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Private Investment Funds Alert

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Impact of Final Dodd-Frank Rules on the Regulation of Federal and Connecticut Investment Advisers

On June 22, 2011, the Securities and Exchange Commission (**"SEC"**) approved final rules and rule amendments related to investment adviser regulation under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the **"Dodd-Frank Act"**).[1] The final rules substantially change the existing regulation of investment advisers under the Investment Advisers Act of 1940 (the **"Advisers Act"**) and shift the responsibility for regulating many investment advisers to state securities authorities. In response to the new SEC rules, the Connecticut Banking Department (the **"CT Department"**) issued three orders on July 11, 2011 clarifying the registration requirements for investment advisers with operations or clients in Connecticut.[2]

This *Private Investment Funds Alert* provides background on the prior federal and state investment adviser regulatory regime and an analysis of the new registration requirements and transition rules for investment advisers.

The effective date of the investment adviser section of the Dodd-Frank Act was July 21, 2011. Recognizing the final rules were adopted a month prior to the effective date, the SEC delayed implementation of the final rules until the first half of 2012.

Background

Prior to the Dodd-Frank Act, investment advisers with assets under management (**"AUM"**)[3] of $30 million or more were required to register with the SEC, unless an exemption from registration was available. As a result of the Dodd-Frank Act, the threshold for mandatory federal registration was increased from $30 million to $100 million, subject to certain "buffer zone" rules.[4] One of the most frequently used exemptions from federal registration was the "less than 15 client" exemption under Section 203(b)(3) of the Advisers Act, which generally exempted investment advisers with less than 15 clients from SEC registration.[5] The Dodd-Frank Act

1 See" Family Offices," Investment Advisers Act Release No. 3220 (June 22, 2011), available at http://sec.gov/rules/final/2011/ia-3220.pdf; "Rules Implementing Amendments to the Investment Advisers Act of 1940," Investment Advisers Act Release No. 3221 (June 22, 2011), available at http://sec.gov/rules/final/2011/ia-3221.pdf, and "Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers," Investment Advisers Act Release No. 3222 (June 22, 2011), available at http://sec.gov/rules/final/2011/ia-3222.pdf.

2 The three orders are available at http://www.ct.gov/dob/cwp/view.asp?a=2252&q=482932, http://www.ct.gov/dob/cwp/view.asp?a=2252&q=482952, and http://www.ct.gov/dob/cwp/view.asp?a=2252&q=482954.

3 Form ADV now specifies the method for calculating AUM for registration, exemption and reporting purposes. "Regulatory AUM" is the total value of "securities portfolios" (inclusive of outstanding indebtedness or accrued, unpaid liabilities) for which the adviser provides "continuous and regular supervisory or management services." Securities portfolios include any account for which securities (including cash) consist of at least 50 percent of the total value of the account. An adviser must include in Regulatory AUM all securities portfolios, even those managed without compensation. A private fund is deemed to be a securities portfolio and thus all assets of the private fund are counted for purposes of the calculation of Regulatory AUM.

4 New Rule 203A-1 creates a buffer zone to accommodate market value fluctuations in AUM for advisers that have AUM between $90 million and $110 million. An adviser must register with the SEC if it has AUM that exceeds $110 million. Once registered with the SEC, an adviser need not withdraw its registration unless AUM is less than $90 million.

5 For the purposes of this exemption, a private investment fund receiving advisory services was deemed to be one client. Accordingly, investors in such fund were not counted as separate clients.

Questions?

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eliminated the "less than 15 client" exemption and added several narrowly-tailored federal exemptions and exclusions, which are as follows:

- ***Private Fund Advisers.*** Advisers solely to private funds with less than $150 million of AUM in the U.S.
- ***Venture Capital Fund Advisers.*** Advisers solely to venture capital funds.
- ***Foreign Private Advisers.*** Foreign advisers that do not have a place of business in the U.S.
- ***Family Offices.*** Certain family offices which are excluded from the definition of "investment adviser."

The old "less than 15 client" exemption permitted advisers to avoid registration both at the state and federal level; under the new regulatory regime, investment advisers will generally have to register either with the SEC or the state in which they have a principal office and place of business.

Eliminating the "less than 15 client" exemption will result in many private equity fund advisers and hedge fund advisers, in particular those with AUM of $150 million or more that were previously exempt from registration, registering with the SEC unless a new exemption is available. In addition, the Dodd-Frank Act established a new class of fund advisers, now known as "exempt reporting advisers," that must file Part 1A of Form ADV and comply with the Dodd-Frank Act "pay to play" rules (even though these advisers are exempt from SEC registration).

Exempt reporting advisers may still be subject to registration in the state in which they have an office and place of business.

Prior to the Dodd-Frank Act, states were precluded from regulating an investment adviser that was registered with the SEC; however, it was not clear whether states could require registration of investment advisers that qualified for the "less than 15 client" exemption.[6] Connecticut has clarified its position with regard to the registration of exempt reporting advisers and other SEC exempt investment advisers by adopting new exemptions that parallel the federal exemptions; however, certain of these exempt advisers will still be required to file reports with the CT Department, subject to the ability of IARD (defined below) to accept such reports.

SEC Registration

The final SEC rules require registration by investment advisers with over $100 million of AUM and shift responsibility for regulatory oversight of most "mid-sized" advisers (advisers with AUM of $100 million or less) to the states by prohibiting registration with the SEC if the investment adviser is required to be registered in the state in which it maintains its principal office and is subject to examination in such state.[7] The final SEC rules require investment advisers with AUM of $25 million or more and having their principal office in Minnesota, New York or Wyoming to register with the SEC unless an exemption is available since investment advisers with their principal place of business in such states are not "subject to examination" by the state securities authorities of those states.[8]

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6 The National Securities Markets Improvement Act of 1996 (**"NSMIA"**) preempted state registration of certain advisers who were registered or excepted from the definition of "investment adviser" under the Advisers Act. NSMIA was silent on whether states were preempted from regulating advisers that were exempt from registration under the Advisers Act. The SEC has since interpreted the Advisers Act to allow state registration of advisers who are exempt from federal regulation.

7 If the adviser advises a registered investment company, a company that has elected to be a "business development company" and has over $25 million AUM or the adviser is required to be registered in 15 or more states, such adviser may register with the SEC.

8 Although the final Implementing Release, IA-3221, includes Minnesota as a state that is not "subject to examination," the SEC subsequently clarified its position by posting an FAQ update on June 28, 2011, *available at* http://sec.gov/divisions/investment/midsizedadviserinfo.htm, in which only the States of New York and Wyoming would be deemed NOT "subject to examination."

New SEC Exemptions

> **_Regulatory AUM is the total value of all securities portfolios managed by the adviser (including debt), even portfolios managed without compensation._**

Private Fund Advisers. Under new Rule 203(m)-1, an adviser can advise an unlimited number of private funds so long as AUM in the United States is less than $150 million.[9] **<u>All</u>** of the private fund assets of an adviser with a principal office and place of business in the United States are required to be included in the AUM calculation even if the U.S. adviser has offices outside of the U.S. In other words, U.S. advisers may not rely on the exemption if they have any clients that are non-qualifying private funds (*e.g.*, managed accounts).

- *Non-U.S. Advisers.* An adviser with a principal office and place of business outside the United States may utilize the exemption so long as its U.S. clients are "qualifying private funds."[10] Non-U.S. advisers that enter the U.S. market and take advantage of the private fund adviser exemption may do so without regard to the number and types of non-U.S. clients and amount of assets managed outside the United States. Only assets managed by a non-U.S. adviser from within the United States are counted for purposes of the exemption. Any assets managed by the non-U.S. adviser from its place of business in the United States (other than qualifying private funds) would make the exemption unavailable.

> **_Determining which assets count for purposes of the private fund adviser exemption is dependent on where the asset management business is located. U.S. advisers count all assets (including foreign AUM); non-U.S. advisers with U.S. offices count only U.S. AUM._**

- *Key Considerations for Non-U.S. Advisers.* The rule's territorial focus is on where the asset management takes place. Accordingly, foreign advisers (with a U.S. office) may avail themselves of the private fund adviser exemption even if they manage non-qualifying private fund clients, provided those clients are not U.S. persons (incorporating the definition under Regulation S of the Securities Act of 1933). A "client" will not be considered a U.S. person if the client was not a U.S. person at the time of becoming a client of the adviser.

In a departure from the proposed regulations, the SEC is allowing advisers relying on the private fund adviser exemption to calculate their private fund assets annually, rather than quarterly. If an exempt reporting adviser relying on the private fund adviser exemption reports in its annual updating amendment that its AUM exceeds the $150 million threshold, the adviser will have 90 days after the filing of its annual updating amendment to register with the SEC as an investment adviser. In order to qualify for the exemption, Part 1A of the Form ADV must be filed annually with the SEC.

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9 Depending on facts and circumstances, the SEC may view two or more separately formed advisory entities that each has less than $150 million in private fund AUM as a single adviser for purposes of assessing the availability of this exemption. Section 208(d) under the Advisers Act prohibits a person from doing indirectly anything that would be unlawful for such person to do directly.

10 A qualifying private fund is a private fund that is not a business development company or a registered investment company. In addition, a fund is a qualifying private fund if it relies on the exclusions from the definition of investment company under Section 3(c)(1) or 3(c)(7) under the Investment Company Act of 1940 (the **"Company Act"**) as well as a real estate fund relying on Section 3(c)(5) of the Company Act. It is important to note that the SEC has expressed concern regarding the treatment of single "LP" funds as qualifying private funds. The SEC believes these funds would be tantamount to managed accounts and may run afoul of Section 208(d) of the Advisers Act (prohibition against circumventing the Advisers Act by doing something indirectly that you couldn't do directly). The SEC recognized that there may be circumstances where it would be appropriate to recognize funds with one investor as a qualifying private fund where the fund seeks to raise capital from multiple investors but has only a single initial investor for a period of time.

Venture Capital Fund Advisers. Section 203(l) of the Advisers Act provides an exemption from registration to advisers who provide advice solely to venture capital funds. The final rules permit a 20% "basket" for non-qualifying investments (i.e., non-venture capital investments) for qualifying venture capital funds. In addition, advisers relying on this exemption will not be required to provide managerial assistance to portfolio companies, as originally proposed. In order to qualify for this exemption, Part 1A of the Form ADV must be filed annually with the SEC.

Exempt reporting advisers will be subject to reporting and recordkeeping requirements under the Advisers Act.

Foreign Private Advisers. Under new Section 202(a)(30) of the Advisers Act, a foreign private adviser is any adviser that (i) has no place of business in the United States; (ii) has, in total, fewer than 15 clients and private fund investors in the United States (using the "look-through" rule described below for fund investors); (iii) has aggregate assets of less than $25 million; and (iv) does not hold itself out generally to the public in the United States as an investment adviser. New Rule 202(a)(30)-1 defines many of the terms included in Section 202(a)(30), including the term "investor." Under the rule, an "investor" is any person included in determining the number of beneficial owners of the outstanding securities of a private fund under Section 3(c)(1) of the Company Act or whether such securities are owned exclusively by qualified purchasers under Section 3(c)(7) of the Company Act. Foreign private advisers will be required to "look-through" certain private fund investors organized as commingled vehicles to determine the number of investors. Advisers relying on the foreign private adviser exemption are not required to file a Form ADV with the SEC.

We believe the $25 million threshold and the look-through provisions will make this exemption difficult for foreign advisers to utilize, particularly an adviser to a private fund domiciled in the U.S. with U.S. persons as investors. The SEC has been granted the authority to increase the $25 million threshold, and the SEC acknowledged in the final Exemption Release, IA-3222, that it intends to evaluate whether doing so in the future is appropriate. The SEC has in fact received comments from the American Bar Association and others recommending a registration threshold ranging from $100 million to $500 million.

Family Office Exclusion

The final SEC rules establish an exclusion from the definition of investment adviser for certain family offices. To qualify for the exclusion, the entity must: (i) provide advice only to family clients; (ii) be wholly owned by family clients and controlled by family members and/or family entities; and (iii) not hold oneself out to the public as an investment adviser. Family clients are defined to include lineal descendants spanning ten generations, (including spouses), key employees (and in certain circumstances, former employees), family client trusts, current and former family members, estates of current and former key employees and family members and charities funded exclusively by the foregoing, and companies wholly-owned exclusively by and operated for the sole benefit of family clients (with certain exceptions). Family offices serving multiple families would not be entitled to rely on the exclusion.

Subadvisers and Affiliates

Under the new SEC rules, subadvisers are deemed to be investment advisers, and as such, a subadviser may rely on the new exemptions. In addition, the SEC addressed some interpretative issues with non-registered affiliates and whether an adviser may rely on the new exemptions without taking into account the activities of its

non-registered affiliates. The SEC confirmed that the key precedential guidance on the subject, the *Unibanco* line of no-action letters, would not be withdrawn by the SEC (the staff provided assurances that it would not recommend enforcement action against an unregistered foreign adviser affiliated with a U.S. registered adviser, despite sharing resources and personnel, subject to certain conditions). Further, in an important clarification, the SEC confirmed that "Advisor's lite" treatment of non-U.S. clients of foreign advisers registered with the SEC would continue to apply (*i.e.*, the substantive provisions of the Advisers Act will not apply to non-U.S. clients of a foreign adviser registered with the SEC).

Connecticut Orders

As a result of the repeal of the new SEC rules, the CT Department has adopted exemptions from registration under the Connecticut Uniform Securities Act (the **"CT Act"**), which parallel the federal exemptions, for the following advisers with AUM of $100 million or less:

- A Foreign Private Adviser;
- A commodity trading adviser registered with the Commodity Futures Trading Commission and which is exempt from registration under the Advisers Act;
- An adviser to a Small Business Investment Company;
- A Venture Capital Adviser, except such adviser will be required to file Part 1A of Form ADV with the CT Department electronically once the Investment Adviser Registration Depository (**"IARD"**) system has been updated to accept Part 1A; and
- A Private Fund Adviser, provided that such adviser: (i) files Part 1A of Form ADV with the CT Department electronically once the IARD system has been updated; (ii) not be, nor any of its supervised persons or affiliates be, subject to an administrative, civil or criminal sanction as described in Section 36b-15(a)(2) of the CT Act; and (iii) is in compliance with all rules promulgated under Section 203(m) of the Advisers Act.

Individuals employed by or associated with advisers relying on any of the above exemptions will not be required to register as investment adviser agents under the CT Act. In addition, under Section 36b-6(e)(2) of the CT Act, family offices qualifying under the new exclusion in Section 202(a)(11)(G) of the Advisers Act will be exempt from registration under the CT Act.

The CT Department has amended an existing 1999 Order which defined "client" in reference to Rule 203(b)(3)-1 of the Advisers Act for purposes of the national de-minimis exemption under Section 222(d)(2) of the Advisers Act (**"De-minimis Exemption"**). The De-minimis Exemption will now use the new definition of "client" under Rule 202(a)(30)-1, without giving effect to the double-counting provision intended for the Foreign Private Adviser exemption in clause (b)(4) of that rule.

Any adviser required to register with the State of Connecticut should plan to have all necessary compliance policies and procedures in place and file the Form ADV with the CT Department as soon as possible prior to its applicable registration deadline to allow for what we believe will be a considerable number of applications being processed at that time. A representative from the CT Department provided us with a November 2009 informal analysis of the number of SEC mid-sized advisers transitioning to Connecticut registration.[11] Unlike the Advisers Act, there is no time limit under the Connecticut Act when a registration must be declared effective. Accordingly, the CT Department representative recommended advisers start the registration process as early as November to ensure advisers meet the 2012 deadlines. We also note that in addition to the large volume of

11 In November 2009, 1,875 SEC registered advisers made a notice filing with Connecticut, of which 390 reported AUM of $100 million or less. Of the 390 advisers, 39 relied on an SEC rule permitting federal registration. Therefore, the net figure for advisers subject to state registration was 351 advisers, of which 137 advisers were based in Connecticut. As of March 2011, raw data indicated that 406 Connecticut-based SEC registered advisers had filed a state notice, of which 96 reported AUM of $1.0 billion or more. The CT Department is unable to provide an estimate on the number of new advisers that will be required to register since that number is unknown and cannot be quantified.

expected applications, the State of Connecticut has initiated a statewide hiring freeze, which we believe will greatly impact the CT Department's ability to timely process applications, and thus further necessitates advisers starting the registration process early. Advisers required to register under the CT Act should also consider, among other things, the following when preparing for registration:

- Employees who solicit business within or from the State of Connecticut will be required to register as "investment adviser agents" as defined under the CT Act by filing a Form U-4 through IARD; and
- Unless grandfathered or eligible for a waiver, investment adviser agents must pass their Series 65 or 66 exam.

Transitional Rules and Deadlines for Federal and Connecticut Advisers

- ***Existing SEC Registrants***. Each investment adviser that is registered with the SEC on January 1, 2012, must file an amendment to its Form ADV on the amended Form ADV by **March 30, 2012**. The main purpose of the amendment is to allow the SEC to determine whether the adviser remains eligible for SEC registration. Mid-sized advisers that are registered with the SEC on July 21, 2011, must remain registered with the SEC until **January 1, 2012**, which is the date that the SEC expects the IARD update to be completed. Advisers with AUM of less than $100 million must withdraw their registrations no later than **June 28, 2012** after filing their Form ADV amendments and must register with the CT Department by that date unless an exemption is available. Such advisers located in Connecticut will continue to be subject to state notice filing requirements until their Connecticut registration becomes effective or is withdrawn.
- ***Existing Advisers relying on the "less than 15 client" exemption on July 20, 2011.*** Large advisers (i.e., advisers with over $100 million of AUM) may defer their SEC registration until **March 30, 2012**, which means these advisers should plan to have policies and procedures in place and file Form ADV (both Part 1 and a brochure meeting the requirements of Part 2) by **February 14, 2012** to allow for the 45 days required under the Advisers Act to declare the registration effective. Notice filing with the CT Department may be deferred until **March 30, 2012**. Large advisers are not required to register under the CT Act during the deferral period. Advisers with AUM of less than $100 million will be required to register with the CT Department no later than **March 30, 2012** unless an exemption is available.
- ***New Advisers on or after July 21, 2011.*** New investment advisers with AUM of over $100 million are not entitled to delay their registration with the SEC. Investment advisers seeking to register in Connecticut and commencing business on or after July 21st may not delay registration with the CT Department and are therefore presently subject to applicable registration and notice requirements under the CT Act.
- ***Exempt Reporting Advisers.*** Exempt reporting advisers must file their first reports on Part 1A of Form ADV by **March 30, 2012**.

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