SEC Adopts Extensive Changes to Investment Adviser Regulatory Scheme as Mandated by the Dodd-Frank Act

June 23, 2011

I. Introduction

At an open meeting yesterday, the U.S. Securities and Exchange Commission ("SEC" or "Commission") adopted new rules and rule amendments under the Investment Advisers Act of 1940, as amended (the "Advisers Act"), which: (i) will require advisers to hedge funds and other private funds to register with the SEC; (ii) establish new exemptions from SEC registration and reporting requirements for certain advisers that are exempt from registration ("exempt reporting advisers"); and (iii) reallocate regulatory responsibility for advisers between the SEC and the states.[1] 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 reported by exempt reporting advisers. Also, the Commission revised its pay-to-play rule to allow advisers to pay compensation to solicitors who are registered as broker-dealers, investment advisers or municipal advisors if certain conditions are satisfied.[2]

The SEC also adopted a new rule that exempts "family offices" from regulation under the Advisers Act and provides a definition of such entities.[3] All of the 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").

The rules implement a transitional exemption period under which private fund advisers, including hedge fund and private equity fund advisers, are required to register under the Advisers Act. These advisers have until March 30, 2012, to register.

To provide for the transition of mid-sized advisers to state registration, the new rules require that all Commission-registered advisers file an amended Form ADV by March 30, 2012, indicating whether they are eligible to remain registered with the Commission. Those mid-sized advisers that are no longer eligible will be required to withdraw their Commission registration by June 28, 2012.

The rules setting forth exemptions for venture capital fund and certain private fund advisers, as well as the rule defining "family offices," are effective July 21, 2011. The date by which advisers must comply with the general ban on the use of third-party solicitors to solicit government entity clients is being extended from September 13, 2011, to June 13, 2012.

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[1] *See* Investment Advisers Act Release No. 3221 (June 22, 2011), *available at* http://sec.gov/rules/final/2011/ia-3221.pdf; Investment Advisers Act Release No. 3222 (June 22, 2011), *available at* http://sec.gov/rules/final/2011/ia-3222.pdf. These initiatives were approved by a 3-2 vote of the Commission, with Commissioners Casey and Paredes dissenting.

[2] *See* Investment Advisers Act Release No. 3221 (June 22, 2011), *available at* http://sec.gov/rules/final/2011/ia-3221.pdf.

[3] *See* Investment Advisers Act Release No. 3220 (June 22, 2011), *available at* Investment Advisers Act Release No. 3221 (June 22, 2011). This initiative was approved by a 5-0 vote of the Commission.

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Since the Commission held its open meeting and published the releases implementing the changes yesterday, this Legal Alert provides a high-level overview and analysis of the new rules and rule amendments that were adopted. In the coming days, we will circulate a more detailed analysis of these initiatives.

II. Eligibility for Registration with the Commission

Section 203(b)(3) of the Advisers Act currently exempts from registration any investment adviser who during the course of the preceding 12 months, has had fewer than 15 clients, and who neither holds himself out generally to the public as an investment adviser nor acts as an investment adviser to any investment company registered under the Investment Company Act of 1940, as amended ("Investment Company Act") or a company which has elected to be a business development company. Section 403 of the Dodd-Frank Act eliminates this exemption from registration that many "private fund"[4] advisers currently rely upon, and as a result, most private fund advisers will be required to register with the Commission and be subject to its rules, regulatory oversight, and examination programs. Title IV of the Dodd-Frank Act also includes provisions that reallocate responsibility for oversight of investment advisers by delegating generally to the states responsibility over certain "mid-sized" advisers.[5] To give effect to these registration provisions, the Commission adopted new rules and amended existing rules under the Advisers Act.

Federal and State Registration. As a result of the new rules, Form ADV – the investment adviser registration form – has been amended to address the registration of hedge fund advisers and other private fund advisers. The Commission amended Form ADV in an effort to improve oversight of the operations of private fund advisers. As noted by the Commission in yesterday's open meeting, Form ADV is of critical importance, not only for registration purposes, but also for the Commission's regulatory and examination program. The amendments to Form ADV are noted below in section III.

Title IV of the Dodd Frank Act raised the general threshold required for an adviser to register with the Commission from $25 million to $100 million in assets under management ("AUM"). This provision leaves most mid-sized advisers without the ability to register with the Commission. Accordingly, most mid-sized advisers currently registered with the Commission will have to withdraw their registration with the Commission and register with one or more state securities authorities if they are (i) required to register in the state in which they maintain their principal office and place of business and (ii) subject to examination by that state. Because the State of Wyoming does not have an adviser regulatory regime, the Commission will remain the sole regulator of all advisers in the state of Wyoming. The Commission staff has corresponded with each state to ascertain whether advisers are subject to examination, and the results of this inquiry are noted in the adopting release. At the open meeting, the Commission staff noted that Minnesota does not examine investment advisers, which means all mid-sized investment advisers with a principal place of business in Minnesota will remain subject to SEC regulation. In addition, New York did not respond to the staff's inquiry. The Commission is therefore treating New York similar to

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[4] Section 402(a) of the Dodd-Frank Act added new Section 202(a)(29) to the Advisers Act that defines the term "private fund" as "an issuer that would be an investment company, as defined in Section 3 of the Investment Company Act of 1940 (the "1940 Act"), …but for Section 3(c)(1) or 3(c)(7) of that Act."

[5] A mid-sized adviser is an adviser that (i) manages between $25 million and $100 million for clients, (ii) is required to be registered in the state where it maintains its principal office and place of business and (iii) would be subject to examination by that state, if required to register.

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Minnesota with the result being that all mid-sized New York investment advisers will remain subject to SEC regulation.

The new rules implement the transition to state regulation of mid-sized advisers and amend Form ADV to explain how advisers can determine whether they must switch to state registration or remain registered with the Commission. For purposes of this determination, and for other purposes under the Advisers Act, the new rules implement a uniform method to calculate AUM.

Compliance Date. To provide for the general transition of mid-sized advisers to state registration, the new rules require that all Commission-registered advisers file an amended Form ADV by March 30, 2012, indicating whether they are eligible to remain registered with the Commission. Those advisers that are no longer eligible to remain Commission-registered will be required to withdraw their Commission registration by June 28, 2012. Mid-sized advisers registered with the Commission as of July 21, 2011, must remain registered with the Commission (unless an exemption from Commission registration is available) until January 1, 2012.

Until July 21, 2011, advisers applying for registration with the Commission that qualify as mid-sized advisers under section 203A(a)(2) of the Advisers Act may register with either the Commission or the appropriate state securities authority. Thereafter, such advisers generally are prohibited from registering with the Commission and must register with the state securities authorities.

III. Revisions to Form ADV

In light of the Commission's increased responsibility for oversight of private fund advisers, the new rules require advisers to these funds to provide the Commission with additional information about the operation of the funds, the advisers' management of the funds and certain service providers to the funds. Such additional information will be provided by advisers on their Form ADV filed with the Commission. By amending Form ADV, the new rules now elicit important census-like data from private fund advisers about the funds they advise and the service providers for those funds. Amended Form ADV requires advisers to provide basic organizational and operational information about the private funds they manage and to identify five types of service providers: auditors, prime brokers, custodians, administrators, and marketers, which perform critical roles for the private funds. Notably, the Commission staff indicated at the open meeting that these new Form ADV requirements do not include several of the proposed Form ADV questions that could have resulted in the public disclosure of competitive or proprietary information.

The new rules also include a number of additional amendments to Form ADV to improve the Commission's ability to assess adviser compliance risk. In this regard, the new rules require advisers to provide more information about their advisory business, their conflicts of interest (such as the use of affiliated brokers, soft dollar arrangements, and compensating others for client referrals) and financial industry affiliations.

Compliance Date. After January 1, 2012, any adviser filing an amendment to Form ADV will be required to provide responses to the form revisions that were adopted. The Investment Adviser Registration Depository is expected to be able to accept filings of revised Form ADV by January 1, 2012. Investment advisers filing initial applications for registration after the IARD is re-programmed to accommodate filing of the revised Form ADV must complete the revised form.

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IV. Amendments to "Pay to Play" Rule

The Commission amended the adviser "pay-to-play" rule in response to changes made by the Dodd-Frank Act. The Dodd-Frank Act granted the Municipal Securities Rulemaking Board (the "MSRB") new authority over municipal advisors, and the amendment recognizes this authority. The amended rules will add registered municipal advisors to the categories of regulated entities – referred to as "regulated persons" – excepted from the rule's ban on advisers paying third parties to solicit government entities. Thus, an adviser will be permitted to pay a registered municipal advisor to act as a solicitor to solicit government entities on its behalf, if the municipal advisor is registered with the Commission and subject to the MSRB's pay-to-play rule that is at least as stringent as the Commission's pay-to-play rule. Importantly, advisers will continue to be permitted to hire as a solicitor a Commission registered adviser or a broker-dealer that is subject to a pay-to-play rule adopted by the Financial Industry Regulatory Authority ("FINRA") that is at least as stringent as the Commission's adviser pay-to-play rule.

Compliance Date. To provide sufficient time for the MSRB and FINRA to adopt pay-to-play rules for municipal advisors and broker-dealers, and for third-party solicitors to come into compliance with those rules, the date by which advisers must comply with the third-party solicitation provision is extended to June 13, 2012.

V. New Exemptions: Exempt Reporting Advisers

As noted above, the Dodd-Frank Act repealed, effective July 21, 2011, the "private adviser exemption" contained in section 203(b)(3) of the Advisers Act on which advisers to many hedge funds and other pooled investment vehicles had relied to avoid registration under the Advisers Act. In eliminating this provision, Congress amended the Advisers Act to create, or direct the Commission to adopt, other more narrow exemptions for advisers to private funds.

Advisers solely to venture capital funds and advisers solely to private funds with less than $150 million in assets under management in the United States are referred to as "exempt reporting advisers" because they are still required to report certain information to the Commission on Form ADV.

Advisers to Venture Capital Funds. New section 203(l) of the Advisers Act, as added by the Dodd-Frank Act, exempts from registration advisers that only manage venture capital funds and directs the Commission to define "venture capital fund" within one year of enactment. At yesterday's open meeting, the Commission adopted a definition under which a venture capital fund is a private 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);
- Is not leveraged except for a minimal amount on a short-term basis;
- Does not offer redemption rights to its investors except in extraordinary circumstances;
- Represents itself to investors as pursuing a venture capital strategy; and
- Is not registered under the Investment Company Act and has not elected to be treated as a business development company.

In a significant departure from the proposal, a manager of a venture capital fund may invest up to 20% of the funds committed capital in assets (other than short-term holdings) that are not qualifying investments.

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Small Private Fund Advisers. New section 203(m) of the Advisers Act, as added by the Dodd-Frank Act, directs the Commission to provide an exemption from registration to any investment adviser that only advises private funds if the adviser has assets under management in the United States of less than $150 million. At yesterday's open meeting, the Commission adopted an exemption in the form of new rule 203(m)-1. There only appears to be one significant difference between the exemption that was originally proposed and the exemption that was adopted; under the originally proposed rule, each adviser would have been required to determine the amount of its private fund assets quarterly. The rule adopted modifies this requirement so that an adviser will only need to determine the amount of its private fund assets annually.

Reporting Requirements for Exempt Reporting Advisers. Both section 203(l) and section 203(m) of the Advisers Act provide that the Commission shall require such advisers to maintain such records, which the Commission has the authority to examine, and to submit such reports "as the Commission determines necessary or appropriate in the public interest." To implement sections 203(l) and 203(m), the Commission adopted a new rule to require exempt reporting advisers to submit, and to periodically update, reports to the Commission by completing a limited subset of items on Form ADV. The new rules require that exempt reporting advisers complete three categories of items in Form ADV:

- Basic identifying information about the exempt reporting adviser, its owners, and affiliates;
- Information about the private fund the exempt reporting adviser manages and about the exempt reporting adviser's and its affiliates' other business activities that present conflicts of interest and may pose significant risk to clients; and
- Disciplinary history of the exempt reporting adviser and its employees that may reflect on their integrity.

Effective Date. The rules regarding exempt reporting advisers are effective July 21, 2011.

VI. New Exemption: Foreign Private Advisers

A third exemption, set forth in amended section 203(b)(3) of the Advisers Act, provides an exemption from registration for certain foreign private advisers. New section 202(a)(30) of the Advisers Act defines "foreign private adviser" as an investment adviser that has no place of business in the United States, has fewer than 15 clients in the United States and investors in the United States in private funds advised by the adviser, and less than $25 million in aggregate assets under management from such clients and investors.

Terms Defined in New Rule. In order to implement this new exemption, the Commission adopted new rule 202(a)(30)-1, which defines a number of terms included in the statutory definition of foreign private adviser. The Commission noted at the open meeting that this rule was adopted substantially as proposed and incorporates definitions set forth in other Commission rules which are likely to be familiar to foreign advisers active in the U.S. capital markets.

Not Subject to Reporting Requirements. Foreign private advisers are not required to submit to the Commission the types of reports required of exempt reporting advisers.

Effective Date. New rule 202(a)(30)-1 has an effective date of July 21, 2011.

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VII. New Exclusion: Family Offices

At the open meeting, the Commission adopted new rule 202(a)(11)(G)-1, which defines those “family offices” that are excluded from the definition of investment adviser and thereby exempt from all regulation under the Advisers Act. Section 409 of the Dodd-Frank Act excluded “family offices” from the Adviser Act’s definition of “investment adviser” and charged the Commission with providing a definition for “family office” that is consistent with previous Commission exemptive orders and takes account of the structural and organizational realities of the modern family office. The definition adopted at the open meeting seeks to implement the exclusion as well as incorporate a grandfathering provision required by the Dodd-Frank Act.

General. A “family office” as defined by section 202(a)(11)(G)-1, generally, is a company that:

- Has no clients other than “family clients”;
- Is wholly owned by family clients and exclusively controlled directly or indirectly by family members and/or family entities; and
- Does not hold itself out to the public as an investment adviser.

A “family client” is any family member, former family member, key employee of the family office, certain former key employees, non-profit organization, charitable foundation, charitable trust, or other charitable organization established and funded exclusively by one or more other family clients, certain trusts and estates funded by family clients or where family clients are the only current beneficiaries, and entities wholly owned and controlled exclusively by and operated for the benefit of family clients. A family client may also be any person who becomes a family client, for a period of one year, following the involuntary transfer of legal title of assets from a family member or key employee.

A “family member” is any lineal descendant (including by adoption, stepchildren, foster children, and minors whose legal guardian is a lineal descendant) of a common ancestor and their spouses and spousal equivalents, so long as the common ancestor is no more than 10 generations removed from the youngest generation of family members.[6] In response to requests from several commenters for more flexibility, the Commission adopted an approach that allows the family to select the common ancestor for purposes of defining family office.

Key Employees. The rule permits family offices to continue to manage those assets of former key employees that were managed immediately prior to the date that person became a former key employee. Such former key employee, however, could not make new investments, except for those additional investments that the former key employee was contractually obligated to make prior to becoming a former key employee. In general, a “key employee” is a natural person (and his or her spouse or spousal equivalent) who is (i) an executive officer, director, trustee, general partner, or person serving in a general capacity at the family office or affiliated family office or (ii) any other employee of the family office or affiliated family office who in connection with his or her regular job function, participates in the investment activities of the family office or affiliated family office and has done so at the family office, or on behalf of another company, for at least 12 months. Key employees may also receive investment advice through their investments in family office-advised private funds and certain other family entities.

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[6] A “spousal equivalent” is a cohabitant occupying a relationship generally equivalent of a spouse.

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Charitable Organizations. As noted above, the definition of family client includes those charitable entities funded exclusively by other family clients. Acknowledging that some family offices advise charitable entities that have accepted funding from non-family sources, the Commission implemented a transition period under which family offices have until December 31, 2013, to comply with this part of rule, provided that such charitable entity does not accept any additional funding from a non-family client after August 31, 2011 (other than funding received prior to December 31, 2013, pursuant to any pledge made prior to August 31, 2011). In other words, such organizations must spend the non-family funding so that none of it is “currently held” by the organization or transition advisory arrangements prior to December 31, 2013 (*i.e.*, if the only reason the family office would not meet the exclusion is because it advises a non-profit or charitable organization that currently holds non-family client funding, the family office generally may nevertheless rely on the exclusion until December 31, 2013). To rely on this transition period, however, a non-profit or charitable organization advised by the family office must not accept any additional funding from any non-family clients after August 31, 2011, except that during the transition period the non-profit or charitable organization may accept funding provided in fulfillment of any pledge made prior to August 31, 2011.

Multi-Family Offices. The new rule does not expand the family office exclusion to include multi-family offices. The Commission said that it could not draft a rule that would distinguish a multi-family office that might fit within the exclusion from a family-owned commercial advisory firm.

Effective Date and Registration Deadline. New rule 202(a)(11)(G)-1 is effective July 21, 2011. Family offices currently exempt from registration under the Advisers Act pursuant to the private adviser exemption that do not meet the new family office exclusion must register with the SEC by March 30, 2012.

If you have any questions about this Legal Alert, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

Eric A. Arnold	202.383.0741	eric.arnold@sutherland.com
Clifford E. Kirsch	212.389.5052	clifford.kirsch@sutherland.com
Michael B. Koffler	212.389.5014	michael.koffler@sutherland.com
Sharon Bauer Berman	404.853.8710	sharon.berman@sutherland.com
Cynthia Reid Beyea	202.383.0472	cynthia.beyea@sutherland.com
Jon K. Hadfield	202.383.0878	jon.hadfield@sutherland.com
Issa J. Hanna	212.389.5034	issa.hanna@sutherland.com
William M. Watts III	202.383.0898	bill.watts@sutherland.com

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