Venture Capital and Private Equity Team Alert

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SEC Adopts Final Rules Implementing Dodd-Frank Act Amendments to Investment Advisers Act

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act") enacted in July 2010 introduced significant changes to the regulation of investment advisers. The Securities and Exchange Commission has subsequently adopted several new rules implementing and further clarifying the changes contemplated by the Act. The SEC most recently adopted final rules that implement provisions of the Act eliminating the "private investment adviser" exemption to registration with the SEC under the Investment Advisers Act of 1940 (the "Investment Advisers Act"), establishing new exemptions from SEC registration for small private fund advisers and venture capital fund advisers (but introducing limited reporting requirements for those exempt advisers), transferring regulatory responsibility from the SEC to the states for mid-sized advisers, and revising the "pay-to-play" rule, among other changes. The SEC also adopted a final rule defining "family offices," which are exempt from registration under the Investment Advisers Act.

Elimination of Private Adviser Exemption

The Act eliminated the "private investment adviser" exemption contained in Section 203(b)(3) of the Investment Advisers Act, relied on by investment advisers who had fewer than fifteen clients during the preceding twelve months and who neither held themselves out to the public as an investment adviser nor served as an investment adviser to a registered investment company or business development company. Congress' apparent intent in repealing Section 203(b)(3) was to require advisers to private funds, including hedge funds, private equity funds and other types of pooled investments excluded from the definition of "investment company" under the Investment Company Act of 1940 (the "Investment Company Act") to register with and be subject to oversight by the SEC. Many previously unregistered advisers, particularly advisers to hedge funds and private equity funds, are now required to register with the SEC unless another exemption is available. The rule includes a transition period for previously unregistered advisers, allowing such advisers until March 30, 2012 to register with the SEC.

New Exemptions from Registration

While the SEC has eliminated the private adviser exemption, it provides three new exemptions from registration:

Small Private Fund Advisers. The SEC adopted Rule 203(m)-1 to implement an exemption for investment advisers who only advise "private funds" and who have less than $150 million in assets under management.

Venture Capital Fund Advisers. The SEC adopted Rule 203(l)-(1) to implement an exemption for firms that advise only venture capital funds. The new rule defines "venture capital fund" as a private fund that:

- invests at least 80% of the fund's capital in qualifying venture capital investments (generally private operating companies);
- 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;
- 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.

Foreign Private Advisers. The SEC implemented an exemption from SEC registration for foreign private advisers, which is defined to include advisers that do not have a place of business in the United States and have less than $25 million in aggregate assets under management from U.S. clients and private fund investors and fewer than fifteen U.S. clients and private fund investors.

New Reporting Requirements for Exempt Advisers

Even though small private fund advisers and venture capital fund advisers may rely on exemptions from registration under the Investment Advisers Act, these advisers will, however, be required to file and periodically update reports with the SEC. These reports will consist of a limited number of items on Form ADV.

Changes to the Pay-to-Play Rule

The SEC is amending the investment adviser "pay-to-play" rule – a rule designed to prevent an adviser from seeking to influence government officials' awards of advisory contracts through political contributions – in response to amendments by the Act. The SEC's amendments revise the scope of the rule to apply to exempt reporting advisers and foreign private advisers. The SEC is also amending the rule to add registered municipal advisers to the categories of registered entities excepted from the rule's prohibition on advisers paying third parties to solicit government entities (provided that they are subject to the Municipal Securities Rulemaking Board's own pay-to-play rule).

Reallocation of Regulatory Responsibility for Mid-Size Advisers

Prior to enactment of the Act, advisers managing less than $25 million were primarily subject to state regulation and prohibited from registering with the SEC under the Investment Advisers Act. The Act raised the threshold for registration with the SEC to $100 million. Accordingly, the SEC has adopted amendments to several of its current rules and forms to reflect the higher threshold and provide a buffer to prevent advisers from having to frequently switch between state and SEC registration. Advisers registered with the SEC will have to declare whether or not they are permitted to remain registered with the SEC in a filing in the first quarter of 2012, and those no longer eligible for SEC registration will be required to complete the transition to state registration between January 1, 2012 and June 28, 2012.

SEC Adopts Rule Defining "Family Offices" under Investment Advisers Act

The SEC approved a new rule to define "family offices" that are to be excluded from the registration requirements under the Investment Advisers Act. Prior to the enactment of the Act, family offices with less than fifteen clients generally relied on the "private investment adviser" exemption from registration. Although this exemption was removed by the Act, the Act also included a provision requiring the SEC to adopt a rule defining family offices to be excluded from registration. Pursuant to the final rule, a family office is a company that:

- Has no clients other than "family clients";
- is wholly owned by family clients and exclusively controlled by family members and/or family entities; and
- does not hold itself out to the public as an investment adviser.

Family Members. The new rule defines family member to include all lineal descendants (including by adoption, stepchildren, foster children and, in some cases, by legal guardianship), and such lineal descendants' spouses and spousal equivalents, of a common ancestor (living or deceased) that is no more than ten generations removed from the youngest generation of family members.

Family Clients. Under the new rule, family clients include family members and all of the following individuals and entities:

- key employees, including executive officers, directors, trustees, and general partners for the family office or its affiliated family office, and any other employee of the family office or its affiliated family office (other than a clerical or secretarial employee) who has participated in the investment activities of the family office or its affiliated family office for at least 12 months;
- any non-profit or charitable organization funded exclusively by family clients;
- any estate of a family member, former family member, key employee, or subject to certain conditions, a former key employee;
- certain family client trusts;
- any company wholly-owned by and operated for the sole benefit of family clients.

Family offices that do not meet the terms of the exclusion must register with the SEC under the Investment Advisers Act by March 30, 2012. The SEC's adopted rule incorporates a grandfathering provision that prohibits preclusion of certain family offices from meeting the new exclusion solely because they provide investment advice to certain clients and provided that advice prior to January 1, 2010.

Please contact the authors of this Alert, Jim Stewart (205.521.8087) or Michael Thomason (205.521.8921), the Chairman of the Team, James Childs (205.521.8207), or another member of Bradley Arant Boult Cummings LLP's Venture Capital and Private Equity Team if you have any questions about the new rules.

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