting the responsibility for regulatory oversight of these mid-sized advisers to the states. Mid-sized advisers are those with between $25 million and $100 million of aggregate regulatory assets under management (''regulatory AUM'').[3] Congress decided to reallocate regulatory responsibility for investment advisers between the SEC and the states as a result of the registration of the approximately 750 new advisers the SEC expects to become subject to SEC registration. As a result of this change in threshold, the SEC expects approximately 3,200 advisers currently registered with it to switch to state registration. Even with this shift in responsibility, the SEC may not have the resources necessary to oversee adequately so many new, larger registrants.

Despite the new rule, mid-sized advisers will still be required to register with the Commission in the following circumstances: (a) if the adviser is not required to register as an investment adviser with the state securities authority in which it maintains its principal office and place of business; or (b) if, even though it is registered with the state, the investment adviser is not subject to examination as an investment adviser by the state securities authority. Based on the Commission's discussions with state securities authorities, mid-sized advisers with their principal office and place of business in Minnesota, New York or Wyoming are not subject to examination by the state securities authority and, as such, will be required to register with the Commission even if their regulatory AUM is between $25 million and $100 million. Advisers with less than $25 million of regulatory AUM will continue to be subject solely to state regulation. Many state regulatory authorities may re-examine their own investment adviser statutes in light of the recent changes in the Advisers Act and the SEC's related rules. Consequently, the breakdown in regulatory responsibility may continue to evolve.

Significantly, the Commission, persuaded by several comments received during the comment period, created a buffer so that advisers will not have to switch between federal and state registration due to market volatility. Amended Rule 203(A)-1(a)(1) provides that advisers with regulatory AUM of at least $100 million but less than $110 million may, but are not required to, register with the Commission. Similarly, advisers that are registered with the Commission will not be required to withdraw their registration unless their regulatory AUM drops below $90 million. This buffer is approximately the same relative size as the now eliminated buffer that permitted advisers with between $25 million and $30 million to be registered either with the SEC or the applicable state securities authority.

II. New Exemptions

Investment advisers that are too large to qualify as a mid-sized adviser may still not be required to register with the SEC if they meet one of four new exemptions adopted by the Commission: (a) an exemption for advisers to venture capital funds (the ''venture capital fund exemption''); (b) an exemption for advisers to private funds[4] with less than $150 million in private fund assets under management (the ''private fund adviser exemption''); (c) an exemption for certain foreign advisers with less than $25 million in assets under management attributable to U.S. investors and clients (the ''foreign private adviser exemption''); and (d) an exemption for family offices (the ''family office exemption''). Investment advisers that qualify for one of these exemptions are not, therefore, required to register with an applicable state securities authority; rather, they will not be subject to any registration at the state or federal level.

A. Venture Capital Fund Exemption

This exemption is available if the investment adviser advises only private funds, which either meet the definition of ''venture capital fund'' or qualify under a grandfathering provision. Rule 203(l)-1 contains a five-part test for whether a private fund is a ''venture capital fund.'' The requirements relate to issues such as the fund's holdings, incurrence of leverage, and investor withdrawal rights, and are briefly summarized below.

1. Holding Requirements

First, the final rules provide that the advised fund must hold, immediately after the acquisition of any asset (other than qualifying investments or cash or cash equivalents), no more than 20 percent of its capital commitments in non-qualifying investments (other than cash or cash equivalents) valued at historical cost or fair value, as determined by the fund adviser but consistently applied. The 20 percent limit is a significant change from the proposed rules, which did not provide any bucket for non-qualifying investments. This change is intended to provide advisers to venture capital funds with greater investment flexibility while still precluding

[3] The SEC rescinded the safe harbor previously provided by Advisers Act Rule 203A-4 for an investment adviser that is registered with a state securities authority based on a reasonable belief that it does not meet the threshold amount of assets under management.

[4] Generally, a private fund is a hedge fund, private equity fund or other investment vehicle that is excluded from the definition of investment company under the Investment Company Act of 1940 (the ''1940 Act'') by reason of Section 3(c)(1) or 3(c)(7) of the 1940 Act.

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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.

The SEC specified that a fund need only calculate the 20 percent limit when it acquires a non-qualifying investment, and that after the acquisition the fund need not dispose of a non-qualifying investment simply because of a change in the value of the fund's investments. The fund may be precluded from acquiring additional non-qualifying investments until the value of its then-existing non-qualifying investments falls below 20 percent of its committed capital.

a. *Qualifying Investments*

''Qualifying investment'' means any equity security issued by a qualifying portfolio company that is directly acquired by the private fund from the company (''directly acquired equity''). In addition, any equity security issued by a qualifying portfolio company in exchange for directly acquired equity issued by the same qualifying portfolio company, and any equity security issued by a company of which a qualifying portfolio company is a majority-owned subsidiary or a predecessor that is acquired by the fund in exchange for directly acquired equity, is also a qualifying investment.

b. *Qualifying Portfolio Company*

''Qualifying portfolio company'' means any company that (i) at the time of an investment by a qualifying fund, is not a reporting or foreign traded company (*i.e.*, is not subject to the reporting requirements of Sections 13 or 15(d) of the Securities Exchange Act of 1934 and does not have any publicly traded securities) and does not have a control relationship with a reporting or foreign traded company; (ii) does not incur leverage in connection with the investment by the private fund and distribute the proceeds of any such borrowing to the private fund in exchange for the private fund investment[5]; and (iii) is not itself a fund (*i.e.*, is an operating company).

2. Leverage Limitations

The venture capital fund cannot borrow, issue debt obligations, provide guarantees or otherwise incur leverage in excess of 15 percent of the fund's capital commitments, and any such borrowing, indebtedness, guarantee or leverage must be for a non-renewable term of no longer than 120 calendar days, except that a guarantee of a qualifying portfolio company's obligations, up to the value of the private fund's investment in the qualifying portfolio company, is not subject to the 120-calendar-day limit.

3. No Redemption or Similar Liquidity Rights

The venture capital fund cannot issue securities that provide investors with redemption, withdrawal or similar ''opt-out'' rights, except in ''extraordinary circumstances.'' A material change in tax law after an investor invests in the fund or the enactment of laws that may prohibit an investor's participation in the fund's investment in particular countries or industries would each be considered an ''extraordinary circumstance.'' Similarly, customary withdrawal provisions for investors subject to the Employee Retirement Income Security Act of 1974 or subject to the Bank Holding Company Act of 1956 would likely qualify for the ''extraordinary circumstances'' exception.

4. Represents Itself as Pursuing a Venture Capital Strategy

The venture capital fund must represent to investors and potential investors that it pursues a venture capital strategy. Whether or not a fund meets this requirement will depend on particular facts and circumstances, including the particular statements made by the fund in its offering materials and other communications with prospective investors.

5. Application to Non-U.S. Advisers

A non-U.S. adviser may rely on the venture capital fund exemption, but only if all of its clients, whether U.S. or non-U.S., are venture capital funds under the rule or the grandfathering provision.

6. Grandfathering

The SEC grandfathered advisers to one or more existing private funds that would not meet all of these requirements but represented to investors and potential investors at the time the fund offered its securities that it pursues a venture capital strategy. In order to be grandfathered, the existing fund must have sold securities to one or more investors prior to December 31, 2010 and must not sell any securities to any person after July 21, 2011 (but can call for capital contributions thereafter).

B. Private Fund Adviser Exemption

The SEC adopted rules relating to an exemption from registration under Dodd-Frank for advisers solely to private funds with less than $150 million of regulatory AUM in the United States. In order to qualify for this exemption, advisers can advise an unlimited number of private funds, provided that the aggregate regulatory AUM of the private funds is less than $150 million.

Rule 203(m)-1 requires advisers to calculate the value of regulatory AUM pursuant to instructions in Form ADV, which provide a uniform method of calculating regulatory AUM for the purposes of the Advisers Act. Regulatory AUM is determined by calculating the ''securities portfolios with respect to which an investment adviser provides continuous and regular supervisory or management services,'' as described in the Form ADV instructions. The instructions also specify that advisers must include in their calculations proprietary assets and assets managed without compensation as well as uncalled capital commitments. An adviser must determine the amount of its regulatory AUM based on the market value of those assets (or the fair value if market value is unavailable) and must calculate the assets on a gross basis (*i.e.*, without deducting liabilities).

An adviser relying on the private fund adviser exemption must calculate annually the amount of regulatory AUM and report the amount in its annual updating amendment to its Form ADV. Advisers may be required to register under the Advisers Act as a result of increases in their regulatory AUM that occur from year to year, but changes in the amount of an adviser's regula-

[5] Although qualifying portfolio companies may borrow in the ordinary course of business, they may not borrow ''in connection with'' a venture capital fund investment and distribute the proceeds of such borrowing or issuance to the venture capital fund ''in exchange for'' the fund's investment.

tory AUM between annual updating amendments will not affect the availability of the exemption.

1. Distinction Between U.S. Advisers and Non-U.S. Advisers

Under Rule 203(m)-1, advisers with a principal office and ''place of business'' in the United States must count private fund assets managed at a place of business outside of the United States toward the $150 million regulatory AUM limit. The private fund adviser exemption is available to an adviser with a principal office and place of business outside of the United States as long as all of the adviser's clients that are U.S. persons are private funds and have aggregate regulatory AUM of less than $150 million. Note that a non-U.S. adviser may not rely on the exemption if it has any client that is a U.S. person other than a private fund.

For this purpose, ''place of business'' means any office where an investment adviser regularly provides advisory services, solicits, meets with, or otherwise communicates with clients, and any location held out to the public as a place where the investment adviser conducts any such activities.

2. Transition Period

A previously exempt private fund adviser that reports in an annual updating amendment to its Form ADV that it has $150 million or more of regulatory AUM will have 90 days after filing the amendment to apply for registration.

C. Foreign Private Adviser Exemption

The SEC also approved final rules implementing the exemption from registration of foreign private advisers. The exemption applies to any investment adviser that:

(1) has no ''place of business'' in the United States (as described above);
(2) 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;
(3) has aggregate regulatory AUM 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;
(4) does not hold itself out generally to the public in the United States as an investment adviser; and
(5) does not advise a U.S.-registered fund or a business development company.

1. Counting Clients

For purposes of counting clients for the foreign private adviser exemption, the final rules largely mirror the previous rules regarding counting clients for the repealed ''private adviser'' exemption, except that non-U.S advisers must count as a client any person for whom the adviser provides investment advisory services whether or not the adviser receives compensation from such client.

2. Investor

''Investor'' in a private fund means any person who would be included in determining the number of beneficial owners of the outstanding securities of a private fund under Section 3(c)(1) of the 1940 Act, or whether the outstanding securities of a private fund are owned exclusively by qualified purchasers under Section 3(c)(7) of the 1940 Act. A beneficial owner of short-term paper issued by the private fund is also considered an ''investor.''

D. Family Office Exemption

The SEC approved the final rule exempting family offices from registration. Historically, many family offices were not required to register because of the repealed ''private adviser'' exemption and other SEC guidance.

The final rule defines ''family office'' as an entity that: (1) has no clients other than family clients; (2) is wholly owned by family clients and is exclusively controlled (directly or indirectly) by one or more family members and/or family entities; and (3) does not hold itself out to the public as an investment adviser. An adviser controlled by employees who are not family members would not qualify as a family office under the rule.

In response to comments, the SEC expanded the definition of family members and family clients originally included in the proposed rules, providing family offices relying on the registration exemption more flexibility in structuring their operations.

1. Family Client

For purposes of the exemption, ''family client'' means (a) current and former family members; (b) current key employees of the family office (and, in some circumstances, former key employees); (c) charities funded exclusively by family clients; (d) estates of current and former family members or key employees of the family office (and, in some circumstances, of former key employees); (e) irrevocable trusts existing for the sole current benefit of family clients or, if both family clients and charitable and nonprofit organizations are the sole current beneficiaries, trusts funded solely by family clients; (f) revocable trusts in which one or more other family clients are the sole grantors; (g) trusts solely funded and controlled by key employees; and (h) companies wholly owned and operated for the sole benefit of one or more family clients.

2. Family Members

''Family members'' means all lineal descendants (including by adoption, stepchildren, foster children, and in some cases, legal guardianship) of a common ancestor (who may be living or deceased), as well as current and former spouses or spousal equivalents of those descendants, provided that the common ancestor is no more than 10 generations removed from the youngest generation of family members.[6]

3. Key Employees

''Key employees'' means the following individuals (including any such individual's spouse or spousal equivalent): (i) executive officers, directors, trustees, general partners; and (ii) any other employee of the family office (other than a clerical employee) who, in connection with his or her regular duties, has participated in the investment activities of the family office or similar functions or duties for the entity for at least 12 months.

[6] The SEC eliminated the concept of a ''founder'' from the proposed rule, which defined the founder as the ''natural person and his or her spouse or spousal equivalent for whose benefit the family office was established and any subsequent spouse of such individuals.''

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4. Transition Period

The final rule provides that family offices formerly exempt from registration in reliance on the repealed ''private adviser'' exemption that do not qualify under the new exemption are not required to register with the Commission as investment advisers until March 30, 2012.

III. Filing and Reporting Requirements

A. Registering Advisers

Investment advisers registering with the SEC are required to electronically file with the SEC on the SEC's investment adviser electronic filing system (''IARD''), a disclosure document (Form ADV) and periodic amendments thereto. Form ADV consists of four parts: Part 1A, Part 1B, Part 2A, and Part 2B. Generally, Part 1A contains questions about the identity of the adviser, its business practices, the persons who own and control the adviser, and the persons who provide investment advice on the adviser's behalf. Part 1B must be completed only if the adviser is applying for registration with a state securities authority. Part 2A is a narrative firm brochure containing information about the adviser. Finally, Part 2B is a narrative supplement to the firm brochure containing information about certain employees and other persons who provide advisory services to the adviser's clients.

February 14, 2012 is the last day for private fund advisers relying on the ''private adviser'' exemption as of July 21, 2011 to file Form ADV with the SEC. Filing by February 14, 2012 will allow for 45 days for the Form ADV to be declared effective prior to March 30, 2012, the deadline for Form ADVs to be declared effective by the SEC.

In addition, registering investment advisers must adopt written compliance policies and procedures. The Advisers Act requires that an adviser's compliance policies and procedures be reasonably designed to prevent violations of the Advisers Act. Therefore, a compliance program need only encompass compliance considerations that are relevant to the adviser's operations. The Advisers Act imposes increased burdens on registered investment advisers, including in the areas of recordkeeping and advertising. An adviser's compliance policies and procedures must include a code of ethics and, to the extent relevant, policies regarding investment allocation, best execution, insider trading, advertising and marketing, electronic communications, custody, recordkeeping, valuation, proxy voting, privacy, contingency and disaster recovery, anti-money laundering and pay-to-play and political contributions. The compliance policies and procedures should be in place by the time the adviser files for registration.

Registering investment advisers also must designate a Chief Compliance Officer who is responsible for the administration of the compliance policies and procedures. The Chief Compliance Officer must have knowledge regarding the Advisers Act and have the authority to create and administer appropriate compliance procedures. Among other duties, the Chief Compliance Officer must review the adequacy of the compliance policies and procedures annually.

Registered investment advisers are also subject to compliance examinations by the SEC.

B. Exempt Reporting Advisers

Although advisers who rely on the venture capital fund exemption or the private fund adviser exemption (*i.e.*, ''exempt reporting advisers'') will not be required to register with the SEC, they, along with registered advisers, will be subject to certain reporting requirements. Under the new rules, exempt reporting advisers will be required to file and periodically update abbreviated reports with the SEC, using the same Form ADV that registered advisers file with the SEC.

However, rather than completing all the items on Form ADV, exempt reporting advisers will only be required to fill out a limited subset of the items in Part 1A of Form ADV, including:

- basic identifying information for the exempt reporting adviser and the identity of its owners and affiliates;
- information about the private funds the exempt reporting adviser advises and about other business activities that the exempt reporting adviser and its related persons are engaged in that present conflicts of interest that may suggest significant risk to clients; and
- the disciplinary history (if any) of the exempt reporting adviser and its advisory affiliates that may reflect on the integrity of the firm.

March 30, 2012 is the deadline for exempt reporting advisers to file Part 1A of Form ADV. Exempt reporting advisers will not be required to prepare a brochure or brochure supplements under Part 2A or 2B, respectively, of Form ADV.

As with registered investment advisers, exempt reporting advisers will file their reports on IARD, using the same process as registered advisers. These reports will be available to the public on the SEC's website. An exempt reporting adviser must submit its initial Form ADV within 60 days of relying on either the venture capital fund exemption or the private fund adviser exemption. Thereafter, exempt reporting advisers must amend their reports on Form ADV (a) at least annually, within 90 days of the end of such adviser's fiscal year; and (b) more frequently, if certain information becomes inaccurate.

Exempt reporting advisers will also be subject to recordkeeping rules that the SEC will adopt in the future and limited SEC examination oversight, although SEC Chairman Schapiro has stated that the SEC does not intend to conduct routine examinations of exempt reporting advisers.

C. Amendments to Form ADV

The new rules adopted by the SEC on June 22 include amendments to Part 1A of Form ADV and the related schedules, which the SEC expects will be updated on the IARD system and available for filing with the SEC by January 1, 2012. Under Rule 203A-5, all investment advisers that are registered with the Commission on January 1, 2012 will be required to file an amendment to Form ADV no later than March 30, 2012. Those advisers that are prepared to file in fall of 2011, but that qualify for an exemption from registration until March 30, 2012, may wish to consider delaying registration until after January 1, 2012 in order to avoid having to file both the registration and the update within such a short period of time.

The substantive changes to Part 1A of Form ADV address private fund reporting, the advisory business,

conflicts of interest, non-advisory activities and financial industry affiliations.

D. Withdrawal of Registration

The amendment to Form ADV that advisers registered with the Commission on January 1, 2012 are required to file by March 30, 2012 will also identify mid-sized advisers that are no longer eligible to register with the Commission. These mid-sized advisers must withdraw their registrations by filing a Form ADV-W no later than June 28, 2012. The withdrawal must be filed after filing the Form ADV amendment with the Commission.

IV. Conclusion

The SEC has redrawn the line at March 30, 2012 for private fund adviser registration. Accordingly, advisers will want to review their readiness for SEC (or state) registration and use the remainder of calendar year 2011 to prepare to operate as regulated entities. In addition to finalizing and filing their Form ADVs, investment advisers will need to review, finalize and implement their compliance policies and procedures. Among other things, an adviser facing registration for the first time should:

- Conduct a final review of its Form ADV and compliance policies and procedures to make sure they reflect the adviser's current business, organizational structure and personnel;
- Verify accuracy, completeness and consistency of disclosures across documents, including private placement memoranda and Form ADV;
- Test run compliance procedures to make sure that they are workable in real time;
- Review supervisory processes to make sure that all responsible personnel understand their obligations and are ready to assume those duties;
- Inventory conflicts of interest and processes for ongoing identification, disclosure and management of conflicts;
- Confirm that background information for personnel is current and that all required information regarding outside activities, personal trading and political contributions has been obtained and is current;
- Institute an initial and periodic training program for their personnel to sensitize them to the adviser's compliance policies and procedures; and
- Encourage all personnel to be part of the adviser's compliance policies and procedures.

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