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E-ALERT | Dodd-Frank Act

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KEY ASPECTS OF THE SEC'S RECENT CHANGES TO THE ADVISERS ACT PURSUANT TO THE DODD-FRANK ACT

On June 22, 2011, a divided Securities and Exchange Commission ("SEC") adopted certain rules and rule amendments under the Investment Advisers Act of 1940, as amended (the "Advisers Act") to implement a number of sweeping regulatory changes mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[1] This e-alert highlights key aspects of these changes for investment advisers, including the managers of hedge, private equity and venture capital funds and other pooled investment vehicles.

EXTENSION OF REGISTRATION DEADLINE

For many unregistered advisers, including those to private funds, perhaps the most significant short-term development is the extension of the Advisers Act registration deadline. Effective July 21, 2011, the Dodd-Frank Act will eliminate Rule 203(b)(3) under the Advisers Act – the exemption for advisers with fewer than 15 clients within the preceding 12 months – which has allowed advisers to many private funds and other pooled investment vehicles to avoid SEC registration. The SEC has delayed this registration deadline until March 30, 2012 for all advisers that relied and were entitled to rely on the 15 client exemption, but recommends that advisers file their Forms ADV by at least February 14, 2012 to permit sufficient time for their registrations to become effective before the March 30 deadline.[2] Extension notwithstanding, it would be prudent for private fund advisers to continue their preparations for registration in earnest, given the amount of time, energy and resources needed to comply with the applicable registration and other Advisers Act requirements.

REGISTRATION EXEMPTIONS

The SEC adopted exemptions from the Advisers Act registration requirements for three different types of advisers – advisers solely to venture capital funds, advisers solely to private funds with assets under management ("AUM") of less than $150 million and foreign private advisers.

Venture Capital Funds. Advisers solely to venture capital funds are exempted from the registration requirements under the Advisers Act. A "venture capital fund" is defined narrowly as a private fund[3] that:

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[1] See Investment Advisers Act Release No. 3221 (June 22, 2011), *available at* http://www.sec.gov/rules/final/2011/ia-3221.pdf; Investment Advisers Act Release No. 3222 (June 22, 2011), *available at* http://www.sec.gov/rules/final/2011/ia-3222.pdf.

[2] Investment Advisers Act Release No. 3221 (June 22, 2011), p. 94. The SEC must either grant or deny registration within 45 days after the adviser files its Form ADV.

[3] A "private fund" is a fund that would be an investment company as defined in the Investment Company Act of 1940, as amended (the "Company Act"), but for Sections 3(c)(1) or 3(c)(7) of such Act.

- holds no more than 20% of the fund's total capital commitments in non-qualifying investments (i.e., investments other than equity securities in non-reporting operating companies), other than short-term holdings. The fund can choose to value its investments based on either historical cost or fair value, provided that such valuation method is applied consistently;
- does not borrow or otherwise incur leverage, in excess of 15% of the fund's capital contributions and uncalled committed capital, other than short-term borrowing (excluding certain guarantees of qualifying portfolio company obligations by the fund);
- does not offer its investors redemption or similar liquidity rights except in extraordinary circumstances (e.g., a material change to the tax laws);
- represents itself as having a venture capital strategy; and
- is not registered under the Company Act and has not elected to be treated as a business development company.

The rules grandfather existing private funds that do not meet the definition of a "venture capital fund" as long as they (i) represented to investors and potential investors at the time they offered their securities that they pursued a venture capital strategy; (ii) sold securities to one or more investors prior to December 31, 2010; and (iii) do not sell securities, including additional capital commitments, to any person after July 21, 2011. Funds that accepted capital commitments on or before July 21, 2011, even if such commitments have not yet been called, are included in the grandfather provision.

Private Fund Advisers with Less than $150 million in AUM. Any adviser solely to private funds that has less than $150 million in AUM in the United States is exempt from the Advisers Act registration requirements. Advisers with their principal office and place of business in the United States must count all private fund assets toward the $150 million threshold. A non-U.S. adviser (including one that advises non-U.S. clients) can rely on this exemption if all of its clients that are U.S. persons are qualifying private funds. An adviser may advise an unlimited number of private funds, provided the aggregate value of the assets of the private funds is below $150 million. However, depending on the facts and circumstances, the SEC may consider two or more separately formed but affiliated advisers, each with less than $150 million in AUM, as a single adviser for purposes of this exemption.[4]

An adviser's AUM is assessed annually, and if it reports $150 million or more in AUM (calculated as described below) in its annual updating amendment on Form ADV, it must register with the SEC. If this occurs, the adviser would be entitled to a 90-day transition period, provided it had complied with the exempt reporting adviser reporting requirements (described below) and had not accepted a client that is not a private fund.

Foreign Private Advisers. The SEC adopted substantially as proposed an exemption for "foreign private advisers," which applies to any adviser that (i) has no place of business in the United States;

[4] This approach is consistent with the SEC staff's existing interpretative guidance with respect to the treatment of affiliated entities for Advisers Act registration purposes. In Richard Ellis, Inc. (publicly avail. Sept. 17, 1981), the SEC staff indicated that a separately formed entity would be deemed to operate independently of an affiliate if it: (i) was adequately capitalized; (ii) had a "buffer" between its personnel and the affiliate (such as a board of directors, a majority of whose members are independent); (iii) had employees, officers, and directors who, if engaged in providing advice in the day-to-day business of the entity, are not otherwise engaged in the affiliate's advisory business; (iv) made decisions on the investment advice provided to, or used for, its clients and had and used sources of information other than its affiliate and (v) kept its investment advice confidential until communicated to its clients.

(ii) has, in total, fewer than 15 clients in the United States and investors in the United States in private funds advised by the adviser; (iii) has aggregate AUM attributable to clients and investors in the United States of less than $25 million and (iv) does not hold itself out generally as to the public in the United States as an adviser.

REPORTING FOR EXEMPT REPORTING ADVISERS

Advisers that rely on the venture capital and private fund adviser exemptions described above (collectively, "exempt reporting advisers") are not subject to the full panoply of Advisers Act requirements, but still may face regulatory scrutiny. For example, exempt reporting advisers must file with the SEC upon 60 days of relying on their applicable exemption a Form ADV containing a subset of the information required of registered advisers, including information on the exempt reporting adviser's disciplinary history, financial industry affiliations, control structure and other identifying information, such as the adviser's name, contact information and form of organization. This information will be publicly available and must be amended and updated within the same time-frame and under the same circumstances as is if it were filed by a registered adviser. Chairman Mary Schapiro has directed the SEC staff to reassess these reporting requirements in one year to determine if the data collected is sufficient and whether the disclosure requirements require augmenting.

The SEC retained the authority to examine exempt reporting advisers on the same basis as registered advisers; however, the final release indicates that the SEC does not "anticipate" that its staff will conduct compliance examinations of exempt reporting advisers on a regular basis (a point echoed by Chairman Schapiro at the open meeting relating to the rules).[5] The SEC staff will conduct cause examinations where there are indications of wrongdoing by an exempt reporting adviser.

UNIFORM CALCULATION OF AUM

The new rules set forth a uniform method for advisers to annually calculate their AUM[6] for all regulatory purposes, including eligibility to register with the SEC. In particular, revisions to the instructions to Form ADV clarify that AUM now includes previously excludable categories of assets, including family or proprietary assets, assets managed without the adviser receiving compensation and assets of foreign clients. Advisers must calculate AUM on a gross basis (i.e., without any deductions for outstanding debts or accrued but unpaid liabilities). For private fund advisers, AUM also would include (i) the value of any private fund, regardless of the nature of the assets held by the fund and (ii) any uncalled capital commitments. Private fund advisers must value these assets at their market value, or the fair value if the market value is unavailable.

REGISTRATION OF MID-SIZED ADVISERS

The new rules implement the Dodd-Frank Act's shifting of regulatory oversight of "mid-sized advisers" (i.e., advisers with between $25 million and $100 million in AUM) to state securities authorities.[7] The rules provide that a mid-sized adviser must register with securities regulators in the

[5] Exempt reporting advisers also will be subject to books and records requirements, which will be addressed by the SEC in a future release.

[6] An adviser's AUM consists of the securities portfolios with respect to which the adviser provides continuous and regular supervisory management services.

[7] The Dodd Frank Act increased the AUM threshold above which all advisers must register with the SEC from $25 million to $100 million. The new rules further increase this threshold to $110 million, subject to the buffer zone (described above).

state in which it maintains its principal office and place of business unless such adviser (i) is not required to be registered in such state or (ii) if registered, would not be subject to examination in such state.[8] Consequently, although an adviser relying on an exemption from registration under the laws of the state in which its principal office and place of business is located would not be required to register in the state, it would need to register with the SEC. For example, an adviser with $50 million in AUM that is exempt from the registration requirements under applicable state law must register with the SEC. Additionally, an adviser with a principal office or place of business in a state without examination requirements (i.e., New York, Minnesota and Wyoming) must register with the SEC. Advisers with AUM of less than $100 million may voluntarily register with the SEC if they would be required to register in 15 or more states.

In connection with the shift in oversight of many mid-sized advisers from the SEC to the state securities regulators, all advisers – regardless of size – that are registered with the SEC on January 1, 2012 must amend their Forms ADV no later than March 30, 2012 (generally, the due date for most advisers' annual updating amendments) to determine their continued eligibility to remain registered with the SEC.[9] An adviser with AUM in excess of $110 million must register or remain registered with the SEC. If an adviser has $100 million in AUM it may, but is not required, to register with the SEC. Once registered with the SEC, an adviser would not need to switch to state registration unless its AUM fell to less than $90 million. This buffer zone is designed to mitigate against frequent switches between SEC and state registration for advisers with close to $100 million in AUM based on market fluctuations in the value of their AUM.

The SEC also adopted several transition rules to facilitate an orderly transition to state registration for certain advisers:

- Until July 21, 2011, mid-sized advisers may register with either the SEC or appropriate state. Thereafter, such advisers must register with the appropriate state, subject to the exceptions described above.
- Mid-sized advisers registered with the SEC as of July 21, 2011 that have at least $25 million in AUM must remain registered with the SEC (unless an exemption is available) until January 1, 2012.
- Mid-sized advisers that are not eligible for SEC registration at the time of filing the amendment to Form ADV described above must withdraw their registrations by filing Forms ADV-W with the SEC no later than June 28, 2012.

CHANGES TO FORM ADV

The SEC revised Form ADV to require, in addition to the changes described above, that advisers provide greater disclosure with respect to (i) the private funds they advise, (ii) their advisory business (including data on the types of clients they have, employees, custody and advisory activities) and business practices that present significant conflicts of interest (such as the use of affiliated brokers, soft dollar arrangements and compensation for client referrals) and (iii) non-advisory activities and financial industry affiliations. Advisers to private funds must provide separate information for each individual fund they manage. Such information includes the type of fund by investment strategy, general information about the size and ownership of the fund, the gross asset value of the fund and the adviser's services to the fund. In response to concerns over mandating the disclosure of

[8] A mid-sized adviser also is required to register with the SEC if it is an adviser to a registered investment company or business development company.

[9] This determination must be based on the current market value of the adviser's AUM as calculated within 90 days prior to filing the Form ADV.

potentially sensitive information, the SEC did not require an adviser (1) to provide information on each fund's net assets; (2) to identify the fund's assets and liabilities by class and categorization in the fair value hierarchy established under GAAP or (3) to specify the portion of each fund owned by particular types of persons. The SEC did require advisers to identify five types of "gatekeepers" for each fund, namely administrators, prime brokers, auditors, custodians and marketers.

CONCLUSION

While the full impact of the changes noted in this e-alert may not be entirely clear for some time, such changes will significantly alter the regulatory landscape applicable to advisers, including those to hedge, private equity and venture capital funds and other pooled investment vehicles. These rules and rule amendments likely will generate a number of interpretative questions and require that advisers of various stripes re-evaluate their registration status, operations and internal practices. There is no time like the present to begin this process and prepare for the future.

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