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Legal Risk Management Tip
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SEC ADOPTS RULES WHICH OVERHAUL THE INVESTMENT ADVISER REGULATORY FRAMEWORK

At an open meeting held on June 22, 2011 Securities and Exchange Commission ("SEC" or the "Commission") adopted new rules and rule amendments under the Investment Advisers Act of 1940, as amended, (the "Advisers Act") that, among other things, increase the statutory threshold for registration by investment advisers with the SEC, define "venture capital fund" and provide an exemption from registration for advisers with less than $150 million in private fund assets under management.[1] This Legal Tip will provide an overview of the SEC's recently adopted rules and outline the transition process for those advisers who will be required to switch from SEC to state registration.

A. New $100 Million Threshold for SEC Registration

Previously, the Advisers Act prohibited an investment adviser from registering with the SEC unless it has at least $25 million of assets under management. The newly adopted rules create a category of "mid-sized advisers"– *i.e.*, those that have between $25 million and $100 million of assets under management – and shift primary responsibility for their regulatory oversight to the states. This is accomplished by generally prohibiting mid-sized advisers from registering or remaining registered with the SEC. The SEC estimates that approximately 3,200 SEC-registered advisers will be required to withdraw their registrations and register with one or more state securities authorities. To that end, the SEC has provided new rules for what it termed an "orderly transition" to state registration for mid-sized advisers that will no longer be eligible to register or remain registered with the Commission.

1. *"The Switch" to State Registration*

The rules governing the switch from SEC to state registration differ depending on whether the investment adviser is an existing SEC registrant or is applying for SEC registration for the first time.

- *Existing SEC Registrants.* Under the rule, *each* adviser registered with the SEC on January 1, 2012 must file an amendment to its Form ADV no later than March 30, 2012. These amendments will respond to new items in Form ADV and will identify mid-sized advisers no longer eligible to remain registered with the Commission. Mid-sized advisers that are no longer eligible for SEC registration must withdraw their registrations by filing Form ADV-W no later than June 28, 2012. Mid-sized advisers registered with the Commission as of July 21, 2011 must remain registered with the Commission until January 1, 2012.

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[1] Rules Implementing Amendments to the Investment Advisers Act of 1940, Advisers Act Release No. 3221, *available at* http://www.sec.gov/rules/final/2011/ia-3221.pdf; Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers, Advisers Act Release No. 3222, *available at* http://sec.gov/rules/final/2011/ia-3222.pdf.

- *New Applicants*. Until July 21, 2011, advisers applying for registration with the SEC that are mid-sized advisers may register with either the Commission or the appropriate state securities authority. After July 21, 2011, all mid-sized advisers are prohibited from registering with the Commission and must register with the appropriate state securities authorities.

The SEC also stated that the deadline for mid-sized advisers switching from SEC to state registration was selected because the Financial Industry Regulatory Authority (FINRA) had not prepared the IARD system to accommodate the switch, and in fact would not begin updating the IARD system until November 2011.

Please note that advisers that have assets under management of $100 million or more will continue to register with the SEC (unless an exemption from registration is available).

B. The New "Exempt Reporting Advisers"

The Dodd-Frank Act amends the Advisers Act, as of July 21, 2011, to create two new exemptions from registration for advisers to certain types of private funds and repeal the private adviser exemption, on which many advisers to hedge and other private funds previously relied on in order to avoid registration. The two new exemptions apply to: (1) investment advisers that are solely advisers to "venture capital funds," and (2) advisers that act solely as advisers to private funds that have assets under management ("AUM") in the United States of less than $150 million. While both of these types of advisers are deemed to be "exempt reporting advisers," they still must file certain reports, such as the proposed Form PF, and a truncated version of Form ADV with the SEC through the IARD system.[2]

Notably, advisers relying on either one of these exemptions to avoid registration with the SEC may still have to register as investment advisers with applicable state securities regulators.

1. *Exemption for Advisers Solely to Venture Capital Funds*

The newly adopted rule defines a venture capital fund as a private fund that:

- Holds no more than twenty percent of the fund's capital commitments in non-qualifying investments[3];
- Does not borrow or otherwise incur leverage, other than limited short-term borrowing;
- Does not offer its investors redemption or other similar liquidity rights except in extraordinary circumstances;

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[2] Exempt reporting advisers must complete the following items of Part 1A of Form ADV: Items 1 (Identifying Information), 2.B. (SEC Reporting by Exempt Reporting Advisers), 3 (Form of Organization), 6 (Other Business Activities), 7 (Financial Industry Affiliations and Private Fund Reporting), 10 (Control Persons), and 11 (Disclosure Information). In addition, exempt reporting advisers must also complete corresponding sections of Schedules A, B, C, and D.

[3] "Qualifying investments" generally consist of equity securities of portfolio companies that are directly acquired by the fund. Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers, Advisers Act Release No. 3222, pages 10-19, *available at* http://sec.gov/rules/final/2011/ia-3222.pdf.

- Represents itself as pursuing a venture capital strategy to its investors and prospective investors; and
- Is not registered under the Investment Company Act and has not elected to be treated as a business development company.[4]

An adviser is eligible to rely on the venture capital exemption only if it solely advises venture capital funds that meet all of the elements of the above definition.[5]

2. *The Private Fund Adviser Exemption*

Under the newly adopted rules, the SEC exempts from registration any investment adviser solely to private funds that has less than $150 million in AUM in the United States. The Advisers Act defines the term "private fund" as an issuer that would be an investment company, as defined in section of the Investment Company Act of 1940 but for section 3(c)(1) or 3(c)(7) of that Act. The SEC has coined this new exemption the "private fund adviser exemption."

An adviser that has one or more clients that are not private funds is not eligible for this exemption and must register unless another exemption is available. Consequently, advisers relying on this exemption must solely advise private funds. An adviser may, however, advise an unlimited number of private funds provided that the aggregate value of the assets of the private funds is less than $150 million. Accordingly, advisers to private funds must aggregate the value of all fund assets in order to determine if the adviser is below the $150 million threshold.

For more information about this topic and other legal services, please contact us at (619) 298-2880, info@jackolg.com or visit www.jackolg.com. Thank you.

Author: Brent M. Cunningham, Associate, Editor: Michelle L. Jacko, Esq., Managing Partner, JLG. JLG works extensively with investment advisers, broker-dealers, investment companies, hedge funds and banks on legal and regulatory compliance matters.

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[4] *Id.*
[5] *Id.*