SEC proposes rules implementing new Investment Adviser registration provisions

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written by Peter M. Rosenblum, Jeffrey D. Collins, Meredith A. Haviland

On November 19, 2010, the Securities and Exchange Commission (the "SEC") issued two sets of proposed rules relating to the implementation of amendments to the Investment Advisers Act of 1940, as amended (the "Advisers Act"), contained within the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").

Implementing Rules

The first set of proposed rules (the "Implementing Rules") addresses the implementation of the new registration requirements. Among the changes contained in the Dodd-Frank Act was the removal of the exemption from registration which enabled investment advisers with fewer than 15 clients to avoid registration with the SEC. The Dodd-Frank Act also increased the threshold for registration with the SEC from $25 million in assets under management to $100 million. In addition to raising this threshold, the Dodd-Frank Act set forth new provisions relating to advisers with assets under management between $25 million and $100 million, or "mid-sized advisers."

Under the Dodd-Frank Act, mid-sized advisers are prohibited from registering with the SEC unless (i) the adviser is not required to be registered as an investment adviser with the securities commissioner in the state in which it maintains its principal place of business and, if registered with the securities commissioner of a state, the adviser would not be subject to examination as an investment adviser by that securities commission or (ii) the adviser is required to registered in more than 15 states. The Implementing Rules provide guidance on how to determine whether an adviser is "not required to be registered" as an investment adviser with the relevant state securities authority. Specifically, the Implementing Rules provide that a mid-sized adviser which is not registered as an adviser in the state in which it has its principal office and place of business in reliance on a valid exemption from registration in such state will be considered "not required to be registered" in such state, and therefore must register with the SEC unless another exemption from registration is available to such adviser. Even if registered with a state securities authority, a mid-sized adviser would be required to register with the SEC unless such adviser is subject to examination by such state securities authority. The proposed amendments to the Form ADV will include a list of states which do not conduct such examinations.

The Implementing Rules also set forth a proposal for what information will need to be provided by advisers exempt from registration under either the "private adviser exemption" or the "venture capital exemption" set forth in Sections 407 and 408 of the Dodd-Frank Act, and explained in further detail below. Under the Implementing Rules, these advisers, while exempt from full registration with the SEC, would be required to complete the following portions of Part 1A of the Form ADV, including the corresponding schedules: Item 1 (Identifying Information), Item 2.C (SEC Reporting by Exempt Reporting Advisers), Item 3 (Form of Organization), Item 6 (Other Business Activities), Item 7 (Financial Industry Affiliations and Private Fund Reporting), Item 10 (Control Persons), and Item 11 (Disclosure Information). Such advisers would not be required to complete Part II of the Form ADV. Periodic updates to the Form ADV, including annual amendments, would also be required.

A number of proposed amendments to the Form ADV are also included in the Implementing Rules, including a uniform method by which to calculate Assets Under Management and additional disclosure requirements with respect to: (i) the private funds advised by registered or exempt advisers, (ii) an adviser's employees, clients and advisory activities, (iii) an adviser's other business activities and financial industry affiliations, and (iv) participation in client transactions.

If the Implementing Rules are adopted, all advisers registered with the SEC on July 21, 2011 would be required to file an update to their Form ADV prior to August 20, 2011 to report current assets under management (as determined within 30 days of the filing). Subject to certain grace periods, advisers no longer eligible to register with the SEC would be required to withdraw their registration by October 19, 2011.

Also included in the Implementing Rules are a few proposed amendments to the "Pay to Play" Rule, adopted in July 2010. These include amending the scope of the rule so that it applies to both foreign private advisers and exempt reporting advisers, amending the types of persons advisers can pay to solicit governmental entities on their behalf such that references to "regulated persons" would be changed to "regulated municipal advisers", and minor amendments to the definition of "covered associate" to make clear that entities, and not just natural persons, that serve as the managing member or general partner of an adviser are included within this definition.

Comments regarding the Implementing Rule must be received by the SEC within 45 days after publication of the Implementing Rule in the Federal Register.

Exempting Rules

The second set of proposed rules (the "Exempting Rules") relates to the exemptions from registration for advisers to venture capital funds, private fund advisers with less than $150 million in assets under management and foreign private advisers. Each of these categories of exemptions was established as part of the Dodd-Frank Act. While such categories of advisers are exempt from full registration with the SEC, the Dodd-Frank Act granted the SEC authority to require that such advisers maintain and provide certain information to the SEC. As described above, the Implementing Rules set forth proposals relating to the filing and reporting requirements for such exempt advisers.

Venture Capital Funds

The Dodd-Frank Act provides for an exemption from registration with the SEC for advisers that are advisers solely to venture capital funds. The Exempting Rules propose to define "venture capital fund" as a private fund that:

1. holds itself out as a venture capital fund;
2. owns only: (a) equity securities issued by qualifying portfolio companies (and at least 80 percent of the equity securities of each qualifying portfolio company owned by the fund must be acquired directly from the qualifying portfolio company); and (b) cash and cash equivalents and U.S. Treasuries with a remaining maturity of 60 days or less;
3. with respect to each qualifying portfolio company, the fund either controls such company or has an arrangement with such company, pursuant to which either the fund or the investment adviser offers to provide guidance regarding the operations, management and business objectives of the company;
4. does not borrow, issue debt obligations, provide guarantees or otherwise incur leverage in excess of 15% of the fund's aggregate capital commitments, and any such borrowing is for an unrenewable term of 120 calendar days or less;
5. issues securities that do not provide for a redemption right, except in extraordinary circumstances, but can provide for pro rata distributions to investors; and
6. is not an investment company registered under the U.S. Investment Company Act of 1940, as amended, or a company that has elected to be a business development company under such act.

A "qualifying portfolio company" is generally defined as a company that: (1) is private; (2) does not incur leverage in connection with the fund's investment; (3) does not redeem, exchange or repurchase any securities of the company in connection with the fund's investment, but uses the investment proceeds for operating or business expansion purposes; and (4) is an operating company and not a fund.

The Exempting Rules include grandfathering provisions which would include within the definition of "venture capital fund" current venture capital funds that represent themselves to investors as venture capital funds, have sold securities to investors prior to December 31, 2010 and do not accept additional commitments after July 21, 2011.

Private Funds with Less than $150 million in AUM

The Dodd-Frank Act also provides for an exemption from registration with the SEC for advisers that are advisers solely to qualifying private funds and have less than $150 million in assets under management. A "qualifying private funds" is a private fund (i.e. not a registered investment company) which has not elected to be treated as a business development company.

For advisers based in the U.S., all of the private fund assets of such adviser would be considered in calculating assets under management. Advisers with a principal office or principal place of business outside of the U.S. would only need to include assets managed from a place of business within the U.S. Assets under management would be calculated by reference to the Form ADV. As noted above, the Implementing Rules have proposed a uniform method for calculating assets under management for purposes of the Form ADV.

Foreign Private Advisers

Another exemption from registration provided by the Dodd-Frank Act relates to foreign private advisers. A “foreign private adviser” is defined as an adviser that: (1) has no place of business in the U.S.; (2) has fewer than 15 clients and investors in the U.S. in private funds advised by the adviser; (3) has assets under management attributable to U.S. clients and investors of less than $25,000,000 in the aggregate; and (4) does not hold itself out to the U.S. public as an investment adviser and is not an investment adviser for an investment company registered under the U.S. Investment Company Act of 1940, as amended, or a company that has elected to be a business development company under such act.

The Exempting Rules propose certain definitions relating to the foreign private adviser exemption, including clarifying the definition of “client” and “investor”. The proposed definition of “client” is similar to the current rule defining “client” in many respects, including having the ability to count as one client a corporation, limited partnership or limited liability company. The proposed rule does not, however, include the option of not counting among an adviser’s “clients” those persons who receive advisory services but who are not charged a fee. The Exempting Rules also include provisions designed to avoid a double-counting of clients and investors.

Comments regarding the Exempting Rules must be received by the SEC within 45 days after publication of the Exempting Rules in the Federal Register.