Investment Advisers Act of 1940

Robert Bramnik

August 2014

Introduction

- Unless exempt from registration, the investment manager/adviser to a “private fund” in the United States is required to register as an “Investment Adviser” (“IA“) pursuant to the Investment Advisers Act of 1940 (the IA Act).
- A Management Company that does not advise the private fund on the substantive investment or trading activities, and limits its activities to administrative duties and functions, is not required to register as an IA.
- A number of limited exemptions are available from such registration: private fund adviser, foreign adviser, venture capital fund adviser.[1] However, limited registration with the Securities and Exchange Commission (“SEC”) is required to claim such exemptions.

[1] A fourth exemption is for advisers to “Family Offices” is also in force. However, by its terms, the “family office” exemption is generally not available to private funds unless investment is limited to “family members.”

Introduction

- Until adoption of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank”), a broader exemption for “small advisers” having 14 or fewer clients in any rolling 12 month period was available to private fund advisers. Dodd-Frank eliminated that exemption, triggering the requirement that most fund advisers were required to register.

Registration Standards (state/federal)

- Advisers who have at least $100 million "Regulatory Assets Under Management" (or "RAUM") are required to register with the SEC. Advisers with less than $100 million RAUM are generally required to register in one or more states.

- An adviser subject to state regulation must register in the state where it maintains its principal office. However, it may be required to register in additional states, the determination of which is generally determined by whether the adviser has offices, agents and/or advisory clients in a given state.

Registration Standards (state/federal)

- Certain advisers who do not meet the $100 million RAUM standard may register with the SEC, and avoid state registration if they

  a. would be required to register with more than 15 states

  b. are part of a "controlled group" (e.g., family) with a federally registered IA

  c. expect to meet the $100 million standard within 120 days (frequently newly registered IAs)

  d. are pension consultants who provide investment advice on at least $200 million in assets or

  e. are internet investment advisers

Registration Standards (state/federal)

- RAUM includes 100% of assets of U.S. clients managed for compensation as well as proprietary assets, assets of non-U.S. clients and assets managed without receiving compensation.

- RAUM is calculated on a gross basis – thus, indebtedness on advisory accounts (for example, for unpaid fees and charges such as brokerage commissions) are not deducted.

Background

- Before Dodd Frank, “small advisers” were exempt from the IA registration requirement under Section 203(b)(3) of the IA Act. That exemption was frequently relied upon by an individual or entity who might otherwise be classified as an “investment adviser” when they had fewer than 15 US clients during the immediately preceding 12-month period and had not held themselves out to the public as an investment adviser.
- Because most private investment funds were (and are) considered only one person – or client – advisers to such funds and pools could typically take advantage of the exemption.
- Not eligible:
    - An adviser to a Registered Investment Company under the Investment Company Act (including mutual funds and exchange traded funds, or ETFs)
    - Advisers who advertised or otherwise “held themselves out to the [investing] public as being in the investment advisory or investment management business

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“Exempt Reporting Advisers”

Although Dodd-Frank eliminated the “small adviser” exemption, it instructed the SEC to create three categories of limited investment adviser, who are not required to register as IAs:

a. Advisers to “private funds” that have less than $150 million RAUM in the U.S. (the “Private Fund Adviser Exemption”)

b. Advisers solely to “venture capital funds” (the “VC Adviser Exemption”)

c. Non-U.S. advisers with less than $25 million in RAUM attributed to U.S. clients and U.S. private fund investors and fewer than 15 such clients and investors (the “foreign private adviser exemption”)

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“Exempt Reporting Advisers”

- The SEC has adopted a comprehensive set of rules to codify how each category of exempt adviser operates and how the three categories of exemption interact with one another.
- For example, all assets managed by a U.S. Adviser are deemed to be “managed” in the United States. A U.S. Adviser with a foreign (e.g., non U.S.) office is not deemed to be a foreign adviser even with respect to assets of non-U.S. clients that it advises outside of the U.S.
- A “private fund” is defined as an issuer of a security (*i.e.*, the interests in the fund) that would be required to register as an Investment Company but for the exemptions contained in Sections 3(c)(1) [*fewer than 100 beneficial owners*] or 3(c)(7) [*all investors are “qualified purchasers*] of the Investment Company Act.

“Exempt Reporting Advisers”

- A “venture capital fund” is generally a fund that represents to investors and potential investors that it pursues a venture capital strategy, invests only in “qualifying investments” or short term holdings (such as money market funds), does not borrow or otherwise leverage its portfolio investments, does not offer investors redemption or similar liquidity rights except in extraordinary circumstances and is not registered under the Investment Company Act.
- Qualifying investments are also defined to exclude reporting companies (pursuant to the Securities Exchange Act of 1934, as amended) and equivalent foreign companies and companies that do not incur leverage in connection with the private fund’s investment in that company. In addition, a qualifying investment may not be a registered investment company, a private fund, a commodity pool or the issuer of certain asset-backed securities.

"Exempt Reporting Advisers"

- In order to claim the exemption, each "Exempt Reporting Adviser" is required to prepare and file a partial Form ADV Part I. In addition to disclosing identification and background information, the Exempt Reporting Adviser is required to prepare and include a disclosure schedule describing each Private Fund that they advise. In turn, that disclosure schedule requires information on the nature of the fund, its structure and its portfolio business.
- Although not subject to the bookkeeping and record keeping, advisory client documentation or capital requirements of IAs, Exempt Reporting Advisers are subject to "presence examinations" by the SEC's examination staff.

Other IA Act Exemptions

Although most exemptions will not apply to advisers to private funds, they should be reviewed for possible applicability. These exemptions include:

a. Banks (unless the bank advises a Registered Investment Company).

b. Lawyers, Accountants, Engineers and/or Teachers whose advisory activities are solely incidental to the practice of his/her/its profession.

c. Registered brokers and dealers whose advisory activities are incidental to their broker/dealer business and who receive no special compensation for providing advisory services. (Wrap fee program compensation is permitted.)

d. Publishers of bona fide newspapers, news magazines or businesses or financial publication of general and regular circulation.

e. Family Offices, pursuant to SEC regulations.

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Requirements for Registered IAs

The IA Act provides for a broad range of requirements for registered IAs. These fall into broad categories:

a. Qualification. Completion and filing of Form ADV, Parts I, II A and II B.

- Part II A is the "disclosure brochure" that describes business practices and conditions of the IA's advisory business, including the nature of advisory services, fee schedules and policies and other items that a prospective advisory client might deem important.
- Part II B is a disclosure document for advisory clients concerning each IA representative who may be involved in the management or investment advisory conduct of the client's account.

b. Books and Records. Registered IAs must keep and maintain numerous books and records including minimum required information on advisory clients, fees and fee schedules, compliance reviews and documentation and due diligence files on advisory activities. IAs that maintain control and/or custody of client funds, securities or other assets are required to have audited financial statements and special examinations of custodial assets and funds prepared, distributed to advisory clients and filed with the SEC.

Requirements for Registered IAs

c. Compliance and Supervision Policies. Registered IAs must compile and maintain a Code of Ethics, a written supervisory procedures manual ("WSP"), business continuity plans and Privacy Act policies. All are subject to SEC inspection and examination.

d. Conduct Requirements. There are minimum requirements for advisory contracts as well as prohibitions. For example, an advisory contract may not be assigned by a registered IA without the written consent of the advisory client. Certain self-dealing activities and conflicts are restricted or prohibited (E.g., limitations on IAs investing client accounts in proprietary products absent client consent). Advisory clients may not be required to pay fees after they have terminated their advisory contracts and the IA may not prohibit cancellations (although reasonable restrictions on cancellation by the advisory client are permitted).

Further information

Bob Bramnik, Partner, Chicago & New York

RPBramnik@duanemorris.com

+1 (312) 499 0121

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