

# Current Regulatory Regime for Investment Advisers Post Dodd-Frank

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## I. Introduction

On July 21, 2010, President Barack Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act” or the “Act”) into law.<sup>2</sup> In enacting the Dodd-Frank Act, Congress sought to promote stability within the U.S. financial system.<sup>3</sup> The Act provides for major changes to the financial services industry, makes significant amendments to the Investment Advisers Act of 1940, as amended (the “Advisers Act”)<sup>4</sup>, and creates a number of new requirements found in Title IV of the Act (“Title IV”) entitled the “Private Fund Investment Advisers Registration Act of 2010.” Title IV increases regulatory oversight of investment advisers to larger private funds, thereby enabling the Securities and Exchange Commission (SEC) to assess whether these private funds present a systemic risk to the U.S. economy. Title IV of the Act directed the SEC to create rules implementing certain provisions of the Act. The SEC believes these new rules will “fill a key gap in the regulatory landscape.”<sup>5</sup> The SEC issued the final versions of these rules on June 22, 2011.<sup>6</sup>

Among the changes of note is the rescission of an oft-relied upon exemption from registration for advisers who had fewer than fifteen (15) clients during the preceding twelve (12) months. New exemptions have been installed in its place, including exemptions for certain advisers to private funds and for certain foreign advisers with limited contact with the U.S. For purposes of determining SEC and state registration eligibility, the final rules create a new category of investment advisers for those who have between \$25 million and \$100 million in assets under management. This new category of mid-size advisers in turn raises the threshold for investment advisers that are required to register with the SEC from \$30 million or more in assets under management to \$100 million or more in assets under management. This article addresses all of the foregoing.

The provisions of the Dodd-Frank Act were effective as of July 21, 2011 but, pursuant to the final rules, the SEC postponed the implementation of several registration and compliance requirements for investment advisers until 2012, as discussed further herein.

## II. Registration of Private Fund Advisers

Pursuant to the rules governing investment advisers prior to the Dodd-Frank Act, investment advisers who had \$25 million or more assets under management were permitted to register with the SEC, and investment advisers who had \$30 million or more assets under management were required to register with the SEC absent an exemption from registration, such as Advisers Act § 203(b)(3).<sup>7</sup> As discussed below, Title IV and the amendments to the Advisers Act contain provisions that significantly change the registration requirements for investment advisers and the exemptions therefrom.

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### A. Eligibility for SEC Registration

#### 1. Creation of New Categories of Investment Advisers

The provisions set forth in Dodd-Frank Act § 410 and codified in Advisers Act § 203A(a)(2) create a new classification of “mid-sized advisers.” A “mid-sized adviser” is one that has regulatory assets under management (RAUM) (a new term used by the SEC which is discussed further herein) of between \$25 million and \$100 million.<sup>8</sup> Subject to certain exemptions discussed in section II (A) (2) of this Article below, Dodd-Frank Act § 410 prohibits a mid-sized adviser from registering with the SEC if (i) the adviser is “required to be registered”<sup>9</sup> as an investment adviser in the state where it has its principal office and place of business and, (ii) if registered, is subject to examination as an adviser by that state. If both elements are not met with respect to a mid-sized adviser, it must register with the SEC. The SEC surveyed all fifty states’ securities authorities and has indicated that only advisers in New York and Wyoming are not subject to examination.<sup>10</sup> In addition to the newly created category of mid-size advisers, Dodd-Frank Act § 410 also raised the minimum threshold for required registration with the SEC to \$100 million RAUM.

According to Advisers Act § 203A, if an adviser has less than \$25 million RAUM, it is labeled a “small adviser.” All “small advisers” are prohibited from registering with the SEC and must register or qualify for an exemption from registration at the state level, unless a small adviser qualifies for an exemption from the prohibition on SEC registration (as discussed below).<sup>11</sup> Finally, any investment adviser that is either an adviser to a business development company (BDC) (and also has at least \$25 million RAUM) or an adviser to a registered investment company (RIC) (regardless of its level of RAUM) is *required* to register with the SEC.<sup>12</sup>

### 2. Exemptions from the Prohibition on SEC Registration

Although the Dodd-Frank Act prohibits many small and mid-sized advisers from registering with the SEC, there are several exemptions from this prohibition on SEC registration. Any adviser, regardless of its RAUM level, is allowed to register with the SEC rather than at the state level if it fits into one of the following categories: (i) certain pension consultants; (ii) certain investment advisers affiliated with an adviser registered with the SEC; (iii) investment advisers expecting to be eligible for SEC registration within 120 days of filing Form ADV; (iv) certain multi-state investment advisers;<sup>13</sup> and (v) certain internet advisers.<sup>14</sup>

### 3. Assets Under Management Calculation

The SEC redefined its method of calculating assets under management for the purposes of classifying investment advisers, determining their eligibility for SEC registration and determining their eligibility for certain exemptions from SEC registration. Form ADV will now refer to an adviser’s RAUM in order to have a uniform system of calculating assets under management. For the purposes of Form ADV, RAUM includes all securities portfolios for which investment advisers “provide continuous and regular supervisory or management services, regardless of whether these assets are family or proprietary assets, assets managed without receiving compensation, or assets of foreign clients” whereas an adviser could previously exclude these assets from its calculation of assets under management. RAUM are calculated on a “gross basis” without deducting any outstanding indebtedness or accrued but unpaid liabilities. The SEC is also requiring an annual determination of an adviser’s RAUM (rather than a more frequent basis).<sup>15</sup>

### 4. Process for Transition to State Registration

As many investment advisers previously registered with the SEC will now have to withdraw their federal

registration and register at the state level, the SEC has set forth guidelines for this transition.

*Existing Registrants.* All advisers currently registered with the SEC must file an amended Form ADV by March 30, 2012 to indicate whether or not they remain eligible for SEC registration.<sup>16</sup> Any mid-sized adviser that no longer qualifies for SEC registration must file a Form ADV-W, a form indicating their withdrawal from SEC registration, and register at the state level by June 28, 2012.<sup>17</sup> Any investment adviser that is currently registered with the SEC must remain registered until January 1, 2012 (unless an exemption from registration applies), in order for the SEC to accommodate updates to the Investment Adviser Registration Depository (IARD) system.<sup>18</sup>

*New Applicants.* Mid-sized advisers must now register with the appropriate state securities authority. Only those advisers who have over \$100 million in RAUM, who qualify for an exemption from the prohibition on SEC registration, or who are otherwise eligible for federal registration will be allowed to register at the federal level, and must do so by filing a Form ADV by March 30, 2012.<sup>19</sup>

*Assets Under Management Buffer.* Under the previous rules, an investment adviser would not be required to register with the SEC until it had assets under management of over \$30 million and would be permitted to register with the SEC if it had assets under management between \$25 million and \$30 million. In a similar fashion, amended Advisers Act Rule 203A-1(a)(1) provides that a mid-sized adviser does not have to register with the SEC until its RAUM exceeds \$110 million (as determined at the end of that adviser’s current year-end in its annual updating amendment to Form ADV). Similarly, an already registered investment adviser does not have to withdraw its SEC registration until its RAUM is less than \$90 million (at the end of that adviser’s current year-end).<sup>20</sup> It is important to note that an adviser does not have to utilize these buffers.

### B. Changes to Exemptions from Registration under the Advisers Act for Private Fund Advisers<sup>21</sup>

#### 1. Elimination of Private Adviser Exemption

Title IV eliminated the private adviser exemption that was previously found in Advisers Act § 203(b)(3) (known as the “private adviser exemption”). The private adviser exemption provided that an adviser who (i) had fewer than fifteen (15) clients (where each fund was counted as one client) during the preceding twelve (12) months, (ii) did not hold himself out generally to the public as an investment adviser, and (iii) did not act as an adviser to a RIC or a BDC, was exempt from registration as an

investment adviser under the Advisers Act. Prior to the Dodd-Frank Act, many investment advisers relied on this private adviser exemption. The elimination of this exemption is one of the most notable amendments to the registration rules of the Advisers Act and will require many previously unregistered investment advisers who meet the jurisdictional thresholds described herein to register as investment advisers with the SEC (unless an exemption from registration applies) or a state.

## 2. Limitation on Intrastate Exemption

The Act narrowed the “intrastate exemption” found in Advisers Act § 203(b)(1), which provides an exemption from SEC registration for certain intrastate advisers. As revised, this exemption is no longer available to investment advisers of private funds as of July 21, 2011.

## 3. Change to CFTC-Registered Exemption

The Act preserves Advisers Act § 203(b)(6), which provides an exemption from registration to commodity trading advisors (CTAs) registered with the U.S. Commodities Futures Trading Commission (CFTC) “whose business does not consist primarily of acting” as investment advisers as defined in Advisers Act § 202(a)(11) and who do not serve as investment advisers to a RIC or a BDC. However, Title IV also expands the exemption for registered CTAs who manage a private fund as long as, after July 21, 2011, the business of the adviser does not become “predominantly the provision of securities-related advice.” Of note, the term “predominantly” is not defined in the Act.

## C. New Exemptions from Registration under the Advisers Act

### 1. Addition of Exemption for Certain Private Fund Advisers

Advisers Act Rule 203(m)-1 provides a new exemption from registration for any investment adviser that (i) acts solely as an adviser to private funds<sup>22</sup> and (ii) has RAUM in the U.S. of less than \$150 million. For foreign investment advisers, the exemption is available only if that adviser’s U.S. clients are strictly private funds, and all assets managed by that adviser at a place of business in the U.S. do not exceed \$150 million in private fund RAUM. The SEC has stated that private fund RAUM must only be calculated on a yearly basis. This exemption will not be available to investment advisers that have any clients other than private funds. Investment advisers exempted under this rule will be required to maintain appropriate records and provide periodic reports to the SEC on Form ADV.

### 2. Addition of Exemption for Foreign Private Advisers

Title IV amends Advisers Act § 203(b)(3) to add an exemption for “foreign private advisers.” A “foreign private adviser” is an adviser who (i) has no place of business in the U.S., (ii) has, in total, fewer than 15 clients *and investors* in the U.S. in private funds advised by the investment adviser, (iii) has aggregate RAUM attributable to clients in the U.S. and investors in the U.S.<sup>23</sup> in private funds advised by the investment adviser of less than \$25 million, and (iv) neither (a) holds itself generally to the U.S. public as an investment adviser, nor (b) acts as (I) an investment adviser to any RIC or (II) a company that has elected to be a BDC and has not withdrawn its election.

Advisers Act Rule 202(a)(30)-1 allows an adviser to treat as a single client a natural person as well as (i) that person’s minor children; (ii) any relative, spouse, or relative of the spouse with the same principal residence; and (iii) all accounts and all trusts of which that person and/or the person’s minor child or relative, spouse or relative of the spouse with the same principal residence are the only primary beneficiaries. Rule 202(a)(30)-1 also allows advisers to treat as a single client a corporation, general or limited partnership, trust or other legal organization to which the adviser provides legal advice, as well as two or more legal organizations that have identical shareholders, partners, limited partners, member or beneficiaries. The SEC is also requiring advisers to count as “clients” those persons for whom the adviser provides advisory services without compensation.<sup>24</sup>

### 3. Addition of Exemption for Venture Capital Fund Advisers

Title IV also added Advisers Act § 203(l) to provide an exemption from registration for investment advisers that advise solely one or more “venture capital funds.” In Rule 203(l)-1, the SEC generally defined the term “venture capital fund” as a private fund that: (i) represents to investors and potential investors that it pursues a venture capital strategy; (ii) holds no more than twenty percent (20%) of the fund’s capital commitments in non-qualifying investments<sup>25</sup> (other than short-term holdings); (iii) does not borrow or otherwise incur leverage, other than limited short-term borrowing (excluding certain guarantees of qualifying portfolio company obligations by the fund); (iv) does not offer its investors redemption or other similar liquidity rights except in extraordinary circumstances; (v) is not registered under the Company Act; and (vi) has not elected to be treated as a BDC.

The SEC has also adopted a “grandfather” clause in Advisers Act Rule 203(l)-1 that allows an existing private fund to qualify as a “venture capital fund” if it (i) repre-

sented to investors and potential investors at the time the fund offered its securities that it pursues a venture capital strategy; (ii) has sold securities to one or more investors prior to December 31, 2010; and (iii) does not sell any securities to, including accepting any capital commitments from, any person after July 21, 2011. All investment advisers exempt pursuant to Advisers Act § 203(l) will be required to maintain appropriate records and provide periodic reports to the SEC.

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#### 4. Addition of Exemption for SBIC Advisers

Title IV adds Advisers Act § 203(b)(7) to provide an exemption for an investment adviser who is not a BDC and who solely advises (i) small business investment companies that are licensees under the Small Business Act of 1958, (ii) entities that have received a notice to proceed to qualify as a small business investment company and (iii) applicants that are affiliated with any entity described in subparagraph (i) who have a pending application to be licensed under the Small Business Investment Act.

#### D. New Reporting Requirements for Investment Advisers

##### 1. Form ADV

In an effort to increase oversight of investment advisers, the SEC has adopted several rules that revise the existing Form ADV.

*Private Fund Reporting (Item 7.B).* Item 7.B requires information about each of the private funds advised by an adviser, including a separate § 7.B.(1) and a separate Schedule D for each private fund that the adviser manages. These require information about the size, strategy, organization and other detailed characteristics of each private fund (Part A) as well as information about several of each fund’s service providers, including auditors, prime brokers, custodians, administrators and marketers (Part B). All of the information collected by the SEC in Item 7.B will be disclosed to the public.

*Advisory Business Information (Item 5).* Item 5 requires advisers to provide information regarding the adviser’s business, employees, client base and RAUM as well as details about the types of services they provide. In addition,

advisers must report approximate percentages of RAUM by client type in broad ranges (e.g., twenty-five percent (25%) segments).

*Other Business Activities and Financial Industry Affiliations (Items 6 and 7).* Items 6 and 7 require advisers to provide information pertaining to all types of financial services that they provide to their clients (e.g., whether an adviser is a related person, is a trust company, registered municipal advisor, registered security-based swap dealer or major security-based swap participant, accountant or lawyer). These new rules also require advisers to provide information about other types of business that they are engaged in as well as identifying information for the adviser’s related persons.

*Additional Form ADV Revisions.* The SEC has also made revisions to several other sections of Form ADV including Item 8 (Participation in Client Transactions), Item 9 (Custody) and Item 1.O (Reporting \$1 Billion in Assets) and several other technical amendments.

#### 2. Exempt Reporting Advisers

The SEC has set forth new reporting requirements for investment advisers claiming an exemption from federal registration (as discussed below). Certain exempt advisers (those relying on the exemptions found in Advisers Act § 203(l) (venture capital fund advisers) and 203(m) (certain private fund advisers) as discussed further herein must now complete and file certain portions of Form ADV<sup>26</sup> on an annual basis. In addition, any adviser claiming an exemption under the Advisers Act must submit an initial Form ADV within sixty (60) days of relying on such exemption. Further, these exempt reporting advisers must file an updated Form ADV annually within ninety (90) days of the end of the adviser’s fiscal year. An exempt reporting adviser must also file more frequent updates if certain Form ADV responses become inaccurate. Finally, an adviser must file an amendment to its Form ADV to indicate that it is filing a final report once it no longer relies on an exemption from registration. The SEC does not plan to conduct compliance examinations of exempt reporting advisers on a regular basis, but may do so if it believes there are any indications of wrongdoing.<sup>27</sup>

#### III. Conclusion

The enactment of the Dodd-Frank Act, specifically Title IV of such Act, prompted several significant amendments to the Advisers Act that will alter the regulatory landscape for investment advisers. Investment advisers must therefore determine what actions they need to take to comply with the new regime.

## Endnotes

1. The authors would like to acknowledge Richard E. Strohmenger, an associate in the law firm's Financial Services Department, for his help in the preparation of this Article.
2. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).
3. *See id.*
4. Unless otherwise noted, when we refer to the Advisers Act, or any paragraph of the Advisers Act, we are referring to 15 U.S.C. § 80b of the U.S. Code.
5. SEC Adopts Dodd-Frank Act Amendments to Investment Advisers Act, SEC, June 22, 2011, <<http://www.sec.gov/news/press/2011/2011-133.htm>>.
6. Rules Implementing Amendments to the Investment Advisers Act of 1940, Advisers Act Release No. 3,221 (Jun. 22, 2011); 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. 3,222 (Jun. 22, 2011).
7. *See* Advisers Act § 203(b)(3) as in effect before July 21, 2011. Other investment advisers, such as investment advisers to registered investment companies, were required to register with the SEC regardless of the level of their assets under management.
8. Advisers Act § 203A(a)(2).
9. An adviser is "required to be registered" in a particular state unless that adviser is exempt from registration under the law of the state in which it has its principal office and place of business, or is excluded from the definition of investment adviser in that state. Advisers Act § 203A(a)(2).
10. *See* <<http://www.sec.gov/divisions/investment/midsizedadviserinfo.htm>>.
11. Advisers Act Rule 203A-2. Unless otherwise noted, when we refer to an Advisers Act Rule, or any paragraph of any Advisers Act Rule, we are referring to the appropriate section of the Code of Federal Regulation ("CFR") in which these rules are published.
12. Amended Form ADV, Part 1A, Items 2.A.(6) and (12).
13. In accordance with the Dodd-Frank Act, the SEC amended Advisers Act Rule 203A-2 to allow any investment adviser that is required to register as an adviser with fifteen (15) or more states to register with the SEC.
14. Advisers Act Rule 203A-2.
15. *See* amended Form ADV: Instructions for Part 1A, instr. 5.b.; Amendments to Form ADV, Advisers Act Release No. 3060 (Jul. 28, 2010).
16. Advisers Act Rule 203A-5(b).
17. Advisers Act Rule 203A-5(c)(1).
18. Advisers Act Release No. 3,221 § II.A.1.
19. Advisers Act Rule 203A-5(b).
20. This buffer is not available for advisers to either a RIC or a BDC and is also not available to advisers that are eligible for one of the exemptions from the prohibition on SEC registration as listed in Advisers Act Rule 203A-2.
21. Title IV adds a definition of "private fund" in Advisers Act § 202(a)(29). The term "private fund" is defined as an issuer that would be an investment company, as defined in Investment Company Act of 1940 § 3, as amended (the "Company Act"), but for § 3(c)(1) (i.e., privately-offered funds with fewer than 100 investors) or § 3(c)(7) (i.e., privately offered funds where all investors are qualified purchasers) of the Company Act.
22. The SEC expanded the Title IV "private fund" definition in Advisers Act Rule 203(m)-1(d)(5) to also include any fund that qualifies for an exclusion from the definition of "investment company" found in Company Act § 3, as well as any private fund that invests in other private funds.
23. Advisers Act § 202(a)(30). The SEC generally incorporated the definition of "in the U.S." from that found in Regulation S (with some minor definitional additions).
24. Advisers Act § 202(a)(30).
25. The SEC defines "qualifying investments" as equity securities (i) of qualifying portfolio companies that are directly acquired by the fund from the company, (ii) of qualifying portfolio companies that are exchanged for directly acquired equity issued by the same qualifying portfolio company, or (iii) issued by a company of which a qualifying portfolio company is a majority-owned subsidiary or predecessor, and that is acquired by the fund in exchange for directly acquired equity. Advisers Act Rule 203(l)-1(c)(3).  
The SEC defines a "qualifying portfolio company" as a company that "(i) is not a reporting or foreign traded company and does not have a control relationship with such company, (ii) does not incur leverage in connection with the investment by a private fund and distribute the proceeds of any such borrowing to the private fund in exchange for the private fund investment, and (iii) is not itself a fund." Advisers Act Rule 203(l)-1(c)(4).
26. Exempt reporting advisers must complete Items 1, 2.B., 3, 6, 7, 10 and 11 of Form ADV.
27. Advisers Act Rule 204-4.

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