

Proposed SEC Rules Affecting Investment Advisers and Private Fund Managers

In November 2010, the Securities and Exchange Commission (“SEC”) proposed new rules and amendments to existing rules (“Proposed Rules”) promulgated under the Investment Advisers Act of 1940 (“Advisers Act”).¹ The Proposed Rules seek to implement new registration, reporting and other requirements affecting investment advisers and private fund managers mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”). The Proposed Rules are of particular importance to private fund managers, who will need to determine whether they will be required to register with the SEC or whether they can rely on certain new exemptions from registration as advisers. Additionally, private fund managers who are not required to register with the SEC may also be subject to reporting requirements. Below are highlights of the Proposed Rules.

I. Eligibility for Registration with SEC

A. Increased AUM for SEC Registration

Section 203A of the Advisers Act currently prohibits an investment adviser regulated by the state in which it maintains its principal office from registering with the SEC unless it has at least \$25 million in assets under management (“AUM”). Section 410 of the Dodd-Frank Act increases this asset threshold level from \$25 million to \$100 million effective July 21, 2011. As a result, the SEC estimates that approximately 4,100 SEC-registered advisers will be required to withdraw their SEC registrations and re-register at the state level.² Additionally, the SEC has proposed modifying how AUM should be calculated for purposes of determining registration and reporting AUM on

¹ Rules Implementing Amendments to the Investment Adviser Act of 1940, Investment Advisers Act Release No. 3110 (Nov. 19, 2010), available at <http://sec.gov/rules/proposed/2010/ia-3110.pdf>; and Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than \$150 Million in Assets Under Management, and Foreign Private Advisers, Release No. 3111 (Nov. 19, 2010), available at <http://sec.gov/rules/proposed/2010/ia-3111.pdf>.

² See Advisers Act Rel. No. 3110 (Nov. 19, 2010).

the Form ADV. The Proposed Rules provide more specific guidance to advisers as to how to calculate AUM and how to include assets of private funds managed by the advisers. The required method of calculating AUM should provide more uniformity and less flexibility to advisers, who in the past may have calculated AUM with the goal of either being registered at the state or federal level.

To implement this new threshold level, the Proposed Rules will create a new category of “mid-sized advisers.” Thereafter, these mid-sized advisers will generally be required to register as advisers in the state in which the adviser maintains its principal office. Once this change goes into effect, such mid-size advisers will also be required to withdraw their registration with the SEC.

B. Transition to State Registration

Proposed Rule 203A-5 clarifies the transition process from federal to state registration. Under this Proposed Rule, all SEC-registered advisers must initially file an amendment to the Form ADV. This amendment will report the adviser’s AUM and, if applicable, any basis for continuing the adviser’s SEC-based registration. In essence, this amendment will assist the adviser in determining whether it may remain registered with the SEC and provide the SEC and state regulators with the information needed to identify which advisers may remain registered with the SEC and which may not. In its Proposed Rules, the SEC originally required all advisers registered with the SEC as of July 21, 2011 to file the amendment by August 20, 2011. However, as indicated in a letter dated April 8, 2011 from the SEC to the North American Securities Administrators Association, Inc. (“NASAA”) (“NASAA Letter”), the SEC anticipates that this first step will likely be postponed until the first quarter of 2012.³ Thereafter, all SEC-registered advisers no longer eligible for federal registration will be required to withdraw their registration and re-register at the state level. Pursuant to the NASAA Letter, advisers who are no longer eligible for SEC registration will have a grace period (to be determined) to allow them time to register at the state level and come into compliance with applicable laws prior to withdrawing their SEC registration. Once the initial transition has been completed, advisers will need to determine annually whether they should be registered at the federal or state level. In the event an SEC-registered adviser determines that it is no longer eligible for registration with the SEC, it will have 180 days to switch to state registration.

³ Correspondence dated April 8, 2011 from Robert E. Plaze, Assoc. Dir. of SEC to David Massey, Pres. of NASAA, available at: <http://sec.gov/rules/proposed/2010/ia-3110-letter-to-nasaa.pdf>

C. Certain Investment Advisers May Be Required to Register with the SEC and Others Permitted to Register with the SEC

A mid-sized adviser (AUM of \$25 million to \$100 million) that is either (1) not required to register in the state where its principal office is located, but not otherwise exempt from registering with the SEC, or (2) if registered with the state, not subject to an examination or audit, shall be required to register with the SEC under the Proposed Rules. Additionally, a mid-size adviser that is an adviser to a registered investment company or a business development company (“BDC”) is also required to register with the SEC. Finally, if an adviser is *required* to register in 15 or more states, it may instead register with the SEC. The SEC also proposes eliminating the prohibition against registration for nationally recognized statistical rating organizations (“NSROs”) meaning they may no longer register with the SEC as a result of being an NSRO. The SEC also proposes raising the minimum value of plan assets from \$50 million to \$200 million for pension consultants who may seek to register as advisers with the SEC.

II. Elimination of the Private Adviser Exemption & the Development of New Exemptions

Currently, private fund managers acting as advisers to private funds are not required to register with the SEC if they meet the requirements of Section 203(b)(3) of the Advisers Act, specifically the “private adviser exemption.” Generally, the private adviser exemption exempts an adviser from registration if it has had fewer than 15 clients (i.e., no more than 14 private funds) during the preceding 12-month period, does not hold itself out as an investment adviser, and does not advise registered investment companies or BDCs. The Dodd-Frank Act will eliminate this exemption on July 21, 2011. Upon the repeal of this exemption, many unregistered advisers will be required to register, unless another exemption applies. However, as indicated in the NASAA Letter, the SEC is expected to consider extending the deadline for advisers relying on this exemption to register with the SEC from July 21, 2011, until the first quarter of 2012. Moreover, although the Dodd-Frank Act eliminates the private adviser exemption, it created several new exemptions from registration for advisers to venture capital funds and “private funds,” and certain foreign advisers.

A. Venture Capital Exemption

Proposed Rule 203(l)-1 will exempt advisers solely to one or more venture capital funds from registration. The Proposed Rule defines a “venture capital fund” as a private fund that: (1) invests solely in equity securities of “qualifying portfolio companies” in order to provide operating and business expansion capital as long as at least 80% of each company’s securities owned by the fund were acquired directly from

the qualifying portfolio company; (2) directly, or through its advisers, offers or provides significant managerial assistance to, or controls, the qualifying portfolio company; (3) does not borrow or otherwise incur leverage (other than limited short-term borrowing); (4) does not offer its investors redemption or other similar liquidity rights, except in extraordinary circumstances; (5) represents itself as a venture capital fund to investors; and (6) is not registered under the Investment Company Act of 1940 and has not elected to be treated as a BDC. A “qualifying portfolio company” is defined as any company that: (a) is not, at the time of the investment, publicly traded; (b) does not incur leverage in connection with the investment by the private fund; (c) uses the capital provided by the fund for operating or business expansion rather than to buy out other investors; and (d) is not itself a fund, but rather an operating company. A proposed grandfathering provision will apply to certain existing venture capital funds if the funds meet the requirements set forth in the grandfathering provision. Under the Proposed Rules, a foreign adviser will be able to rely on this exemption if all of its clients, U.S. and non-U.S., are venture capital funds.

B. Private Fund Adviser Exemption

Proposed Rule 203(m)-1 will exempt from registration an investment adviser that manages private fund assets of less than \$150 million in the U.S. and acts solely as an investment adviser to one or more “qualifying private funds.” In general, the term qualifying private fund means a private fund that is not registered under the Investment Company Act and that has not elected to be treated as a BDC. To determine if the adviser remains below the \$150 million threshold, the Proposed Rule provides that a U.S. adviser must aggregate the value of all assets of private funds it manages in the U.S. To rely on this exemption, advisers must determine the amount of their private fund assets quarterly, based on the fair value of the assets at the end of the quarter. Non-U.S. advisers need only count private fund assets managed from a place of business in the U.S. towards the \$150 million threshold. Under this Proposed Rule, an adviser has a grace period of one calendar quarter to register with the SEC, or otherwise come into compliance, after it exceeds \$150 million in private assets. This grace period is expected to only be available to advisers that are in compliance with all applicable SEC reporting requirements.

C. Foreign Private Adviser Exemption

As a result of the Dodd-Frank Act, Section 203(b)(3) of the Advisers Act now provides an exemption from registration for “foreign private advisers.” Under section 202(a)(30) of the Advisers Act, a foreign private adviser is defined as any adviser that: (1) has no place of business in the U.S.; (2) has, in total, fewer than 15 clients in the U.S. and investors in the U.S. in private funds advised by the investment adviser; (3) has less than \$25 million in aggregate AUM from U.S. clients and private fund investors; and (4) does not hold itself out generally to U.S. investors as an adviser. The Proposed Rules

provide further clarification as to when a foreign adviser may utilize this exemption. Additionally, under the Proposed Rules, foreign private advisers will not need to comply with the reporting and examination requirements for exempt reporting advisers discussed below in (IV).

III. Changes to the Form ADV

As a result of changes in the law under the Dodd-Frank Act, and in part, as a result of the SEC's desire to obtain additional information to monitor risk, the SEC has proposed changes to the information reported on the Form ADV. The Form ADV will be updated to include the new bases upon which the adviser may register with the SEC (i.e., whether it has \$100 million in AUM, whether it is a mid-sized adviser permitted to register with the SEC, etc.) The Form ADV will also require advisers to specifically disclose whether they have \$1 billion in AUM for identification purposes. The SEC has also proposed more substantive revisions to the Form ADV as a result of its desire for additional information about advisers. Generally, these proposed changes focus on three areas. The first set of changes to the Form ADV would require an adviser to provide additional information concerning private funds it advises (Form ADV - Item 7.B. and Sections 7.B.1. and 7.B.2. of Schedule D). The second set of changes seeks additional information concerning advisers' employees, clients and advisory activities (Form ADV - Item 5). The third set of changes seeks additional information concerning the adviser's non-advisory activities and its financial industry affiliations (Form ADV - Items 6 and 7). Finally, the SEC has proposed that advisers disclose whether a broker-dealer recommended to a client is a related person and whether the adviser receives compensation for making referrals (Item 8).

IV. Reporting Requirements for Exempt Reporting Advisers

Proposed Rule 204-4 will require advisers relying upon the exemptions from registration for advisers to venture capital funds or private funds, to electronically file reports with the SEC on the Form ADV. In particular, these exempt reporting advisers will be required to complete a limited subset of Form ADV items, which includes Items I (Identifying Information), 2.C. (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), 11 (Disclosure Information) and corresponding schedules. The Proposed Rules do not require that exempt reporting advisers also prepare Part 2 of the Form ADV. Information filed by exempt reporting advisers would be publicly available. Exempt reporting advisers would be required to file their Form ADVs at least annually, and more frequently, if certain material information contained in the Form ADV changes. Under the Proposed Rules, exempt reporting advisers will be required to file their initial Form ADVs no later than August 20, 2011. However, based on the NASAA Letter, this deadline may also be extended.

V. Conclusion

Although some of the highlights are set forth above, the Proposed Rules also contain amendments to the “Pay to Play” rule, other amendments which implement other requirements of the Dodd-Frank Act and other more technical amendments. Additionally, the SEC has proposed other rules that will affect advisers and private fund managers, such as those rules relating to the reporting of private fund information for entities registered with the SEC or the Commodity Futures Trading Commission, and the filing of Form PF.⁴ During the comment period on the Proposed Rules, the SEC received almost 150 comment letters and had approximately 30 meetings with outside interested parties. Presumably, the SEC has also had countless internal meetings to discuss the Proposed Rules and comments it has received. As a result of comments received and input from various members of the financial services industry, the SEC will undoubtedly modify some of its Proposed Rules. Nevertheless, the SEC indicated in the NASAA Letter that it believes final rules will be issued in advance of the July 21, 2011 deadline. Once the final rules become effective, advisers and private fund managers will face a substantially different regulatory landscape.

⁴ Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, Investment Advisers Act Release No. 3145 (Jan. 26, 2011), available at: <http://sec.gov/rules/proposed/2011/ia-3145.pdf>.

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