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SEC Proposes Rules Under the Investment Advisers Act to Implement New Dodd-Frank Act Registration and Reporting Requirements for Advisers to Private Funds, as well as Exemptions and Exclusions for Certain Categories of Advisers and to Modify the Pay-to-Play Rules

PRIVATE CAPITAL AND INVESTMENT GROUP ALERT

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Executive Summary

The Securities and Exchange Commission (SEC) has proposed new rules to implement certain provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) requiring investment advisers to private funds, such as private equity funds, hedge funds and venture capital funds, to register with and/or report to the SEC for the first time, commencing in July of 2011, under the Investment Advisers Act of 1940 (Advisers Act). These proposals, included in a series of releases (Rules Releases or Rules Release, as applicable)[1], would:

- Establish exemptions and exclusions from the Dodd-Frank Act's registration and reporting requirements for certain advisers to private funds, including:

  (i) an exemption from registration for advisers solely to private funds with less than $150 million in assets under management (AUM);

  (ii) an exemption from registration for advisers solely to venture capital funds;

  (iii) an exemption from registration and reporting for foreign private advisers; and

  (iv) an exclusion from the definition of an investment adviser under the Advisers Act for "family offices" as defined by the SEC.

- Raise the threshold for permitted SEC investment adviser registration from $25 million in AUM to $100 million in AUM (with certain exceptions), thereby shifting more regulatory responsibility to the states.

- Establish new reporting requirements for private fund advisers that are currently required to register with the SEC, as well as "exempt reporting advisers," such as advisers to venture capital funds and private equity funds with less than $150 million in AUM, who are not required to register, but will be required to file certain reports with the SEC.

- Expand the required disclosures for all registered investment advisers on Form ADV.

In addition, the SEC recently amended the so-called "pay-to-play" rules by adoption of new rule 206(4)-5 under the Advisers Act, which became effective on September 13, 2010.

The vast majority of the proposed rules regarding oversight of private fund advisers were published in the Federal Register on December 10, 2010. Comments to the proposed rules must be submitted to the SEC on or before January 24, 2011, and the new rules become effective on July 21, 2011, the anniversary of the signing of the Dodd-Frank Act (Effective Date). For additional background on the investment adviser-related provisions under the Dodd-Frank Act, please see our July 22, 2010 PCIG Alert.

New Registration and Reporting Obligations and Exemptions

The Dodd-Frank Act eliminates the private adviser exemption contained in section 203(b)(3) of the Advisers Act, which exempted an investment adviser from registration if it (i) had fewer than 15 clients in the preceding 12 months, (ii) did not hold itself out to the public as an investment adviser and (iii) did not act as an investment adviser to a registered investment company (*e.g.*, a mutual fund) or a business development company. Prior to the Dodd-Frank Act, an adviser to private funds was exempt from registration so long as 14 or fewer private funds were advised, since each private fund, as opposed to the investors in each fund, counted as a single client. Previously exempt advisers to private funds will now be required to register with and report to the SEC under the Advisers Act, unless they qualify for an exemption from registration.

The Dodd-Frank Act defines “private funds” as those that would be investment companies under the Investment Company Act of 1940, as amended (Company Act), but for the exemptions in sections 3(c)(1) and 3(c)(7) thereunder.

The Dodd-Frank Act creates four principal exemptions from registration and/or exclusions from the definition of an investment adviser under the Advisers Act, which include (i) advisers solely to private funds with less than $150 million in AUM in the aggregate in the United States, without regard to the number or type of private funds advised; (ii) advisers solely to venture capital funds, without regard to the number or size of such funds advised by the adviser; (iii) non-U.S. advisers with less than $25 million in aggregate AUM from U.S. clients and private fund investors having fewer than 15 such clients and investors; and (iv) family offices. The proposed rules implement these statutory exemptions and exclusions.

Exemption for Private Fund Advisers with less than $150 million in AUM

New section 203(m) of the Advisers Act provides an exemption from registration for any investment adviser solely to private funds that has less than $150 million in AUM in the United States, and the Rules Release proposes new rule 203(m)–1 to implement this exemption, which would provide a new method for calculating AUM, as explained below. An adviser based outside the U.S. would be exempt if it has no U.S. persons as clients except for private funds, and if all assets managed from the adviser’s place of business (if any) in the U.S. are solely attributable to private funds with a total value of less than $150 million.

The SEC has proposed a new method for calculating AUM, as explained below (see “*Guidance for Private Funds Calculating AUM*”), and the “$150 million AUM” threshold is generally calculated in the aggregate as to all funds advised by the investment adviser. In addition, AUM for these purposes includes the sum of uncalled capital commitments of private fund investors plus the fair value of the assets of the fund.

Notwithstanding this exemption, such advisers will be subject to certain reporting requirements, as discussed below.

Venture Capital Exemption

The Dodd-Frank Act provides that an investment adviser that solely advises venture capital funds is exempt from registration under the Advisers Act, and directs the SEC to define “venture capital fund" by the Effective Date. Noting that Congress sought to distinguish advisers to venture capital funds from the larger category of advisers to "private equity funds," which are not exempt from registration, the Rules Release proposes in new rule 203(1)-1 that a "venture capital fund" be defined as a private fund that:

- represents to investors and potential investors that it is a venture capital fund;
- owns solely:
  - (i) equity securities issued by qualifying portfolio companies (QPCs), provided that at least 80 percent of the securities were acquired directly from the QPC rather than stockholders or others; and
  - (ii) cash and cash equivalents and U.S. treasury securities with a remaining maturity of 60 days or less;
- offers to provide (or provides if the offer is accepted) significant guidance and counsel to the management, operations or business objectives and policies of the QPC or controls the QPC;
- does not incur leverage (including debt or guarantees) in excess of 15 percent of the fund's aggregate capital contributions and uncalled committed capital and if incurred, any such leverage has a maturity of no longer than 120 days;
- does not provide investors with redemption or withdrawal rights except in extraordinary circumstances; and
- is not a registered investment company or business development company.

The SEC has also proposed "grandfathering" existing venture capital funds that may not currently satisfy all of the foregoing requirements. Under this proposal, an existing fund would satisfy the definition of "venture capital fund" if it (i) has represented to investors that it is a venture capital fund; (ii) prior to December 21, 2010, has sold securities to one or more unrelated persons; and (iii) does not sell any securities nor accept any additional committed capital after July 21, 2011.

As described above, a venture capital fund must invest solely in QPCs. The SEC proposes to define a QPC as a company that:

- is not publicly traded at the time of an investment by the venture capital fund (and that, directly or indirectly, does not control, is not controlled by or under common control with another public company);
- does not incur leverage in connection with the investment by the venture capital fund;
- does not recapitalize in connection with a venture capital fund investment by redeeming, exchanging or repurchasing any of its securities or by making a distribution, directly or indirectly; and
- is an operating company, as opposed to a private fund, mutual fund or commodity pool.

The list of specific requirements necessary to satisfy the SEC's proposed definition of a venture capital fund will undoubtedly force some venture capital fund advisers to modify their fund structures and practices in order to avoid SEC registration as an investment adviser. For example, the Rules Release notes that under the proposed venture capital fund definition, a fund would not qualify as a venture capital fund for purposes of the exemption if it invested in debt instruments (unless such instruments met the definition of ‘‘equity security’’) of a portfolio company or otherwise lent money to a portfolio company, indicating that such strategies are not the typical form of venture capital investing. At the same time, the Rules Release acknowledges that some venture capital funds extend ‘‘bridge’’ financing to portfolio companies, and this type of financing may take the form of investment in instruments that are ultimately convertible into a portfolio company’s common or preferred stock at a subsequent investment stage and thus would meet the definition of "equity security." However, it is unclear whether the Staff will ultimately classify this type of convertible bridge financing as permissible venture capital fund investment activity, and the Staff requested comment on whether the venture capital fund definition should include any fund that extends bridge financing that does not meet the definition of ‘‘equity security’’ on a short-term limited basis to a qualifying portfolio company, and whether the venture capital fund definition should be limited to those funds that make bridge loans to a portfolio company that are convertible into equity funding only in the next round of venture capital investing. In the event the Staff does not clarify the type of bridge financing that venture capital funds may pursue, it is possible that the common practice of start-up companies' issuing convertible debt that later converts into preferred stock to be issued to the investors at the closing of a venture financing may be cast into doubt.

As with advisers relying on the $150 million AUM exemption, advisers solely to venture capital funds will be subject to certain reporting requirements, as discussed below.

Foreign Private Adviser Exemption

The Dodd-Frank Act creates a new exemption from investment adviser registration for “foreign private advisers,” which are defined as any investment adviser that:

- does not have a place of business in the U.S.;
- has fewer than 15 clients and investors in the U.S. in private funds advised by the adviser;
- has less than $25 million in aggregate AUM from clients and private fund investors in the U.S.; and
- does not hold itself out in the U.S. as an investment adviser and does not act as an adviser to a registered investment company or business development company.

The proposed rules indicate that private funds must be looked through for the purpose of counting U.S. clients, but that a private fund, itself, need not be counted if one or more U.S. investors in the fund are included as clients. Nor does the same U.S. investor in more than one private fund advised by a foreign private adviser need to be counted more than once. The proposed rules define “place of business” as any office where the adviser regularly provides advisory services, solicits, meets or otherwise communicates with clients and any location held out to the public as such. Additional proposed rules expand the reach of private fund investors to be counted, and define “U.S. person” and “United States” which follow the definitions of such terms as contained in Regulation S under the Securities Act of 1933, as amended. Any foreign private adviser should immediately examine its investor base and operations to determine whether it can avoid registration and reporting obligations under the Advisers Act as of July 2011.

Unlike advisers relying on either the $150 million AUM exemption or the venture capital fund exemption, exempt foreign private advisers will not be subject to any reporting requirements.

Family Office Exclusion from the Definition of an Investment Adviser

"Family offices" are established by wealthy families to manage their wealth, administer charitable giving and provide other services, such as tax and estate planning, to family members. Since family offices typically provide advice about investing in securities for compensation, they would be required to register with the SEC under the Advisers Act absent an exemption. While the Dodd-Frank Act eliminated the private adviser exemption used by many family offices, it created an exclusion for "family offices" from the definition of "investment adviser" under the Advisers Act and directed the SEC to define "family offices" that would qualify for the exclusion.

On October 18, 2010, the Federal Register published proposed new rule 202(a)(11)(G)-1 under the Advisers Act to define "family offices" that would be excluded from the definition of an "investment adviser" under the Advisers Act. Note that, unlike exempt reporting advisers (such as advisers to venture capital funds and private fund advisers with less than $150 million in AUM), family offices that qualify for the exclusion under the proposed rule would be excluded entirely from regulation under the Advisers Act, and would be required neither to register nor report as investment advisers. The proposed rule largely would codify previous exemptive orders issued to family offices by the SEC, and also would address new issues that the SEC deems appropriate for a rule of general applicability. In general, the proposed rule contains three conditions:

- family offices may provide advice about securities only to certain family members and key employees;
- family members must wholly own and control the family office; and
- a family office may not hold itself out to the public as an investment adviser.

In addition to these conditions, the proposed rule also incorporates the "grandfathering" provision required by section 409 of the Dodd-Frank Act.

Persons Allowed to Receive Advisory Services

The first condition requires that family offices provide investment advisory services only to "family clients." Family clients are defined as:

- "family members," which are defined as an individual and his or her spouse or spousal equivalent for whose benefit the family office was established and any of their subsequent spouses or spousal equivalents, their parents, their lineal descendants (including by adoption and stepchildren), and such lineal descendants' spouses or spousal equivalents;
- "key employees," who include an executive officer, director, trustee, general partner, or person serving in a similar capacity of the family office or any employee of the family office who has participated in the investment activities of the family office (or another company) for at least 12 months;
- any charitable organization established and funded exclusively by one or more family members;
- any trust or estate existing for the sole benefit of one or more family clients; and
- any corporation or other entity wholly owned and controlled (directly or indirectly) exclusively by, and operated for the sole benefit of, one or more family clients; provided it is not an "investment company" under the Investment Company Act of 1940.

Family clients also include former family members (*e.g.*, former spouses) and former key employees, provided that such persons may not receive investment advice (or invest additional assets with a family office-advised trust or other entity) except as to assets advised by the family office at the time such person was still a family member or key employee.

If a person who is not a family client (i.e., family member or key employee) becomes a client of the family office by reason of inheritance from a family client or another involuntary transfer, there is a four-month grace period to permit the assets to be transitioned to another adviser.

Ownership and Control

The second family office condition requires that the family office be "wholly owned and controlled" (directly or indirectly) by family members (note that family members are a more restrictive group than family clients and do not include key employees). "Control" is defined as the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of being an officer of such company. The SEC has indicated that this control condition is necessary to ensure that (i) the family is in a position to protect its own interests rather than relying on the federal securities laws and (ii) the family office is distinguished from typical commercial investment advisers.

However, if, as appears to be the case, the "wholly owned and controlled" test means 100% family member control, many family offices with non-family trustees or board members may be required to restructure, absent clarification in the final rules. Service by a non-family member as an officer of the family office is expressly permitted, but, as is commonly the case, for a family office to reach out to non-family members with the appropriate expertise to serve as trustees or board members could run afoul of this condition and endanger the ability to qualify for the family office exclusion.

No Publicity as an Investment Adviser

The third family office condition requires that a family office not hold itself out to the public as an investment adviser. This is consistent with the idea that the family office should not provide, or offer to provide, advisory services to non-family clients.

"Grandfathering"

Finally, the proposed rule excluding family offices incorporates the "grandfathering" concept required by the Dodd-Frank Act. The persons who are "grandfathered" as family office advisory clients include:

- natural persons who, at the time of their applicable investment, are officers, directors, or employees of the family office who have invested with the family office before January 1, 2010 and are accredited investors, as defined in Regulation D under the Securities Act of 1933 (largely overlapping permitted "key employees" described above);

- any company owned exclusively and controlled by one or more family members (included in one element of the "family client" definition); or

- any investment adviser registered under the Advisers Act that provides investment advice to the family office and who identifies investment opportunities to the family office, and invests in such transactions on substantially the same terms as the family office invests, but does not invest in other funds advised by the family office, and whose assets as to which the family office directly or indirectly provides investment advice represents, in the aggregate, not more than 5 percent of the value of the total assets as to which the family office provides investment advice (provided that the anti-fraud provisions of the Advisers Act would apply to such a family office).

New Reporting Requirements for Registered Investment Advisers and Exempt Reporting Advisers

The SEC proposes to amend Form ADV to require additional information from registered investment advisers as to (i) private funds advised, (ii) their advisory business, including types of clients and (iii) non-advisory activities and financial industry affiliations. Moreover, exempt venture capital fund advisers and advisers to other private funds with less than $150 million in AUM would now be classified as “exempt reporting advisers” and would be required to provide and update certain information on Form ADV (although not the entire Form ADV).

New Reporting Requirements for Venture Capital Funds and Other Private Funds with Less than $150 Million in AUM (Exempt Reporting Advisers)

Commencing August 20, 2011, exempt reporting advisers would be required to file Form ADV through the Investment Adviser Registration Depository (IARD) using the same process as registered advisers. Exempt foreign private advisers and family offices are not deemed to be “exempt reporting advisers” and would not be required to report. Exempt reporting advisers will file a subset of Form ADV, including basic identifying information, form of organization, ownership of the adviser, other business activities that pose conflicts of interest, disciplinary history and a comprehensive overview of private funds advised. However, unlike registered investment advisers, exempt reporting advisers would not be required to complete Part 2 of Form ADV (the client brochure). This Form ADV information would need to be updated annually by the exempt reporting adviser, within 90 days of the end of the adviser’s fiscal year, provided that certain information, such as disciplinary proceedings, must be updated promptly during the course of the year.

Reporting as to Private Funds

Registered investment advisers and exempt reporting advisers to private funds must now provide extensive additional disclosure as to their advised funds on Form ADV. Such advisers will be required to disclose organizational, operational and investment characteristics of their advised private funds, including, but not limited to:

- identifying information, state of organization, identity of general partners, managers and the like;
- relevant exemption under the Company Act;
- organizational information about their funds (*e.g.*, master fund, feeder fund, fund of funds);
- gross and net assets;
- investment strategy (*e.g.*, private equity, hedge fund or venture capital fund);
- number and types of investors;
- fund characteristics that could present a conflict of interest; and
- information as to service providers (or “gatekeepers”), including auditors, prime brokers, custodians, administrators and marketers.

Additional Reporting Requirements for Registered Investment Advisers

In addition, the SEC has proposed that registered investment advisers (but not exempt reporting advisers) provide additional disclosure on Form ADV in the following areas:

- advisory business, including advisory activities of the adviser, types of clients, number of registered investment adviser representatives or insurance agents;
- non-advisory activities, including business as a trust company, registered municipal advisor, accountant, attorney or additional non-advisory activities; and
- potential conflicts of interest, including identifying information as to related persons and relationships and practices that may present conflicts, such as the use of affiliated brokers, soft dollar arrangements, compensation for client referrals and the like.

Increase in Threshold (from $25 million AUM to $100 million AUM) for Eligibility for Registration with the SEC

Mid-Sized Advisers

Currently, under section 203A of the Advisers Act, an investment adviser regulated by the state in which it maintains its principal office and place of business is generally not permitted to register with the SEC unless it has assets AUM of at least $25 million. Section 410 of the Dodd-Frank Act expands this prohibition to a new class of "mid-sized advisers," effectively raising the AUM threshold for registration with the SEC to $100 million. The creation of this new class of advisers under the Dodd-Frank Act shifts primary responsibility for the regulatory oversight of mid-sized advisers having AUM between $25 million and $100 million from the SEC to the states. As a result, a significant number of investment advisers currently registered with the SEC who fit within these parameters will be required to withdraw their registrations with the SEC and register with one or more state securities regulators, unless they qualify under certain exemptions to the proposed rule.

Under this expanded prohibition, an investment adviser is prohibited from registering with the SEC if:

- the investment adviser is required to be registered as an investment adviser with the securities regulator of the state in which it maintains its principal office and place of business;
- if registered, the investment adviser would be subject to examination as an investment adviser by such state securities regulator; and
- the investment adviser has AUM between $25 million and $100 million.

However, an investment adviser with AUM between $25 million and $100 million will still be required to register with the SEC if it advises a registered investment company or business development company. Further, if as a result of this expanded prohibition an investment adviser would be required to register in 15 or more states, then the adviser may (but is not required to) register with the SEC instead of those states.

The Rules Release proposes to require a mid-sized adviser that is registering with the SEC to affirm on an annual basis that it is not required to be registered as an investment adviser with the state securities authority in the state where it maintains its principal office and place of business. Under proposed rule 203A-1(b) under the Advisers Act, an investment adviser registered with the SEC that is no longer able to make such an affirmation would have 180 days from its fiscal year end to withdraw from SEC registration.

In the Rules Release, the SEC acknowledges that there is not necessarily a clear and obvious answer to whether an investment adviser registered with a particular state would be subject to examination as an investment adviser by that state's securities regulator. The Rules Release explains that not all state securities authorities conduct compliance examinations, but that the SEC does not intend to review or evaluate each state's investment adviser examination program. Instead, the SEC proposes to correspond with each state securities authority and request that each advise the SEC whether an investment adviser registered in the state would be subject to examination. The SEC would then identify for investment advisers filing on IARD those states in which the securities regulator did not certify that investment advisers are subject to examination. In the event that a state fails to respond and the SEC is unable to provide guidance, mid-sized advisers in that state will need to determine independently whether investment advisers registered in that state are subject to examination, in order to determine whether SEC registration is prohibited.

Transition to State Registration

The SEC is proposing an initial 30-day grace period after July 21, 2011 for a registered investment adviser to determine whether it remains eligible for SEC registration, and thereafter, a 60-day period during which an investment adviser no longer eligible for SEC registration would be required to transition to state registration.

Proposed rule 203A-5 under the Advisers Act would require each investment adviser registered with the SEC on July 21, 2011 to report the market value of its AUM to the SEC by filing an amendment to its Form ADV within 30 days (*i.e.*, no later than August 20, 2011). This filing would be the first step by which an adviser no longer eligible for SEC registration would transition to state registration. It would require each investment adviser to determine whether it meets the revised eligibility criteria for SEC registration, and would provide the SEC and the state regulatory authorities with information necessary to identify those advisers required to transition to state registration. An adviser no longer eligible for SEC registration would have to withdraw its SEC registration by filing Form ADV-W no later than 60 days after the required filing of the Form ADV amendment (*i.e.*, no later than October 19, 2011). The SEC indicates in the Rules Release that it would expect to cancel the registration of investment advisers that fail to file an amendment or withdraw their registrations in accordance with the rule.

In the Rules Release, the SEC acknowledges the uncertainty for investment advisers that are not currently registered with the SEC and that may have AUM in excess of $30 million but less than $100 million prior to July 21, 2011. In the absence of SEC guidance, a state registered investment adviser might be required to register with the SEC (because its AUM exceeds $30 million) and then be required to withdraw its registration when the threshold for SEC registration increases to $100 million.

The SEC indicates that it will not object if any state-registered or newly registering investment adviser is not registered with the SEC if, on or after January 1, 2011, until the end of the transition process (which would be October 19, 2011 under proposed rule 203A-5), the investment adviser reports on its Form ADV that it has between $30 million and $100 million of AUM, provided that:

- the investment adviser is registered as an investment adviser in the state in which it maintains its principal office and place of business; and
- the investment adviser has a reasonable belief that it is required to be registered with, and is subject to examination as an investment adviser by, that state.

The SEC states that such investment advisers should remain registered with, or in the case of a newly registering adviser, apply for registration with, the applicable state securities regulators.

Assets Under Management

Section 203A(a)(2) of the Advisers Act currently defines "assets under management" as the "securities portfolios" with respect to which an investment adviser provides "continuous and regular supervisory management services." This definition was not amended by the Dodd-Frank Act. Historically, investment advisers have relied upon the instructions to Form ADV for further guidance in calculating AUM. Those instructions currently list certain types of assets that investment advisers may, but are not required, to include when calculating AUM, including proprietary assets, assets managed without receiving compensation, and assets of foreign clients. As a result, there is currently not a uniform method of calculating AUM used by investment advisers, and those advisers with AUM near the $25 million or $30 million threshold are potentially able to manipulate their calculation of AUM (by including, or not including, certain assets as permitted by the Form ADV instructions). This effectively has permitted certain investment advisers to "opt in" or "opt out" of state or federal regulation.

In light of the additional uses of the term "assets under management" by the Dodd-Frank Act and any new regulatory requirements related to systemic risk that might be triggered by registration with the SEC, the SEC is proposing to eliminate these options by changing the Form ADV instructions and establishing a new rule which together would create a uniform method of calculating AUM, called "regulatory assets under management" (RAUM). This new calculation method would be used for reporting AUM on Form ADV and determining eligibility for registration, or exemptions from registration, with the SEC under the Advisers Act. More specifically, the SEC is proposing to require all investment advisers to include in their RAUM all securities portfolios for which they provide continuous and regular supervisory or management services, regardless of whether these assets are proprietary assets, assets managed without receiving compensation, or assets of foreign clients, all of which an adviser currently may (but is not required to) exclude. Further, the SEC would not allow an investment adviser to subtract outstanding indebtedness and other accrued but unpaid liabilities, which remain in a client's account and are managed by the investment adviser. The proposed changes would result in some investment advisers reporting greater AUM than they do today.

Guidance for Private Funds Calculating AUM

As discussed elsewhere in this Alert, the Dodd Frank Act will have the effect of requiring many private fund advisers that previously relied on the "private adviser exemption" to now determine their AUM and whether they must register as an investment adviser with the SEC. The current Form ADV and the instructions thereto provide no meaningful guidance for advisers to private funds in calculating AUM.

The SEC's proposed guidance provides that an investment adviser would be required to include in RAUM:

- the value of any private fund over which it exercises continuous and regular supervisory and management services, regardless of the nature of the assets held by the private fund; and

- the amount of any uncalled capital commitments made to the private fund.

In determining the value of a private fund, the proposed guidance provides that an investment adviser must use the "fair value" of the private fund's assets. As the SEC explains in the Rules Release, the use of the cost basis of a private fund's assets, rather than the fair value of those assets, could grossly understate the value of appreciated assets and result in advisers avoiding registration with the SEC. In recognition of the fact that the limited partnership agreement (or similar governing document) for many private funds includes specific provisions as to the process of valuation of a fund's assets, the Rules Release specifically provides that an adviser to a private fund may rely on that process in determining "fair value" for purposes of calculating RAUM.

Advisers to private funds should take particular note of the proposed requirement to use the fair value of a private fund's assets, rather than the cost basis of those assets, when calculating RAUM. This means that advisers to private funds, when calculating RAUM and determining whether they must register with the SEC, cannot look solely to the "size of the fund" as commonly described, which typically refers to the aggregate capital commitments of the fund's investors. For example, an investment adviser to a single "$100 million buyout fund" (i.e., a fund that had aggregate original capital commitments of $100 million) would satisfy the $150 million exemption from SEC registration as of the closing of the fund. However, if the fund's current portfolio investments appreciate significantly in value, such that the "fair value" of those investments plus the amount of any remaining uncalled capital commitments exceeds $150 million, then the investment adviser would no longer satisfy the exemption and would be required to register with the SEC.

Switching Between State and SEC Registration

Currently, rule 203A-1 under the Advisers Act provides a means of preventing an investment adviser from having to switch frequently between state and SEC registration as a result of changes in AUM or the departure of one or more clients.

The rule provides for a $5 million buffer that permits an investment adviser having between $25 million and $30 million of assets under management to remain registered with the states and does not subject the adviser to cancellation of its SEC registration until its AUM falls below $25 million. The SEC is proposing to amend rule 203A-1 to eliminate this $5 million buffer, in light of the increase in the registration threshold of AUM from $30 million to $100 million.

The rule also permits an investment adviser to rely on the firm's AUM reported annually in the firm's annual updating amendments to Form ADV for purposes of determining its eligibility to register with the SEC. This portion of the rule will remain unchanged, allowing an investment adviser to avoid the need to change registration status based upon fluctuations that occur during the course of the year. If an investment adviser is no longer eligible for SEC registration, the rule provides a 180-day grace period from the investment adviser's fiscal year-end to allow it to switch to state registration.

Amendments to Pay to Play Rules

On June 30, 2010, the SEC voted unanimously to adopt new rule 206(4)-5 under the Advisers Act, which is designed to prevent the fraudulent, deceptive or manipulative "pay to play" practices of investment advisers in soliciting investment advisory business from public pension plan assets and similar government investment accounts. This rule applies to SEC-registered investment advisers and unregistered advisers relying on the exemption to registration available under section 203(b)(3) of the Advisers Act. It prohibits an investment adviser and certain of its executives and employees from:

- Providing advisory services for compensation – either directly or through a pooled investment vehicle – for two years, if the adviser or certain of its executives or employees make a political contribution to an elected official who is in a position to influence the selection of the adviser. There is a de minimis exception for contributions of up to $350 per election per candidate if the contributor is entitled to vote for the candidate, and up to $150 per election per candidate if the contributor is not entitled to vote for the candidate.

- Soliciting and coordinating campaign contributions from others – a practice referred to as "bundling" – for an elected official who is in a position to influence the selection of the adviser. It also prohibits solicitation and coordination of payments to political parties in the state or locality where the adviser is seeking business.

- Paying a third party, such as a solicitor or placement agent, to solicit a government client on behalf of the adviser, unless that third party is an SEC-registered investment adviser or broker-dealer subject to similar pay to play restrictions.

- Engaging in pay to play conduct indirectly, such as by directing or funding contributions through third parties such as spouses, lawyers or companies affiliated with the adviser, if that conduct would violate the rule if the adviser did it directly.

Rule 206(4)-5 became effective on September 13, 2010. Compliance with the rule's provisions generally will be required within six months after the effective date, which is March 13, 2011. Compliance with the third-party ban and those provisions applicable to advisers to registered investment companies subject to the rule will be required one year after the effective date, which is September 13, 2011.

The more recent Rules Release is proposing three amendments to rule 206(4)-5, which the SEC believes are necessary as a result of the enactment of the Dodd-Frank Act and certain interpretive questions received by the SEC. In summary they are as follows:

- Extend rule 206(4)-5 to apply to exempt reporting advisers.

- Amend the provision of rule 206(4)-5 that prohibits advisers from paying persons to solicit government entities unless such persons are "regulated persons."

- Amend rule 206(4)-5's definition of a "covered associate" of an investment adviser to clarify that a legal entity, not just a natural person, that is a general partner or managing member of an investment adviser would meet the definition.

Application to Exempt Reporting Advisers

In addition to registered investment advisers, rule 206(4)-5 currently applies to unregistered advisers relying on the exemption to registration available under the old language contained in section 203(b)(3) of the Advisers Act. As discussed above, before its repeal under the Dodd-Frank Act, the 203(b)(3) exemption was the general private adviser exemption, which was available to U.S. and foreign advisers to various types of investment funds. Section 203(b)(3) of the Advisers Act has now been replaced with the "foreign private adviser" exemption. As a consequence, the application of rule 206(4)-5 to unregistered advisers relying on the exemption available under the new language in section 203(b)(3) of the Advisers Act, would necessarily include only "foreign private advisers" who choose not to register with the SEC. It would leave out exempt reporting advisers, who previously could rely on the 203(b)(3) exemption, but who can now rely on the venture capital fund and $150 million AUM exemptions which are codified under new sections 203(l) and (m) of the Advisers Act.

In adopting rule 206(4)-5, the SEC did not intend for the rule to have such a narrow application. Accordingly, it now desires to amend the rule to include exempt reporting advisers by inserting references to same in paragraphs (a)(1), (a)(2) and (d) of the rule.

Replacing "Regulated Person" with "Regulated Municipal Advisor"

Rule 206(4)-5 currently prohibits advisers from paying placement agents and other solicitors to solicit a government entity unless any such person is a "regulated person," which the rule defines as (i) a registered investment adviser that has not, and whose covered associates have not, within two years of soliciting a government entity, made contributions to an official of that government entity (other than *de minimis* contributions) and coordinated the bundling of contributions; or (ii) a registered broker-dealer that is a member of a national securities association (*e.g.*, the Financial Industry Regulatory Authority (FINRA)) that prohibits its members from engaging in pay to play activities and which the SEC deems to be substantially equivalent or more stringent on broker-dealers than rule 206(4)-5 imposes on investment advisers and consistent with rule 206(4)-5's objectives.

The SEC proposes to amend the rule by replacing the term, "regulated person," with a new term, "regulated municipal advisor," which is defined as a municipal advisor registered with the SEC under section 15B of the Securities Exchange Act of 1934, as amended, and subject to the pay to play rules adopted by the Municipal Securities Rulemaking Board (MSRB) and which the SEC deems to be substantially equivalent or more stringent on municipal advisors than rule 206(4)-5 imposes on investment advisers and consistent with such rule 206(4)-5's objectives.

The reason for this amendment is that the Dodd-Frank Act created a new category of persons known as "municipal advisors," which are third-party solicitors, including registered investment advisers and broker-dealers, who undertake a solicitation of a municipal entity (*e.g.*, public pension plan or other corporate instrumentality of a State, a political subdivision thereof, or a municipality) on behalf of an unrelated investment adviser. The SEC understands that the MSRB intends to consider subjecting municipal advisors to pay to play rules similar to its rules governing municipal securities dealers, and therefore, registered investment advisers and broker-dealers generally meeting the statutory definition of a "municipal advisor" would be subject to MSRB rules. Accordingly, the SEC believes that given the new regulatory regime applicable to municipal advisers, it would be unnecessary for FINRA to adopt similar pay to play rules; hence, the replacement of the term, "regulated person," with the new term, "regulated municipal advisor."

"Covered Associate" Definition

The term, "covered associate," as used in rule 206(4)-5, generally refers to owners, managers, officers, employees and political action committees controlled by an investment adviser, in order that these sub-sets of the investment adviser be included in the pay to play prohibitions. In particular, the first part of the definition of a "covered associate" includes "any general partner, managing member or executive officer, or other individual with a similar status or function."[2] The SEC proposes a minor amendment to this part of the definition by replacing the word "individual" with the word "person" to clarify that a legal entity, not just a natural person, that is the general partner or managing member of an investment adviser would meet the definition.

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We will continue to monitor developments, including comments that may be submitted in response to the Rules Releases, the final rules voted on by the SEC, and the progress of the SEC's and other Federal agencies' ongoing rulemaking that impact investment advisers, in order to keep our clients and friends informed. Please do not hesitate to contact your Patton Boggs attorney or one of the lawyer/authors listed on the first page of this Alert with any inquiries.

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[1] Release No. IA-3110, SEC Proposed Rules Implementing Amendments to the Investment Advisers Act of 1940, December 10, 2010; Release No. IA-3111, SEC Proposed Rules on Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers, December 10, 2010; and Release No. IA-3098, SEC Proposed Rule on Family Offices, October 18, 2010.

[2] Rule 206(4) 5(f)(2)(i) under the Advisers Act.