

SEC Finalizes Dodd-Frank Rules Affecting Investment Advisers: Many 'Mid-Sized Advisers' Must Transition from SEC Registration to State Registration

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At an open meeting June 22, 2011 (the "June 22 Meeting"), the Securities and Exchange Commission (the "SEC" or "Commission") voted to adopt new rules and rule amendments under the Investment Advisers Act of 1940 (the "Advisers Act") that will:

- Reallocate regulatory responsibility for advisers between the SEC and the states
- Require certain advisers to hedge funds and other private funds to register with the SEC
- Establish new exemptions from SEC registration
- Establish reporting requirements for certain advisers who are exempt from registration¹

In addition, the Commission amended rules and Form ADV to expand the disclosure provided by registered investment advisers and to require certain items of Form ADV to be completed and filed by "exempt reporting advisers." The SEC also adopted a new rule that exempts "family offices" from regulation under the Advisers Act and provides a definition of such entities.² These new rules and rule and form amendments arise out of Congressional directives contained in Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").

Below, we cover the reallocation of responsibility for mid-size advisers between the SEC and the states. Please check our website, www.reedsmith.com, under the "Publications" tab for our Client Alerts relating to private fund advisers, foreign advisers, and family offices.

Currently, subject to certain exceptions, the SEC is the primary regulator of advisers with more than \$30 million in assets under management ("AUM"), while the states are the primary regulators of advisers with less than \$25 million AUM.³ Title IV of the Dodd-Frank Act changes the basic thresholds for state versus federal registration. Specifically, it creates a new category of mid-sized advisers (*i.e.*, advisers with between \$25 million and \$100 million AUM) and *prohibits* a mid-sized adviser from registering with the SEC unless it is either:

- Not required to register as an adviser with the state securities authority in the state where it maintains its principal office and place of business
- Not subject to examinations as an adviser by the state where it maintains its principal office and place of business

A mid-sized adviser *must* register with the SEC if it meets one of the two above-listed criteria,⁴ unless it falls within an exemption from registration, such as the registration for certain advisers to private funds.⁵

In other words, generally speaking, the basic threshold for SEC registration has been raised to \$100 million AUM, subject to a host of exceptions.⁶ As discussed below under "Buffer Rules," the SEC then "tweaked" this statutory threshold by adding a 20

percent buffer around the \$100 million cut-off, such that a state-registered adviser need not switch to SEC registration unless its assets under management reach at least \$110 million and, at the other end of the "buffer," an adviser registered with the Commission need not withdraw such registration until its assets under management fall below \$90 million. Three key questions arise when applying the mid-sized adviser provisions: (1) how is AUM calculated, (2) what constitutes an adviser's "principal office and place of business," and (3) how can an adviser determine whether or not it is "subject to examinations" in its home state? The SEC has adopted rules to answer these questions.

How is AUM calculated?

When calculating its AUM for purposes of the mid-sized adviser provisions, an adviser must generally include the full value of all securities portfolios for which it provides continuous and regular supervisory or management services. An account is a securities portfolio if at least 50 percent of the total value of the account consists of securities. An adviser must include in its AUM all of the assets of private funds it manages, as well as those securities portfolios that are family accounts, proprietary accounts, accounts for which no compensation is received, and accounts of foreign clients.⁷

What constitutes a "principal office and place of business"?

An adviser's "principal office and place of business" is its executive office from which its officers, partners, or managers direct, control, and coordinate its activities.⁸

How can an adviser determine whether or not it is "subject to examinations" in its home state?

The SEC has posted a list of states that do not subject their adviser registrants to examination. The list is available [here](#), and currently only identifies New York and Wyoming as non-examining states.⁹ Thus, if a mid-sized adviser's principal office and place of business is located in New York or Wyoming, it is not subject to examinations, and thus must register with the SEC unless it falls within an exemption from registration.

Examples

The following examples illustrate the practical application of the mid-sized adviser provisions, and how they interact with other Advisers Act provisions, related rules, and state laws.

Scenario 1

Facts: Adviser A has \$60 million AUM. It has no investment company clients. Its principal office and place of business is in New Jersey. It is not required under state law to register in New Jersey because it has fewer than six clients resident in that state.¹⁰ It does not qualify for any federal exclusion or exemption from registration.

Conclusion: Adviser A must register with the SEC.

Scenario 2

Facts: Adviser B exclusively advises hedge fund clients and has \$85 million AUM. Its principal office and place of business is in New York. It is exempt from federal registration under the terms of the new "private fund adviser exemption."¹¹

Conclusion: Adviser B is not required to register with the SEC, but it may choose to register with the SEC if it so desires. If it does not register with the SEC, it must examine the laws of each state in which it has clients or a place of business to determine whether it must register therein.

Scenario 3

Facts: Adviser C has \$35 million AUM. It has no investment company clients. Its principal office and place of business is in Connecticut, and it is required to register as an investment adviser with the Connecticut Department of Banking under state law. Adviser C is not: a pension consultant, affiliated with an adviser registered with the SEC, expecting to be eligible for SEC registration within 120 days of filing Form ADV, nor is it an "Internet adviser."

Conclusion: Adviser C (a) is prohibited from registering with the SEC, (b) must register in Connecticut, (c) and must examine the laws of each state in which it has clients or a place of business to determine whether it must register therein. However, if, as a result of (c), Adviser C determines that it would be required to register with 15 or more states, then it may (but is not required to) register with the SEC instead.

Buffer Rules

In an effort to prevent adviser from having to switch frequently between state and SEC registration as a result of changes in the value of its assets under management or the departure of one or more clients, the SEC amended Rule 203A-1 to provide a buffer for mid-sized advisers. Mid-sized advisers with AUM close to \$100 million can use this buffer to determine whether and when to switch between state and SEC registration. Rule 203A-1 raises the threshold above which a mid-sized investment adviser must register with the SEC to \$110 million; but, once registered with the SEC, an adviser need not withdraw its registration until it has less than \$90 million of assets under management. In addition, the SEC decided that eligibility for registration be determined annually as part of an adviser's annual updating amendment, allowing an adviser to avoid the need to change registration status based on fluctuations that occur during the course of the year.

Transition Rules and Compliance Dates

The SEC has estimated that approximately 3,200 SEC-registered advisers will be required to transition to state registration as a result of the Dodd-Frank Act and related rules and amendments.¹² To provide for an orderly transition from federal to state registration for these thousands of advisers, the SEC has adopted transition rules, as described below.

Current SEC Registrants:

A mid-sized adviser registered with the SEC as of July 21 of this year must remain registered with the SEC until January 1, 2012, unless it is otherwise exempt from SEC registration. Advisers registered with the SEC as of January 1, 2012 must file an amendment to Form ADV by March 30, 2012, setting forth information that will identify those mid-sized advisers no longer eligible to remain registered with the SEC.¹³ A mid-sized adviser who is no longer eligible for SEC registration as evidenced in this Form ADV filing must register with the relevant state securities authority and must withdraw its SEC registration by filing a Form ADV-W by no later than June 28, 2012.¹⁴

New Applicants post-July 21, 2011:

Unlike mid-sized advisers who are current SEC registrants, new applicants may only register with the SEC if they satisfy the requirements of Section 203A(a)(2).¹⁵

- See Investment Advisers Release No. 3221, Rules Implementing Amendments to the Investment Advisers Act of 1940, available at: www.sec.gov/rules/final/2011/ia-3221.pdf (June 22, 2011) (hereinafter "Release 3221"); Investment Advisers Release No. 3222, Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than \$150 Million in Assets Under Management, and Foreign Private Advisers, available at: www.sec.gov/rules/final/2011/ia-3222.pdf, (June 22, 2011).
- 2. See Investment Advisers Release No. 3220, Family Offices, available at: www.sec.gov/rules/final/2011/ia-3220.pdf, (June 22, 2011).
- 3. See Section 203A of the Advisers Act, and Rule 203A-1 thereunder. Pursuant to Rule 203A-1, SEC registration is optional for advisers with \$25 million - \$30 million AUM.
- 4. See Section 410 of the Dodd-Frank Act.
- 5. If it falls within an exemption, a mid-sized adviser may choose to register with the SEC, but it is not required to do so. See Division of Investment Management: Frequently Asked Questions Regarding Mid-Sized Advisers, Question 2, available at www.sec.gov/divisions/investment/midsizedadviserinfo.htm.
- 6. For example, the following types of advisers with less than \$100 million AUM may nonetheless register with the Commission: pension consultants, certain investment advisers affiliated with an adviser registered with the SEC, investment advisers expecting to be eligible for SEC registration within 120 days of filing Form ADV, and certain Internet advisers (see Rule 203A-2, as amended). An adviser who would be required to register with 15 or more states may also register with the Commission despite having less than \$100 million AUM (see Section 203A(a)(2)(A) of the Advisers Act, as amended by Title IV of the Dodd-Frank Act).
- 7. See Rule 203A-3, which cross-references Form ADV (as revised by Releases 3221 and 3222), Part 1A Instruction 5.b, available at www.sec.gov/rules/final/2011/ia-3221-appb.pdf. Note that for accounts of private funds, an adviser must also include in its AUM any uncalled commitment pursuant to which a person is obligated to acquire an interest in the private fund, or make a capital contribution to it. See *id.*
- 8. See Rule 203A-3(c).
- 9. Note that Release 3221 also identifies Minnesota as a non-examining state, but Minnesota does not appear on the Mid-Sized Adviser FAQ, which was last modified six days after the date of Release 3221, and would thus appear to supersede the Release on this point.
- 10. See NJ Rev. Stat. Section 49:3-56(g)(2011).
- 11. See Rule 203(m)-1.
- 12. See Release 3221.
- 13. See Rule 203A-5.

- 14. *Id.*
- 15. *I.e.*, it is prohibited from registering with the SEC unless it is either (i) not required to register as an adviser with the state securities authority in the state where it maintains its principal office and place of business; or (ii) not subject to examinations as an adviser by the state where it maintains its principal office and place of business, subject to the exceptions described in this Alert.

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