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CLIENT ALERT

New SEC Investment Adviser Regulations: What Do You Need To Know?

June 28, 2011

On June 22, 2011, the SEC adopted final rules and amendments to SEC rules under the Investment Advisers Act of 1940 (the "Advisers Act"). These rulemaking proceedings have significant importance to advisers to private funds.

Prior to the Dodd-Frank Act, advisers with fewer than 15 clients were not required to register with the SEC pursuant to the Advisers Act, and clients were defined to include funds receiving advisory services (rather than the investors in such funds). The June 22 SEC rules implemented the Dodd-Frank Act registration requirements for previously exempt advisers and clarified remaining exemptions from registration. In an important concession, however, the SEC, as had been expected, extended the deadline for registration for advisers previously exempt from registration until March 30, 2012.

SEC Chairman Mary Schapiro noted that these registration requirements will provide the SEC and the public with more information about these advisers and their business operations, investment strategies, conflicts of interest, disciplinary history, fund size, and the identity of their auditors and prime brokers. Additional advisers also will now be subject to the Commission's examination program, though the SEC indicated its intent to generally not exercise this authority over advisers who are required to comply only with reporting requirements but remain exempt from registration.

Although the SEC has not yet released the full final rules, highlights of the new rules reflected in the SEC releases include the following:

New Exemptions

The Dodd-Frank Act included exemptions from registration for (i) advisers solely to venture capital funds, (ii) private fund advisers with less than $150 million under management in the United States, (iii) foreign advisers that do not conduct U.S. business and (iv) family offices. In order to implement these exemptions, the SEC clarified the definitions of venture capital funds, foreign advisers and exempt family offices (private fund advisers were defined consistent with the Dodd-Frank Act).

Under the rules, a "venture capital fund" is a fund that:

- Invests primarily in "qualifying investments" (generally, private operating companies that do not distribute proceeds from debt financings in exchange for the fund's investment in the company);
- Does not invest in more than 20 percent of its committed capital in "non-qualifying investments" (with this aspect of the rules marking a change from prior SEC proposed rules which did not include the 20 percent exception);
- Is not leveraged except for a minimal amount on a short-term basis;
- Does not offer redemption or put rights to its investors, except in extraordinary circumstances; and
- Represents itself to investors as pursuing a venture capital strategy

The venture capital fund rules have a grandfather clause under which funds that commenced raising capital by the end of 2010 and represented themselves as pursuing a venture capital strategy will remain qualified as venture capital funds.

Foreign advisers are defined as advisers that (i) do not have a place of business in the United States, (ii) have less than $25 million in aggregate assets under management from U.S. clients and foreign private fund investors; and (iii) have fewer than 15 U.S. clients and private fund investors.

Family offices are exempt so long as they:

- Provide investment advice only to "family clients" (family members, key employees of the family office, non-profit or charitable organizations funded solely by family clients, estates and family client trusts). Family members, in turn, are defined fairly broadly to include the lineal descendants of a common ancestor not more than 10 generations removed from the youngest generation of family members;
- Are wholly-owned by family clients and controlled by family members or entities; and
- Do not hold themselves out publicly as an investment adviser.

The rules also include grandfather clauses for family offices which the SEC has previously exempted from registration under exemptive orders (a process which remains available for advisers similar to a family office which do not fit within the new definition) and family offices that provided advice prior to January 1, 2010.

Modified Threshold for Mid-Sized Advisers

Commission rules traditionally have required that advisers with under $25 million of assets under management register with state authorities rather than the SEC (unless there is no corresponding state regulation under which the adviser would be subject to examination). The Dodd-Frank Act raised the threshold for registering with the SEC from $25 million to $100 million. The SEC adopted certain implementing rules for the increased threshold. Although details of this were not reflected in the SEC's release (so await the release of the final rules), the SEC has created a buffer to prevent advisers from having to frequently switch between SEC and state registration. The rules require a recertification by advisers eligible to remain SEC regulated, so advisers will need to take note of their assets under management and be sure to register with state authorities if necessary or to accurately recertify with the SEC.

Registration Deadline

Advisers (including non-exempt family offices) now required to register were granted until March 30, 2012 to complete the registration process.

The registration deadline may prove particularly tricky for advisers undergoing changes in their business. This would include private fund advisers who are currently in the process of raising capital and who might surpass the $150 million threshold and foreign advisers which may be expanding their roster of U.S. clients and private funds.

Registration Process

The registration process involves completing the SEC's adviser registration form, which is being amended under the new rules.

The application has traditionally required the adviser to provide information about its services, its compensation, its type of clients, the types of investments it makes, its methods of analysis, sources of information and investment strategies, background and experience, other business activities, conflicts of interest, account review and reporting practices.

Under the new rules, advisers who are not exempt will need to report information (in some cases expanding upon the reporting requirements listed above) regarding:

- The funds they manage (type of fund, fund size and ownership, general fund data and services provided by the advisers);
- The identity of "gatekeepers" (auditors, prime brokers, custodians, administrators and marketers);
- Types of clients, employees and advisory activities;
- Conflicts of interest; and
- Non-advisory activities and financial industry affiliations

Reporting Requirements for Exempt Advisers

Even exempt advisers will need to comply with new reporting requirements by providing information including:

- Basic identifying information;
- Information about managed funds and conflicts of interest; and
- Disciplinary history.

This reporting will commence in the first quarter of 2012 and the information reported will be publicly available. The requirement that exempt advisers comply with reporting requirements was the subject of much debate among the SEC Commissioners.

For more information, please contact the professional(s) listed below, or your regular Crowell & Moring contact.

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