

SEC Adopts Investment Adviser Rules Implementing the Dodd-Frank Act

June 23, 2011

At an open meeting on June 22, the Securities and Exchange Commission (SEC) adopted a number of rules implementing Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). The newly adopted rules require, for the first time, certain investment advisers to register with the SEC or a state securities regulator, allow other advisers to remain unregistered, and cause yet other advisers “close to the line” to consider whether to restructure their operations to qualify for an exemption from registration. Certain advisers eligible for an exemption from registration because they advise qualifying venture capital funds or less than \$150 million in qualifying private fund assets (as further described below) will nonetheless have to keep records and file annual reports with the SEC—a requirement that two Commissioners voted against. Other advisers with between \$25 million and \$100 million in assets under management will have to switch from SEC to state regulation. The SEC also adopted a rule regarding the treatment of family offices. Finally, SEC Chairman Mary Schapiro announced that the deadline for investment adviser registration for advisers previously relying on former Section 203(b)(3) of the Investment Advisers Act of 1940 (Advisers Act)—the 14-client exception—would be March 30, 2012, meaning that these advisers would need to file Form ADV no later than February 15, 2012. Below is a summary of the open meeting. We will follow up with a more detailed analysis of the adopted rules, which have just been published.

Venture Capital Fund Advisers

The Dodd-Frank Act added Section 203(l) to the Advisers Act to provide an exemption from registration for venture capital fund advisers. At the open meeting, the SEC adopted final rules defining the term “venture capital fund” as a fund that, among other things, does each of the following:

1. Invests at least 80% of its committed capital (as opposed to invested capital) in “qualifying investments” (allowing a fund to invest up to 20% of its committed capital in “non-qualifying investments” and still be considered a “venture capital fund”).
2. Does not incur leverage in excess of 15% of its committed capital or for a term longer than 120 days.
3. Does not offer redemption of shareholder interests except in extreme circumstances.
4. Holds itself out to investors as employing a venture capital strategy.
5. Has not registered under the Investment Company Act of 1940 or elected to be treated as a business development company.

The new rules also set forth a grandfathering provision for certain existing venture capital funds.

Private Fund Advisers

As provided by the Dodd-Frank Act, Section 203(m) of the Advisers Act requires the SEC to provide an exemption from registration to any investment adviser that acts solely as an adviser to private funds and has assets under management in the United States of less than \$150 million. At the open meeting, the SEC adopted rules to implement this exemption. A private fund adviser may advise an unlimited number of private funds and still qualify for the exemption from registration under the new rule, provided that the adviser's assets under management in the United States are less than \$150 million in the aggregate, calculated annually (not quarterly, as proposed). Advisers to private funds with less than \$150 million of assets under management in the United States will still need to comply with applicable state investment adviser registration requirements, although the absence of state regulation will not require the advisers to register with the SEC.

Venture Capital and Private Fund Advisers: “Exempt Reporting Advisers”

Sections 203(l) and 203(m)(2) of the Advisers Act, as amended by the Dodd-Frank Act, mandate that the SEC require venture capital fund advisers and private fund advisers exempted from registration to maintain records and file reports with the SEC. At the open meeting, the SEC adopted rules—in the same form as proposed—requiring those exempt advisers annually to electronically file reports consisting of certain items from Form ADV, which will be publicly available on the SEC's website. Chairman Schapiro noted that the SEC would reconsider the information required to be submitted after one year to determine whether it is sufficient. She also noted that although these “exempt reporting advisers” will not be subject to routine examinations by the SEC, the SEC retains the ability to examine them if warranted.

Mid-Sized Advisers

Another effect of the Dodd-Frank Act is the treatment of “mid-sized” advisers under the Advisers Act. Advisers with between \$25 million and \$100 million in U.S. assets under management are prohibited from registering with the SEC and will instead switch to state registration. However, if an adviser's state has not adopted an investment adviser statute (i.e., Wyoming) or does not examine registered advisers (i.e., New York and Minnesota), then the adviser will have to register with the SEC, unless the adviser can fit within an SEC registration exemption, such as the venture capital fund adviser or the private fund adviser exemptions.

Foreign Private Advisers

The Dodd-Frank Act amended Section 203(b)(3) of the Advisers Act to replace the 14-client exemption with an exemption from registration for “foreign private advisers,” as defined in Section 202(a)(30) of the Advisers Act. As a practical matter, this exemption would apply only to foreign advisers that do not otherwise qualify for the private fund adviser exemption. At the open meeting, the SEC adopted rules requiring an adviser with no place of business in the United States to register with the SEC if, among other things, (i) it holds itself out to the public in the United States as an investment adviser, or (ii) (a) it has 15 or more clients and private fund investors in the United States or (b) it has \$25 million or more of assets under management from clients and private fund investors in the United States, regardless of the number of clients or investors. It was noted that the SEC was not withdrawing any relief previously given under the *Unibanco* line of no-action letters, which will likely affect both foreign private advisers

and non-U.S. private fund advisers.¹ Foreign private advisers will not be required to file reports with the SEC.

Family Offices

The SEC also adopted a rule exempting a “family office” from registration under the Advisers Act, implementing Section 409 of the Dodd-Frank Act. A “family office” is an entity providing investment advisory services that also meets each of the following criteria:

1. Its only clients are “family clients” (family members and certain alter-ego entities formed for tax, charitable, or estate planning purposes).
2. It is wholly owned by family clients and controlled by family members.
3. It does not hold itself out to the public as an investment adviser.

Many commenters had criticized the proposed rule’s definitions of “family client” and “family member” as too restrictive, and the SEC staff acknowledged that in response to these comments the “family member” definition had been broadened to include, for example, former spouses, adopted children, and stepchildren. At the open meeting, an SEC staff member stated that a family member was a lineal descendant of a single founder no more than 10 generations removed from the founder. This 10-generation concept was not mentioned in the proposing release, and is a concept borrowed from trust law.² The SEC also retained the proposed rule’s “key employee” provision permitting key personnel of a family office to be clients of the family office.

The final rule, like the proposed rule, treats a charitable entity as a family client only if it is funded exclusively by family members. If a charity has received donations from non-family members in the past, it may still be a “family client” so long as it does not accept contributions from non-family members after August 31, 2011, unless the contributions are in fulfillment of a pledge, in which case the cutoff date is December 31, 2013. Family offices that cannot meet the definition of “family office” are required to be registered with the SEC as investment advisers by March 30, 2012, unless they choose to seek exemptive relief from registration.

Pay-to-Play Rule

The SEC also amended the pay-to-play rule³ to provide that registered municipal advisers may act as solicitors for registered investment advisers that seek business from state and local governments. Registered broker-dealers and investment advisers may also act as solicitors, provided that they are subject to “pay to play” regulation.

Additional Information

If you have any questions or would like more information on the issues discussed in this LawFlash, please contact any of the authors, **Ethan W. Johnson** (305.415.3394; ejohnson@morganlewis.com),

1. *Uniao de Banco de Brasileiros S.A.*, SEC No-Action Letter (July 29, 1992).

2. Advisers Act Release No. 3098 (Oct. 12, 2010).

3. Rule 206(4)-5 under the Advisers Act, Advisers Act Release No. 3043 (July 1, 2010) (Adopting Release).

Monica Lea Parry (202.739.5692; mparry@morganlewis.com), or **Trina C. Winkelmann** (202.739.5254; twinkelmann@morganlewis.com), or any of the following Morgan Lewis attorneys:

New York

Andrew J. Donohue 212.309.6160 adonohue@morganlewis.com

Philadelphia

Timothy W. Levin 215.963.5037 tlevin@morganlewis.com
John J. O'Brien 215.963.4969 jobrien@morganlewis.com

Washington, D.C.

Thomas S. Harman 202.739.5662 tharman@morganlewis.com

In addition, Morgan Lewis's multidisciplinary [Financial Regulatory Reform resource team](#) is available to assist with a wide range of issues and areas of concern related to the reform effort. You can access a complete collection of the firm's updates and alerts on the subject on our website's [Financial Regulatory Reform page](#).

About Morgan, Lewis & Bockius LLP

With 22 offices in the United States, Europe, and Asia, Morgan Lewis provides comprehensive transactional, litigation, labor and employment, regulatory, and intellectual property legal services to clients of all sizes—from global Fortune 100 companies to just-conceived startups—across all major industries. Our international team of attorneys, patent agents, employee benefits advisors, regulatory scientists, and other specialists—nearly 3,000 professionals total—serves clients from locations in Beijing, Boston, Brussels, Chicago, Dallas, Frankfurt, Harrisburg, Houston, Irvine, London, Los Angeles, Miami, New York, Palo Alto, Paris, Philadelphia, Pittsburgh, Princeton, San Francisco, Tokyo, Washington, D.C., and Wilmington. For more information about Morgan Lewis or its practices, please visit us online at www.morganlewis.com.

This LawFlash is provided as a general informational service to clients and friends of Morgan, Lewis & Bockius LLP. It should not be construed as, and does not constitute, legal advice on any specific matter, nor does this message create an attorney-client relationship. These materials may be considered **Attorney Advertising** in some states. Please note that the prior results discussed in the material do not guarantee similar outcomes.

© 2011 Morgan, Lewis & Bockius LLP. All Rights Reserved.