Summary Steps: Investment Adviser Registration

Registration Requirements

Pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"), an investment adviser that acts solely as an adviser to private funds[1] will be required to register with the Securities and Exchange Commission (the "SEC") as a registered investment adviser ("RIA") under the Investment Advisers Act of 1940, as amended ("Advisers Act") upon reaching $150 million of assets under management in the United States.[2] If an investment adviser is ineligible to register as an RIA for a significant period of time after commencing operations as an investment adviser, the investment adviser may need to register as an investment adviser with the state of its principal place of business.

Key Exemptions

The Act provides exemptions from registration for certain types of investment advisers. In particular:

- "Foreign private advisers" are exempt from registration as RIAs. Foreign private advisers are defined as investment advisers that (i) have no place of business in the U.S.; (ii) have, in total, less than 15 clients and investors in the U.S. in private funds advised by the investment adviser (such clients and investors, "Advised U.S. Clients"); (iii) have aggregate assets under management attributable to Advised U.S. Clients of less than $25 million; and (iv) neither (a) hold themselves out generally to the public in the U.S. as an investment adviser, nor (b) advise any registered investment company (mutual fund) or business development company.
- Advisers to "family offices" are exempted from the definition of "investment adviser" under the Advisers Act and thus from registration as RIAs. The definition of "family office" shall be determined through rule making by the SEC.
- No person that acts as an investment adviser solely to one or more "venture capital funds" (which term shall be defined by the SEC) shall be required to register as an RIA. Notwithstanding such exemption from registration, advisers to venture capital funds shall be required to maintain and file such records with the SEC as the SEC deems necessary or appropriate.

If you believe that your business falls within one of the above-mentioned exemptions, please contact us to discuss the parameters of the relevant exemption in more detail.

Steps to Registering as an RIA

The process of registering as an RIA is fairly simple; most of the burdensome aspects of registration relate to compliance with the requirements imposed by the Advisers Act upon RIAs, not the actual registration process. Compliance under the Advisers Act is addressed in the next section. The steps to achieving registration are:

- The first step in the SEC registration process is to create an Investment Advisers Registration Depository (IARD) User Account through a process called "Entitlement" that is managed by the Financial Industry Regulatory Authority ("FINRA"). In essence, this process involves completing several forms and sending them to FINRA. Approximately two weeks after receiving the forms, FINRA will consider the applicant to be "Entitled" and will send a username and password to access IARD. At this time, the applicant must also pay a nominal fee to the SEC.
- Once the applicant has set up an IARD account, the next step is to complete Part 1A and Part II of the investment adviser registration form (i.e., Form ADV). Part 1A must be filed electronically through IARD; Part II may be filed for public viewing on IARD on a voluntary basis and must be provided to the SEC on demand. Also, Part II of Form ADV must be provided to investors at least 48 hours before they invest with the adviser and updated copies of Part II must be offered to investors on an annual basis.[3] Part 1A is intended to solicit basic information from the investment adviser (mostly through check-the-box and fill-in the blank style questions) and Part II is largely a narrative form that requires registrants to provide a detailed description of their business, the way in which investment decisions are made, fees charged to clients, and a description of certain conflicts affecting the business. A copy of the Form ADV is available upon request.
- Once the SEC receives Part 1A of Form ADV from an applicant, the SEC will review the materials to confirm that the application is complete and in compliance with the Advisers Act. Registration must be accepted or denied within 45 days (and generally advisers are notified within a few weeks).

Complying with the Advisers Act

As noted above, conducting business as an RIA requires the investment adviser to establish a substantial compliance program. An RIA is expected to be in compliance with the Advisers Act and the rules thereunder upon registration, so the investment adviser should plan on being in compliance with the following requirements before submitting Part 1A of its Form ADV to the SEC. There are many aspects of compliance with the Advisers Act that are beyond the scope of this memorandum; we have briefly listed those that we think will be of the most concern to an unregistered investment adviser.

Development of a Compliance Program

Pursuant to Rule 206(4)-7 of the Advisers Act (the "Compliance Rule"), an RIA must establish an internal compliance program that addresses the adviser's substantive and fiduciary obligations under the Advisers Act. Although the Compliance Rule requires all RIAs to implement internal compliance programs, it gives each RIA the flexibility to decide what to cover in their own policies and procedures (subject to a number of suggested topics listed in the adopting release to the Compliance Rule).

Chief Compliance Officer

The Compliance Rule requires an RIA to designate a chief compliance officer who has knowledge about the Advisers Act and who has the authority to create and administer appropriate compliance policies and procedures for the RIA. The chief compliance officer's (and, if applicable, his or her subordinates') duties include, but are not limited to:

- Reviewing the policies and procedures of the RIA at least annually for adequacy and effectiveness;

- Reviewing and "forensically testing" brokerage arrangements and execution, portfolio management and trade allocation, and valuation procedures;
- Reviewing all advertising to ensure compliance with the specific requirements of the Advisers Act (especially those related to performance reporting);
- Managing personal trading procedures as required by the RIA's Code of Ethics (see below);
- Managing the recordkeeping required by the Advisers Act (see below);
- Filing "blue sky" offering notices with the SEC and state regulatory authorities (actually required whether the adviser is registered or not);
- Filing SEC Forms 13 and 3/4 to the extent that the investment adviser ever takes significant positions in publicly-traded equity securities; and
- Serving as the point of contact for the SEC during surprise examinations.

Development of a Code of Ethics

Rule 204A-1 of the Advisers Act (the "Code of Ethics Rule") requires RIAs to develop and follow a Code of Ethics. An RIA's Code of Ethics is largely comprised of procedures to monitor (and sometimes prevent) the personal activities of personnel that conflict with the interests of advisory clients. The Code of Ethics must include standards of conduct, rules governing personal securities transactions, preapproval of certain securities transactions, and guidelines regarding reporting of violations. The portion of the Code of Ethics that typically requires the most tailoring is the section governing personal trading by employees.

Recordkeeping

Under Rule 204-2 of the Advisers Act (the "Books and Records Rule") an RIA must maintain (and retain) true, complete, and current books and records relating to its investment advisory business. These books and records generally fall within three categories: (i) business records of the adviser; (ii) records of the adviser that relate to the adviser's clients and the advisory activities of the adviser; and (iii) records relating to the adviser's compliance program. Rule 204-2 lists many specific categories of materials that must be maintained; the RIA's compliance staff will need training and guidance to develop an appropriate and robust recordkeeping system.

Custody of Client Assets

Rule 206(4)-2 of the Advisers Act (the "Custody Rule") requires that an RIA that has custody of client assets (which private funds and managed accounts are generally deemed to have if they have authority to withdraw funds from the client's accounts to pay fees) must maintain them with a "qualified custodian."[4] The Custody Rule is complex and requires attention to several considerations in order to ensure compliance.

Many of the assets in which the RIA may invest (i.e., those that are (i) acquired from the issuer in a private placement; (ii) uncertificated; and (iii) transferable only with the consent of the issuer or the other holders of such securities) do not require custody with a qualified custodian to the extent that they are held in a private fund that is audited on an annual basis (such securities, "Restricted Securities"). However, if funds managed by the RIA hold securities that are not Restricted Securities, the RIA will be required to custody them with a qualified custodian.

With respect to a managed account, the RIA will generally need to avoid having custody of the assets of the account (other than custody derived from the ability to withdraw fees from the account) in order to avoid the account being subject to "surprise" audits. Managed account clients must also receive quarterly statements directly from the qualified custodian.

The Act Increases Burden on RIAs

The Act significantly increases the burden of complying with the Advisers Act; in particular, RIAs will be required to report their use of leverage, any side letters with investors, and their various private funds' AUM to the SEC on a regular basis.

Please do not hesitate to contact us if you have questions regarding any of the information in this memorandum. We look forward to assisting you in determining whether you are required to become an RIA and, if applicable, with the registration process.

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[1] For purposes of the Act, "private funds" are defined as any issuer that would be an "investment company" (as defined in the Investment Company Act of 1940, as amended (the "1940 Act")) but for the exceptions to such status set forth in sections 3(c)(1) and 3(c)(7) of the 1940 Act (i.e., most private equity funds, hedge funds, and venture capital funds are considered to be "private funds," but (i) real estate funds that rely on the exception contained in Section 3(c)(5)(C) under the 1940 Act, and (ii) CLOs and CDOs that rely on the exception contained in Rule 3a-7 under the 1940 Act are not considered to be "private funds."

[2] An investment adviser is exempt from SEC registration until it reaches $150 million of assets under management only if the investment adviser exclusively advises private funds. For investment advisers who advise clients other than exclusively private funds (e.g., separate accounts), the registration thresholds operate as follows: (i) subject to clause (ii), such an investment adviser generally will be permitted to register with the SEC if it has at least $25 million of assets under management, and (ii) with respect to advisers registered with the state in which they have their principal place of business and who are subject to examination by such state, such advisers shall only be permitted to register with the SEC once they have $100 million of assets under management (provided that this $100 million threshold can generally be disregarded where the adviser is required to register as an adviser with 15 or more states).

[3] It is possible to take the position that because investors in funds are not technically "clients" of the RIA for purposes of the Advisers Act that they are not entitled to Part II of the ADV, but we believe that it is best practice to distribute Part II to fund investors just as if they were direct clients of the RIA.

[4] In order to avoid additional reporting requirements, we suggest that RIAs custody client assets with a qualified custodian who is not affiliated with the RIA.

Contacts

We welcome the opportunity to discuss how Dechert can serve your needs. For more information, please contact one of the lawyers below, or the Dechert attorney with whom you regularly work.

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