

The New Era of Regulation

REGISTRATION REQUIREMENTS FOR INVESTMENT ADVISERS UNDER THE DODD-FRANK ACT

Hedge fund and other private investment fund advisers should be aware of a number of significant changes to the registration and reporting requirements under the Investment Advisers Act of 1940 (the “Advisers Act”), as amended by the Private Fund Investment Advisers Registration Act of 2010 (the “Act”), Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”). Several of the key changes include the following:

- Repeal of the current private adviser exemption¹ under Section 203(b)(3) of the Advisers Act;
- New asset thresholds for federal registration of investment advisers;
- Authorizes the SEC to create an exemption from federal registration for advisers who advise only private funds and have assets under management of less than \$150 million; and
- Exclusion of “family offices” from the definition of investment adviser based on prior SEC exemptive relief.²

The effective date of the Act is July 21, 2011, except as otherwise provided in the Act. However, an investment adviser to a private fund³ may register during the one-year transition period, subject to Securities and Exchange Commission (“SEC”) rules.



¹ The private adviser exemption was the exemption typically relied upon by hedge fund and other private investment fund investment advisers to avoid registration under the Advisers Act. An investment adviser was previously exempt from registration under the private adviser exemption if the adviser (i) did not generally hold itself out to the public as an investment adviser; (ii) had fewer than 15 clients in the preceding 12 months and (iii) did not act as an adviser to registered investment companies or business development companies.

² On October 12, 2010, the SEC released proposed rules and a request for comment, with respect to the definition of “family office” for purposes of a new exclusion from the definition of investment adviser. See “Family Offices,” Investment Advisers Act Release 3098 (Oct. 12, 2010), available at <http://www.sec.gov/rules/proposed/2010/ia-3098.pdf>.

³ As used in the Act, the term “private fund” means an issuer that would be an investment company as defined in section 3 of the Investment Company Act of 1940, as amended (the “Investment Company Act”), but for section 3(c)(1) or 3(c)(7) of the Investment Company Act.

INVESTMENT ADVISER REGISTRATION MATRIX

What if...	SEC Registration Required	State Registration Required	SEC Reporting Only	No SEC Registration Required
AUM is less than \$25 million		✓(1)		
AUM is greater than \$25 million but less than \$100 million (3)		✓(2)		
AUM is greater than \$100 million (3)	✓			
Adviser is a foreign private adviser				✓(4)
Adviser advises ONLY private funds and has AUM in the United States under \$150 million		✓(5)	✓(5)	✓(5)
Adviser advises ONLY venture capital funds		✓(5)	✓(5)	✓(5)
Adviser advises only SBICs		✓(6)		✓(6)
Adviser advises only family office clients				✓(7)
Adviser advises registered investment companies or business development companies	✓			
Adviser is a registered commodities trading advisor				✓(8)
Adviser must register with 15 or more states	✓			

(1) Prohibition from SEC registration does not apply if the investment adviser is an adviser to an investment company registered under the Investment Company Act or the adviser is eligible for one of six exemptions the SEC has previously adopted.

(2) An adviser that has its principal office and place of business in a state which does not require BOTH registration and examination of its investment advisers would require such adviser to register with the SEC regardless of AUM.

(3) Assumes no exemptions from registration are available.

(4) Adviser relying upon the foreign private adviser exemption is not subject to any U.S. federal or state investment adviser registration or reporting requirements.

(5) Adviser must file certain items of Part 1A of Form ADV and may be subject to state registration, reporting and other obligations.

(6) Adviser may be subject to state registration and reporting requirements.

(7) Adviser is excluded from the definition of investment adviser, and thus is not subject to any federal or state investment adviser registration and reporting requirements.

(8) Adviser is exempt from registration and reporting with the SEC unless its business becomes predominantly securities-related.

REPEAL OF THE PRIVATE ADVISER EXEMPTION

The repeal of the private adviser exemption leaves many private fund investment advisers without an exemption to rely upon to avoid registration under the Advisers Act. As such, many private fund investment advisers (including foreign advisers with U.S. clients) may be required to register with the SEC for the first time. Additionally, many registered investment advisers that do not meet the revised eligibility threshold will be required to de-register with the SEC and become regulated by the states. Therefore, subject to certain limited exceptions, investment advisers will be required to register with either the state in which they have a principal office and place of business or with the SEC (The Act does, however, provide a series of exemptions from the registration requirements of the Advisers Act, based upon assets under management or the type of private fund, as detailed below).

THRESHOLDS FOR STATE AND FEDERAL REGISTRATION

Section 203A of the Advisers Act generally prohibits investment advisers regulated by the state in which it maintains its principal office and place of business from registering with the SEC unless the adviser has assets under management (“AUM”) of more than \$25 million.⁴ Accordingly, except for certain limited exceptions, any investment adviser with less than \$25 million AUM must register with the state in which it has its principal office and place of business. For investment advisers with AUM between \$25 and \$100 million, Section 410 of the Act creates a new group of “mid-sized advisers” and shifts responsibility of their oversight to state regulators.⁵ The Act does this by prohibiting such advisers from registering with the SEC⁶ unless (i) such adviser is NOT required to be registered as an investment adviser with the securities commissioner of the state in which it maintains its principal office and place of business; (ii) if registered, such adviser would not be subject to examination as an investment adviser by that securities commissioner⁷; or (iii) if such adviser is required to register in 15 or more states.⁸ Subject to the exemptions described below, investment advisers with AUM of \$100 million or greater, will be required to register with the SEC by no later than July 21, 2011.



⁴ This prohibition does not apply if the investment adviser is an investment adviser to an investment company registered under the Investment Company Act, or the adviser is eligible for one of six exemptions the SEC has previously adopted. In addition, the Dodd-Frank Act has also added exemptions for: (i) any investment adviser that is registered with the Commodities Futures Trading Commission as a commodity trading advisor and advises a private fund and (ii) any investment adviser, other than a business development company, that solely advises small business investment companies.

⁵ Investment advisers that are prohibited from registering with the SEC are still subject to the anti-fraud provisions of the Advisers Act. For SEC-registered advisers, state laws requiring registration, licensing and qualification are preempted, but states may investigate and bring enforcement actions alleging fraud, and may require notice filings and state notice filing fees from advisers.

⁶ The SEC has created six exemptions from the prohibition on registration. Rule 203A-2 of the Advisers Act permits the following types of advisers to register with the SEC: (i) pension consultants; (ii) nationally recognized statistical rating organizations; (iii) investment advisers affiliated with SEC-registered advisers; (iv) investment advisers expected to be eligible for SEC registration within 120 days of filing Form ADV; (v) multi-state advisers and (vi) internet advisers. The SEC is proposing amendments to three of these exemptions to reflect developments since the enactment of the Dodd-Frank Act.

⁷ Currently all U.S. states except Wyoming require certain investment advisers to register. New York, however, does not currently have a routine examination program in place for its registered investment advisers and thus it is not clear whether or not New York subjects its registered investment advisers to “examination” under the Martin Act (i.e., New York’s securities laws) for purposes of the Act. Neither the Attorney General nor the Bureau of Investor Protection has issued a statement on this matter.

⁸ A mid-sized investment adviser will also be required to register with the SEC if it is an adviser to a registered investment company or business development company under the Investment Company Act.

RECENT SEC PROPOSED RULES AND AMENDMENTS TO THE ADVISERS ACT

On November 19, 2010, the SEC proposed rules and amendments to the Act to:⁹

- Implement a new rule to assure an orderly transition of investment adviser registrants to state regulation;
- Implement an exemption from registration for advisers working solely or exclusively with private funds with aggregate AUM in the United States of less than \$150 million;
- Clarify terms included in the new registration exemption for “foreign private advisers;”
- Define “venture capital fund” for purposes of a new registration exemption for advisers that solely advise one or more venture capital funds;
- Implement a new rule requiring “exempt reporting advisers” to file certain parts of Form ADV;
- Determine the calculation of “regulatory” AUM; and
- Clarify the application of the exemptions to subadvisers and affiliates.

Please note that the aforementioned implementing and exemption releases are subject to comment and further revision. The comment period for these proposed releases ends 45 days after publication in the Federal Register.

TRANSITION TO STATE REGISTRATION

As a consequence of the creation of the “mid-sized” adviser designation, the SEC estimates approximately 4,100 SEC-registered advisers will be required to withdraw their registration and register with one or more state securities regulators. The SEC has proposed new Rule 203A-5, requiring each adviser registered with the SEC as of July 21, 2011 to file an amendment to its Form ADV no later than August 20, 2011 to report the market value of its AUM. An adviser who no longer meets the AUM eligibility criteria for SEC registration would have to withdraw its registration by filing Form ADV-W no later than October 19, 2011. Failure by the adviser to file an amendment or withdraw its registration would result in the SEC cancelling the adviser’s registration. The SEC is proposing the foregoing two “grace periods” to streamline the transition process to ensure an adviser will have sufficient time to register with the applicable state or states and to arrange for its associated persons to qualify for investment adviser representative registration, which may include preparing for and passing an examination, before withdrawing from SEC registration.

Advisers expressing concern that they may need to register with the SEC beginning in January (because their AUM exceeds \$30 million) only to withdraw in October, need not worry about such regulatory burdens. The SEC has indicated that it will not object to an adviser’s failure to register with the SEC so long as such adviser: (i) reports on Form ADV that its AUM is between \$30 and \$100 million; (ii) such adviser is registered with the state in which its principal office and place of business is located; and (iii) it has a reasonable belief that it is required to be registered and subject to examination in that state.

EXEMPTIONS FOR ADVISERS ONLY TO PRIVATE FUNDS WITH LESS THAN \$150 MILLION IN AUM

The Act created new Section 203(m) of the Advisers Act, which requires the SEC to adopt a rule exempting investment advisers that only advise private funds and have less than \$150 million in AUM in the United States (the “Private Fund Adviser Exemption”).

The application of the Private Fund Adviser Exemption hinges on the adviser’s principal office and place of business. To meet the exemption’s conditions, advisers with their principal place of business in the United States (a “US Adviser”) would include all of their AUM even if managed from a non-US branch office.¹⁰ Non-US Advisers with a principal office and place of business outside the United States would have to meet the conditions with respect to their AUM in the United States but generally not assets managed abroad.

For example, a non-US Adviser would not have to include the AUM of a managed account beneficially owned by a non-US person for purposes of the Private Fund Adviser Exemption; however, such non-US Adviser would include the AUM of a managed account beneficially owned by a United States person (as that term is defined under Regulation S under the Securities Act of 1933, as amended). In addition to the foregoing, the adviser must maintain AUM below \$150 million on a quarterly basis. Upon exceeding the \$150 million AUM threshold, the adviser would have one calendar quarter to register with the SEC.

As proposed by the exemption release, an adviser relying on the Private Fund Adviser Exemption would be required to file reports with the SEC on Form ADV, meet certain recordkeeping requirements and be subject to SEC examination. The adviser may also be subject to state registration, reporting or other obligations.

⁹ See “Rules Implementing Amendments to the Investment Advisers Act of 1940,” Investment Advisers Act Release No. 3110 (Nov. 19, 2010), available at <http://www.sec.gov/rules/proposed/2010/ia-3110.pdf>; “Exemptions for Advisers to Venture Capital Funds, Private Funds With Less than \$150 Million in Assets Under Management, and Foreign Private Advisers,” Investment Advisers Act Release No. 3111 (Nov. 19, 2010), available at <http://www.sec.gov/rules/proposed/2010/ia-3111.pdf>.

¹⁰ The SEC notes that US Advisers that manage private fund assets outside the United States through subsidiaries organized in such non-US jurisdictions would not have to count the assets managed by the non-US subsidiaries for purposes of the Private Fund Adviser Exemption.

FOREIGN PRIVATE ADVISERS

The Act added an exemption from SEC registration in Section 203(b)(3) of the Act for “foreign private advisers” - advisers that have (i) no place of business in the United States¹¹; (ii) have less than \$25 million in AUM related to clients or investors located in the United States or such higher amount as determined by the SEC; (iii) have fewer than 15 clients and investors in private funds in the United States; and (iv) do not hold themselves out generally to the public in the United States as an investment adviser. The AUM attributable to United States clients and investors would be measured using “regulatory” AUM, as described below. Unlike the exemptions for venture capital fund advisers (as described below) and private fund advisers, foreign private advisers would not be subject to the additional reporting and recordkeeping requirements.

EXEMPTIONS FOR ADVISERS ONLY TO VENTURE CAPITAL FUNDS

The Act added new Section 203(l) to the Advisers Act, which will exempt investment advisers that solely advise “venture capital funds” from the registration requirements of the Advisers Act. Congress declined to exempt “private equity” funds (e.g., “buyout” and “growth” funds) and other private funds that utilize leverage, and thus Congress believed contributed to systemic risk in the U.S. financial system. The exemption release proposes that a venture capital fund be defined to include any private fund that: (i) represents to its investors that it is a venture capital fund; (ii) owns solely equity securities issued by one or more qualifying portfolio companies, cash or cash equivalents; (iii) acquired at least 80 percent of those equity securities directly from the issuer; (iv) either (a) controls the qualifying portfolio company or (b) has an arrangement to provide significant guidance and counsel concerning the management, operations or business objectives and policies of the qualifying portfolio company; (v) does not borrow, issue debt obligations, provide guarantees or otherwise incur leverage in excess of 15% of the private fund’s aggregate capital contributions and commitments; (vi) limits any such borrowing, indebtedness or guarantees to a term of 120 days on a nonrenewable basis; (vii) does not permit its holders to withdraw or redeem their securities except in extraordinary circumstances; and (viii) is not registered as an investment company or a business development company.

Section 203(l) will require exempt reporting investment advisers to maintain their records and file reports with the SEC on Form ADV and be subject to SEC examination. The exempt reporting adviser may also be subject to state registration, reporting or other obligations.

EXEMPT REPORTING ADVISERS AND PROPOSED FILING REQUIREMENTS

The amendments to the Advisers Act that exempt from registration certain investment advisers also provides that the SEC may require such advisers (“Exempt Reporting Advisers”) to maintain records, be subject to examination and submit reports as the SEC deems necessary or appropriate in the public interest or for the protection of investors. Under the proposed rules, Exempt Reporting Advisers would be required to file a limited Form ADV Part 1A which would include the following:¹²

- Identifying information (Item 1);
- An Exempt Reporting Adviser section identifying the exemption relied upon (if the Private Fund Adviser Exemption is relied upon, the amount of AUM (Item 2.C);
- Form of organization of the investment adviser (Item 3);
- Other business activities of the investment adviser (Item 6);
- Information on private funds advised by the investment adviser and affiliations with other entities in the financial industry (i.e., conflicts of interest) (Item 7); and
- Disciplinary history and other events information (Item 11).

Exempt Reporting Advisers would not be required to fill out any other Part 1 items or complete a brochure under Part 2A. An Exempt Reporting Adviser would be required to amend its reports on Form ADV at least annually, within 90 days of the adviser’s fiscal year end and more frequently if otherwise required by the instructions to Form ADV. The initial report will be required to be filed no later than August 20, 2011. Exempt Reporting Advisers may also be subject to state registration and reporting requirements and other state regulatory obligations.

CALCULATION OF “REGULATORY” ASSETS UNDER MANAGEMENT

The proposed rules require determination of an investment adviser’s “regulatory” AUM for a number of purposes, including (i) determining eligibility for SEC registration; (ii) determining eligibility for the new registration exemptions; and (iii) reporting AUM on Part 1A of Form ADV. AUM is defined under Section 203A(a)(2) of the Advisers Act as the value of “securities portfolios” with respect to which the investment adviser provides “continuous and regular supervisory or management services.” The new definition in Form ADV would require that investment advisers include in the calculation of AUM all securities portfolios that are proprietary and family assets, assets managed without compensation and assets of clients who are not United States persons (all of which may currently be excluded).

¹¹ A “place of business” is defined as an office at which the investment adviser regularly provides investment advisory services, solicits, meets with, or otherwise communicates with clients; and any other location that is held out to the general public as a location at which the investment adviser provides advisory services, solicits, meets with, or communicates with clients.

¹² The SEC intends to retitle Form ADV to reflect its dual purpose as both a registration and reporting form.

In addition, the assets of any private fund to which the investment adviser provides continuous and regular management services must be included in the calculation regardless of the types of assets held by the fund as well as any uncalled capital commitments in that securities portfolio. The investment adviser would NOT be allowed to subtract any outstanding indebtedness (including margin) and other accrued but unpaid liabilities from the calculation of AUM.

As with the previous calculation of AUM, the investment adviser would be required to calculate AUM based on the current market value of the assets determined within 90 days prior to filing the Form ADV.

SUBADVISERS AND AFFILIATED REGISTERED INVESTMENT ADVISERS

The SEC states in its exemption release that it is appropriate to permit subadvisers to rely on each of the new registration

exemptions so long as such subadviser satisfies all the terms and conditions of the applicable exemptions. In many subadvisory relationships, the SEC recognizes that the subadviser has contractual privity with the primary adviser rather than the private fund itself. Nonetheless, even though each of the private fund and the primary adviser may be viewed as the subadviser's client, the SEC would consider a subadviser eligible to rely on the venture capital fund exemption and the Private Fund Adviser Exemption if the application exemption conditions are met.

The SEC also recognizes there are a number of interpretive issues as to whether an adviser with adviser affiliates may rely on any of the new exemptions without taking into account the activities of its affiliates. The adviser may have affiliates that are registered or that provide advisory services inconsistent with an exemption upon which the adviser seeks to rely on. The SEC is soliciting comments on, among other things, whether or not there should be a rule specifying whether or not an exemption should be available to an affiliate of a registered adviser.

Peter Bilfield is a partner at Shipman & Goodwin LLP, resident in the Stamford, Connecticut office and chair of the firm's Private Investment Funds Group. Mr. Bilfield's practice focuses on advising investors, investment funds and their investment managers. Peter assists clients with structuring and organizing domestic and offshore investment funds, including renewable energy funds, synthetic option and total return swap funds, carbon emission credit funds, structured credit funds, commodity pools, real estate funds, venture capital funds, private equity funds and "fund of funds." Mr. Bilfield also provides ongoing regulatory, securities, commodities and general corporate advice to investment advisers and their affiliates. With respect to investor-side representation, Mr. Bilfield assists institutional investors with conducting reviews for existing and prospective investments in private investment funds and other investment vehicles. Mr. Bilfield also works with fund principals to implement contractual arrangements that govern their relationships within the fund management company structure.

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85 Natoma Street
Suite No. 1
San Francisco, CA 94105
T 415.230.8480

Stamford Harbor Park
333 Ludlow Street, South Tower
Stamford, CT 06902
T 203.987.4949

www.battea.com