SIDLEY AUSTIN LLP

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INVESTMENT MANAGEMENT UPDATE

SEC Adopts Rules Implementing Dodd-Frank Requirements for Private Fund Advisers and Others

The Private Fund Investment Advisers Registration Act of 2010 ("Title IV") of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") eliminates (effective July 21, 2011) the current "private adviser exemption" from registration and mandates extensive rulemaking with respect to investment advisers. In an open meeting held on June 22, 2011, the Securities and Exchange Commission (the "SEC") adopted rules designed to give effect to provisions of the Dodd-Frank Act relevant to private fund advisers and other investment advisers. [1,2]

The SEC unanimously adopted exemptive rules but adopted implementation rules in a contentious 3-2 vote. The rules were adopted essentially as proposed with some revisions and interpretive guidance in response to comments. Among other things, the new rules and amendments:

- Postpone the registration deadline (originally July 21, 2011) until March 30, 2012 for investment advisers relying on the private adviser exemption as of July 20, 2011;
- Establish new exemptions from SEC registration for certain venture capital fund advisers (the "venture capital fund adviser exemption") and advisers that advise solely private funds with aggregate assets under management in the United States of less than $150 million (the "private fund adviser exemption");
- Provide definitions and requirements for exemption from registration for certain non-U.S. advisers (the "foreign private adviser exemption");
- Establish reporting requirements for advisers relying on the venture capital fund adviser or private fund adviser exemptions ("exempt reporting advisers") (*see* "Reporting Requirements for 'Exempt Reporting Advisers'" below);

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[1] "Rules Implementing Amendments to the Investment Advisers Act of 1940," Investment Advisers Act Release No. 3221 (June 22, 2011), *available at* http://www.sec.gov/rules/final/2011/ia-3221.pdf (the "*Implementing Release*"); "Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers," Investment Advisers Act Release No. 3222 (June 22, 2011) *available at* http://www.sec.gov/rules/final/2011/ia-3222.pdf (the "*Exemptions Release*"). These rules were proposed on November 19, 2010 (the "November 19 Proposals"). The November 19 proposals were summarized in Sidley Client Update "SEC Proposes Rules Implementing Dodd-Frank Requirements for Private Fund Advisers," *available at* http://www.sidley.com/files/News/c12c79fe-11f2-4a5f-8e90-20a6674106ca/Presentation/NewsAttachment/115da6c0-4d13-4d7b-9e66-342cbf37b3c0/Investment%20Funds%2011.23.2010%20SEC%20Proposes%20Rules.pdf.

[2] "Rules Implementing Amendments to the Investment Advisers Act of 1940," Investment Advisers Act Release No. 3110 (Nov. 19, 2010), *available at* http://www.sec.gov/rules/proposed/2010/ia-3110.pdf; "Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers," Investment Advisers Act Release No. 3111 (Nov. 19, 2010), *available at* http://www.sec.gov/rules/proposed/2010/ia-3111.pdf.

- Reallocate regulatory responsibility between the SEC and the states for certain "mid-sized advisers";
- Amend Form ADV to require additional information from registrants and new information from exempt reporting advisers designed to enhance SEC oversight of both registered and certain unregistered advisers; and
- Expand the scope of the SEC "pay-to-play" rule to include exempt reporting advisers and foreign private advisers and permit third-party solicitation by registered municipal advisors.

At the open meeting, the SEC also discussed its position regarding examinations for exempt reporting advisers and adopted a rule regarding the exclusion of "family offices" from investment adviser regulation.[3] The family office rule is discussed in detail in a separate Sidley Client Update entitled "SEC Adopts Final Rule Regarding 'Family Offices.'"[4]

According to Robert E. Plaze, Associate Director of the Division of Investment Management, the new rules complete the majority of the required rulemaking under Title IV.[5] The SEC indicated that additional rules regarding recordkeeping for exempt reporting advisers and the collection of information from financial entities on proposed Form PF[6] to evaluate systemic risk would be forthcoming.[7]

New Adviser Registration Requirements and Exemptions

The Dodd-Frank Act amends the Investment Advisers Act of 1940 (the "Advisers Act") to eliminate the provisions of Section 203(b)(3) that currently exempt from registration any investment adviser that during the course of the preceding 12 months has had fewer than 15 clients and does not hold itself out generally to the U.S. public as an investment adviser (the so-called "private adviser exemption"). As a result, investment advisers relying on the private adviser exemption generally will be required to register with the SEC (or, in the case of certain mid-sized advisers, with one or more states) unless another exemption applies.

In enacting Title IV, Congress focused specifically on advisers to "private funds." The Dodd-Frank Act defines a "private fund" as any issuer that would be an investment company under the Investment Company Act of 1940 (the "Company Act") but for the exclusion from the definition of "investment company" set forth in Section 3(c)(1) or 3(c)(7) of that Act (*i.e.,* funds sold privately and either beneficially owned by fewer than 100 holders or owned exclusively by "qualified purchasers").[8] The Advisers Act and the new rules therefore apply not only to advisers to hedge and private equity funds but also may apply to advisers to investment vehicles such as real estate funds, collateral pools and insurance products.

Transition Period and Registration Deadlines

To facilitate an orderly transition and to enable new registrants to come into compliance with Advisers Act requirements, the SEC postponed the deadline for registration triggered by Title IV to March 30, 2012. An adviser that currently relies on the private adviser exemption and does not qualify for another exemption is expected to file its

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[3] "Family Offices," Investment Advisers Act Release No. 3220 (June 22, 2011), *available at* http://www.sec.gov/rules/final/2011/ia-3220.pdf.

[4] *Available at* http://www.sidley.com/sidleyupdates/Detail.aspx?news=4871.

[5] *See* http://www.sec.gov/news/openmeetings/2011/062211openmeeting.shtml.

[6] "Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF," Investment Advisers Act Release No. 3145 (Jan. 26, 2011), *available at* http://www.sec.gov/rules/proposed/2011/ia-3145.pdf.

[7] *Implementing Release* at footnote 163.

[8] A non-U.S. fund conducts a private U.S. offering without violating the Company Act only if the fund complies with either Section 3(c)(1) or 3(c)(7) with respect to U.S. investors (or complies with another available exemption or exclusion). A non-U.S. fund qualifies as a "private fund" if it makes use of U.S. jurisdictional means, directly or indirectly, to offer or sell any security of which it is the issuer to U.S. investors in compliance with the requirements of Section 3(c)(1) or 3(c)(7).

completed application on Form ADV (comprising both Part 1A and Part 2A) by February 14, 2012. An adviser that commences operations on or after July 21, 2011, however, and does not qualify for another exemption must register immediately (*i.e.,* postponement of the registration deadline does not apply to newly registering advisers).

An unregistered adviser currently relying on the private adviser exemption that may be required to register in one or more states because it manages less than $100 million in assets must look to the laws of the applicable state(s) to determine its registration obligations and pertinent deadlines (*see* "Reallocation of Regulatory Responsibility Between the SEC and the States," below).

"Venture Capital Fund Adviser Exemption"

The Dodd-Frank Act exempts from Advisers Act registration advisers that manage only "venture capital funds." Congress also considered exempting advisers to private equity funds, including "buyout" funds, but ultimately declined to do so. With that distinction in mind, new Rule 203(l)-1 defines a venture capital fund as a private fund that:

- Holds no more than 20% of the fund's capital contributions in non-qualifying investments (other than short-term holdings);[9]
- Does not borrow or otherwise incur leverage, other than limited short-term borrowing (excluding certain guarantees of qualifying portfolio company obligations by the fund);[10]
- 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 Company Act and has not elected to be treated as a business development company.

The new rule also "grandfathers" any pre-existing fund as a venture capital fund if it satisfies certain criteria described below.

Although a venture capital fund adviser will be exempt from SEC registration, such adviser nevertheless will be an exempt reporting adviser required to file reports with the SEC on Form ADV, meet certain recordkeeping requirements and be subject to SEC examination (although the SEC indicated that "we do not anticipate that our staff will conduct compliance examinations of these advisers on a regular basis"[11]). Such an adviser also may be subject to state registration, reporting or other obligations (*see* "New Reporting Requirements for 'Exempt Reporting Advisers'" below).

Notable aspects of the venture capital fund definition in the final rule, particularly as compared to the rule as proposed, include the following:

- *"Non-qualifying investments basket."* To provide some flexibility, the rule as adopted provides for a 20% "basket" for investments that may be outside the strict investment parameters imposed on the remaining 80% of the fund's assets. A venture capital fund may invest up to 20% of its aggregate capital contributions and uncalled capital commitments in non-qualifying investments, subject to the following restrictions:

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[9] "Qualifying investments" generally consist of equity securities of "qualifying portfolio companies" that are directly acquired by the fund. *See* note 15 and accompanying text below.

[10] The fund may not issue debt obligations, provide guarantees or otherwise incur leverage in excess of 15% of its aggregate capital contributions and uncalled committed capital, and any such borrowing, indebtedness, guarantee or leverage is for a non-renewable term of no longer than 120 calendar days (except that any guarantee by the private fund of a qualifying portfolio company's obligations up to the amount of the value of the private fund's investment in the qualifying portfolio company is not subject to the 120 calendar day limit). *Exemptions Release* at 55.

[11] *Implementing Release* at 48; *see also* "Reporting Requirements for 'Exempt Reporting Advisers'" below.

- The 20% calculation is made immediately after the fund acquires any asset, other than qualifying investments or short-term holdings.[12]
- The 20% is measured against the qualifying fund's total called and uncalled capital commitments, but only *bona fide* capital commitments may be included in the calculation.[13]
- Short-term holdings are to be excluded when calculating the value of a fund's non-qualifying investments.
- The fund may use either historical cost or fair value in calculating the percentage of its non-qualifying investments, as long as it does so in a consistent manner during the term of the fund.

- *Short-term holdings.* Under the final rule, "short-term holdings" include cash, certain cash equivalents, U.S. Treasury securities with a remaining maturity of 60 days or less and shares of registered money market funds. Qualifying funds may hold other types of short-term securities, but these count toward the 20% basket.
- *Participation in certain reorganizations or mergers of qualifying portfolio companies.* A "qualifying investment" under the final rule generally consists of any equity security issued by a qualifying portfolio company that a fund acquires directly from the issuer and certain equity securities exchanged for the directly-acquired securities.[14]
    - Under the final rule, a venture capital fund may acquire qualifying investments in one of three ways that suggest the fund's capital is being used to finance the operations of portfolio companies rather than to trade in the secondary markets. As under the proposed rule, a fund may acquire any equity security directly from the qualifying portfolio company that issues such security ("directly acquired equity").
    - In addition, the final rule allows a venture capital fund to acquire two other types of equity security in exchange for a qualifying portfolio company's directly acquired equity: (i) any equity security issued by the same company in exchange, and (ii) any equity security issued by a company of which that qualifying portfolio company is a majority-owned subsidiary or a predecessor.
- *Acquisition of equity shares in secondary market transactions.* A venture capital fund may purchase shares in the secondary markets (or deviate from the qualifying investment restrictions in any other manner) to the extent that it has room to do so in its non-qualifying basket.
- *Qualifying portfolio company stock that becomes publicly traded.*[15] An investment adviser may continue to rely on the venture capital fund adviser exemption even if the fund's entire portfolio eventually consists of securities of public reporting companies, so long as the portfolio companies were not reporting or foreign-traded (listed or traded on a non-U.S. exchange or organized market) at the time the fund acquired them.
- *Borrowing in the ordinary course of portfolio company business.* As under the proposed rule, the rule as adopted includes a leverage limitation in the definition of "qualified portfolio company" to distinguish "venture capital funds" (which invest directly in a portfolio company for purposes of funding the expansion and development of the company's business) from "buyout funds" (which obtain majority ownership of a portfolio company by buying out the company's existing shareholders or causing the company to issue debt). The adopted rule, however, prohibits a

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[12] A fund will not be required to dispose of a non-qualifying investment simply due to changes in the value of that investment or of the fund's other investments.

[13] For example, a capital commitment is not *bona fide* if an investor makes the commitment pursuant to an understanding with the fund or adviser that the entire commitment will not be called.

[14] The definition of equity security is unchanged from the proposed rule and includes common stock, preferred stock, warrants and other securities convertible into common stock and limited partnership interests.

[15] The final rule defines a "qualifying portfolio company" as any company that: (i) at the time of any investment by the private fund is not a reporting or foreign-traded company and does not control, is not controlled by or is not under common control with a reporting or foreign traded company; (ii) does not incur leverage in connection with the investment by the private fund *and* distribute the proceeds of any such borrowing to the private fund in exchange for the private fund's investment; and (iii) is an operating company (*i.e.,* is not a fund of any kind).

qualified portfolio company from borrowing or issuing debt "in connection with" a venture capital fund's investment only when the company also distributes to the fund the proceeds of such borrowing or issuance in exchange for the fund's investment. This narrower leverage limitation, therefore, does not "disqualify" portfolio companies that borrow in the ordinary course of their businesses (*e.g.,* to finance inventory or capital equipment, manage cash flows or meet payroll).

- *Indirect buyouts.* The proposed rule prohibited a qualified portfolio company from engaging in indirect buyouts by redeeming, exchanging or repurchasing any securities of the company or distributing cash or other company assets to pre-existing security holders in connection with a private fund's investment. This prohibition was deleted from the final rule.
- *Financing or loans to qualified portfolio companies.* A venture capital fund may provide financing or loans to a portfolio company, provided that the financing meets the definition of equity security or is made subject to the 20% basket.
- *Qualified portfolio companies must be operating companies.* A qualifying portfolio company must be an operating company and may not be another private fund, a commodity pool, other investment company or securitized asset vehicle. This restriction precludes a venture capital fund from investing in a fund of venture capital funds unless it does so pursuant to its 20% basket.
- *"Managerial assistance" not required.* According to the SEC, the managerial assistance requirement was deleted from the final rule because providing managerial assistance to portfolio companies does not distinguish a venture capital fund from a private equity fund and including such a requirement would make the venture capital fund adviser exemption unnecessarily complicated to apply.[16]
- *Guarantees of portfolio company obligations.* A venture capital fund may not borrow, issue debt obligations, provide guarantees or otherwise incur leverage in excess of 15% of the fund's capital contributions and uncalled capital commitments. Any such borrowing, indebtedness, guarantee or leverage must be for a non-renewable term of no longer than 120 days. Unlike the proposed rule, however, the final rule excludes from the 120 calendar day limit any guarantee by the private fund of a qualifying portfolio company's obligations up to the value of the private fund's investment in that company.
- *No redeemable securities.* Like the proposed rule, the final rule requires a venture capital fund to issue securities that do not provide investors with any right to withdraw, redeem or require the repurchase of such securities, except in "extraordinary circumstances," but *pro rata* distributions to investors are allowed.[17]
- *A venture capital fund must pursue a "venture capital strategy."* A fund is not required to include the term "venture capital fund" in its name, but the fund must describe its investment strategy to investors and potential investors as a "venture capital strategy." This may impose certain restrictions on an investment adviser's management of a venture capital fund. For example, the SEC observes in the *Exemptions Release* that a venture capital fund that invests its initial capital call entirely in non-qualifying investments may implicate the Advisers Act anti-fraud rule, even if such an investment is within the fund's 20% basket.[18]
- *Registered funds and BDCs excluded.* The final rule, like the proposed rule, excludes funds that are registered investment companies or that elect to be regulated as business development companies from the venture capital fund definition.

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[16] *Exemptions Release* at 54.

[17] Circumstances are "extraordinary" if they are foreseeable but unexpected and not under the investor's or investment adviser's control, such as material changes in tax law or the enactment of a law that prohibits an investor's participation in a fund. Whether redemption or opt out rights for particular groups of investors are extraordinary depends on all the facts and circumstances. Funds may not circumvent the redemption prohibition by creating "extraordinary" withdrawal or transfer rights for limited partners conditioned on the consent of the general partner, if the general partner in the ordinary course of business typically consents. *Exemptions Release* at 61-64.

[18] *Exemptions Release* at 28-29, footnotes 120 and 121.

- *Non-U.S. advisers.* A non-U.S. adviser may rely on the venture capital fund adviser exemption provided that all of the adviser's U.S. and non-U.S. clients are either venture capital funds as described above or grandfathered funds as described below.[19]
- *Qualification of non-U.S. funds.* Under both the proposed rule and the final rule, only a "private fund" may qualify as a venture capital fund. Under the proposed rule, this would potentially have jeopardized the exemption for advisers to non-U.S. funds that, because they have not made any offering to U.S. investors, have not had to comply with Section 3(c)(1) or 3(c)(7) and therefore do not technically fit the definition of "private fund," but which otherwise meet the definition of venture capital fund. However, a note included in Rule 203(l)-1, as adopted, indicates that, for purposes of the venture capital fund adviser exemption, an investment adviser may treat as a private fund a fund formed under the laws of a jurisdiction other than the United States that has not offered or sold its securities in the United States or to U.S. persons in a manner inconsistent with being a private fund, provided that the adviser treats the issuer as a private fund under the Advisers Act and the rules thereunder for all purposes.[20]

Under the grandfathering provision as adopted, an existing fund generally would be deemed to meet the proposed definition, as long as the fund:

- Represented itself at the time the fund offered its securities to investors as pursuing a venture capital strategy;
- Sold securities to at least one investor prior to December 31, 2010; and
- Does not sell any securities to, or accept any capital commitments from, any person after July 21, 2011.

Notable aspects of the final rule's grandfathering provisions include:

- Like a "venture capital fund," a grandfathered fund must have represented to investors and potential investors that it "pursues a venture capital strategy" (but is not required to be named "a venture capital fund").
- A grandfathered fund may call investors' capital after July 21, 2011, provided that it has accepted all capital commitments, including any additional commitments by existing investors, on or before that date.

If an adviser initially qualifies for the Rule 203(l)-1 venture capital fund adviser exemption, it may not accept a non-venture capital fund client without first registering with the SEC (or state regulatory authority, as applicable) or qualifying for another exemption. No transition period applies (*see* "New Reporting Requirements for 'Exempt Reporting Advisers'—Reporting on Form ADV" below).

"Private Fund Adviser Exemption"

Rule 203(m)-1 exempts from registration any investment adviser solely to qualifying private funds that has less than $150 million in assets under management in the United States. Like venture capital fund advisers, an adviser relying on this "private fund adviser exemption" will be an "exempt reporting adviser" required to file reports with the SEC on Form ADV, meet certain recordkeeping requirements and be subject to SEC examination (although the SEC indicated that "we do not anticipate that our staff will conduct compliance examinations of these advisers on a regular basis"[21]). An exempt private fund adviser also may be subject to state registration, reporting or other obligations (*see* "New Reporting Requirements for 'Exempt Reporting Advisers'" below).

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[19] The SEC notes that this approach explicitly differs from the approach the SEC takes to the private fund adviser exemption, because the venture capital fund exemption is based on the strategy of the funds the adviser manages and not where the advisory activity is conducted. *Exemptions Release* at 70.

[20] Accordingly, an adviser relying on the venture capital fund exemption by virtue of the SEC's note would be required to satisfy the same SEC-imposed reporting and recordkeeping requirements in connection with a non-U.S. fund that is not offered in the U.S. as any other adviser relying on the venture capital fund exemption must meet for the funds it advises.

[21] *Implementing Release* at 48; *see also* "Reporting Requirements for 'Exempt Reporting Advisers'" below.

U.S. exempt private fund advisers. To rely on the private fund adviser exemption, a U.S.-resident adviser must meet the exemption's conditions with respect to all of its assets under management.[22] A U.S. adviser that has one or more clients that are not qualifying private funds, regardless of where those clients are located, is not eligible for the exemption. An adviser may advise an unlimited number of private funds, provided the aggregate value of the assets of the private funds is less than $150 million.[23]

U.S.-based advisory firms that manage private fund assets outside the United States through one or more separate non-U.S. affiliates generally would not have to count the assets managed by the non-U.S. affiliates.[24]

Non-U.S. exempt private fund advisers. A non-U.S. adviser cannot rely on the exemption if it directly advises any client that is a United States person (defined generally by incorporating the definition of a "U.S. person" in Regulation S[25]) other than a qualifying private fund. A non-U.S. adviser need count only private fund assets it manages at a place of business in the United States toward the $150 million asset limit.[26]

A non-U.S. adviser may enter the U.S. market and take advantage of the exemption without regard to the type or number of its non-U.S. clients or the amount of assets it manages at a place of business outside of the United States. According to the SEC, the rule is designed to encourage participation of non-U.S. advisers in the U.S. markets by applying the U.S. securities laws in a manner that does not impose U.S. regulatory and operational requirements on a non-U.S. adviser's non-U.S. advisory business.[27]

In response to commenters' requests, the SEC sought to clarify the circumstances in which a non-U.S. adviser manages assets at a "place of business in the United States." According to the staff, whether a non-U.S. adviser has a place of business[28] in the United States depends on the facts and circumstances, and "assets under management" are the securities portfolios for which an adviser provides continuous and regular supervisory or management services (also an inherently factual determination). Commenters sought guidance specifically as to whether limited-purpose U.S. offices of non-U.S. advisers would be considered U.S. places of business (*e.g.,* offices conducting research or due diligence). The SEC staff does not view providing research or conducting due diligence to be continuous and regular

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[22] The definition of a "qualifying private fund" in Rule 203(m)-1 permits an adviser to treat as a private fund for purposes of the exemption a fund that qualifies for an exclusion from the definition of investment company as defined in Section 3 of the Company Act (for example, Section 3(c)(5)(C), which excludes certain real estate funds) in addition to the exclusions provided by Section 3(c)(1) or 3(c)(7). This provision also may apply to non-U.S. funds that make offerings in the United States in compliance with Section 3(c)(1) or 3(c)(7). An adviser relying on this provision must treat the fund as a private fund under the Advisers Act and the rules thereunder for all purposes.

[23] Depending on the facts and circumstances, the SEC may view two or more separately formed advisory entities that each has less than $150 million in private fund assets under management as a single adviser for purposes of assessing the availability of exemptions from registration. *Exemptions Release* at footnote 314.

[24] "We continue to believe that rule 203(m)-1 will have only a limited effect on multi-national advisory firms, which for tax or business reasons keep their non-U.S. advisory activities organizationally separate from their U.S. advisory activities." *Exemptions Release* at 97.

[25] The definition in amended Rule 203(m)-1 and in the Form ADV Glossary is identical to that for a U.S. person in Regulation S, except that under Rule 203(m)-1(d)(8), any discretionary account or similar account that is held for the benefit of a person in the United States by a non-U.S. dealer or other professional fiduciary is a United States person if the dealer or professional fiduciary is a related person of the adviser relying on the exemption. *Exemptions Release* at 99.

[26] With respect to non-U.S. advisers with no place of business in the United States, the SEC noted that Section 203(a) of the Advisers Act provides that an adviser may not, unless registered, make use of any means or instrumentality of interstate commerce in connection with its business as an investment adviser. Hence, according to the SEC, whether a non-U.S. adviser with no place of business in the United States and no U.S. clients would be subject to registration depends on whether there is sufficient use of U.S. jurisdictional means. *Exemptions Release* at footnote 415.

[27] The SEC further states, "[t]he rule reflects our long-held view that non-U.S. activities of non-U.S. advisers are less likely to implicate U.S. regulatory interests and that this territorial approach is in keeping with general principles of international comity." *Exemptions Release* at 77.

[28] Rule 203(m)-1 defines a place of business as any office where the adviser regularly provides advisory services, solicits, meets with, or otherwise communicates with clients, and any other location that is held out to the general public as a location at which the investment adviser provides investment advisory services, solicits, meets with, or otherwise communicates with clients.

supervisory or management services at a U.S. place of business if a person outside of the United States makes and implements independent investment decisions.[29]

Qualification of non-U.S. funds

- *Funds offered to U.S. investors through U.S. jurisdictional means*. The SEC has indicated that, to the extent a non-U.S. adviser advises a non-U.S. fund that uses U.S. jurisdictional means and sells its securities to U.S. investors, such fund must be a qualifying private fund, even though it is not a U.S. client.

- *Funds not offered to U.S. investors through U.S. jurisdictional means*. The SEC did not include a "note" regarding non-U.S. funds in Rule 203(m)-1 as it did in Rule 203(l)-1 (*see* "'Venture Capital Fund Adviser' Exemption—Qualification of Non-U.S. Funds" above). The SEC did indicate, however, that a non-U.S. fund not offered to U.S. investors may still be a "qualifying private fund," for purposes of the private fund adviser exemption as it is for the venture capital fund adviser exemption, even though it is not offered to U.S. investors and technically cannot comply with Section 3(c)(1) or 3(c)(7), so long as the fund has not offered or sold its securities in the United States or to U.S. persons in a manner inconsistent with being a private fund and provided that the adviser treats the issuer as a private fund under the Advisers Act[30] and the rules thereunder for all purposes.[31]

Single-investor funds. Commenters sought guidance regarding whether a single-investor fund or a managed account structured as a fund would be considered a "private fund" for purposes of the exemption. The SEC noted its concern that an adviser could convert client accounts to single-investor funds (which would be tantamount to separately managed accounts) in order to avoid registering under the Advisers Act, which would violate the Advisers Act prohibition on doing indirectly what it is unlawful to do directly. It appears to be the SEC's view generally that single investor funds generally would not be considered private funds, even if no actual conversion from a managed account takes place. The SEC also indicates, however, that under certain facts and circumstances it may be appropriate to treat a single-investor fund as a private fund.[32]

Valuation. Under Rule 203(m)-1, an adviser must aggregate the value of all assets of private funds it manages to determine whether it is below the $150 million limit. Advisers must calculate the value of private fund assets pursuant to instructions in Form ADV, which has been amended to provide a uniform method of calculating assets under management for regulatory purposes under the Advisers Act (*see* "Calculating Assets Under Management" below).

Annual eligibility determination. An adviser relying on the private fund adviser exemption must calculate annually the private fund assets it manages and report the amount in its annual updating amendment to Form ADV. If an adviser reports in its annual updating amendment that it has $150 million or more of private fund assets under management, the adviser is no longer eligible for the exemption.[33]

A private fund adviser that has complied with all SEC reporting requirements applicable to an exempt reporting adviser may apply for registration with the SEC up to 90 days after filing the annual updating amendment. Under certain circumstances, the private fund adviser may continue to act as a private fund adviser, consistent with the requirements of Rule 203(m)-1, during this transition period as it prepares to register and implements a compliance program that meets the pertinent Advisers Act requirements. This transition period is designed to accommodate events that may be

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[29] *Exemptions Release* at 99.

[30] *See* note 20 above.

[31] *See Exemptions Release* at footnotes 299 and 319 and accompanying text.

[32] For example, a fund that seeks to raise capital from multiple investors but has only a single, initial investor for a period of time could be a private fund, as could a fund in which all but one of the investors have redeemed their interests. *See Exemptions Release* at footnote 325 and surrounding text.

[33] Advisers thus may be required to register as a result of increases in their private fund assets that occur from year to year, but changes in the amount of an adviser's private fund assets between annual updating amendments will not affect the availability of the exemption.

beyond the adviser's control, such as an increase in the value of the adviser's assets under management (*see* "New Reporting Requirements for 'Exempt Reporting Advisers'—Reporting on Form ADV" below).

"Foreign Private Adviser Exemption"

The Dodd-Frank Act amends the Advisers Act to replace the current private adviser exemption from registration in part with a new exemption for a "foreign private adviser," defined as an investment adviser that:

- Has no place of business in the United States;
- Has, in total, fewer than 15 clients in the United States and investors in the United States in private funds advised by the adviser;
- Has aggregate assets under management attributable to clients in the United States and to investors in the United States in private funds it advises of less than $25 million; and
- Neither holds itself out generally to the public in the United States as an investment adviser nor acts as an investment adviser to a registered investment company or business development company.

The SEC adopted, substantially as proposed, new Rule 202(a)(30)-1, which defines certain terms included in the statutory definition of "foreign private adviser" to clarify the application of the exemption. The terms and points clarified include, among others:

- *"Client."* Any person for which the adviser provides investment advisory services – whether or not the adviser is compensated – must be counted.
  - To avoid double-counting, an adviser need not count a private fund as a client if the adviser counted any investor in the private fund as an investor for purposes of determining the availability of the exemption.
  - An adviser is not required to count a person as an investor if the adviser counts such person as its client.
- "*Investor*." Generally, an adviser must determine the number of investors in a private fund based on the facts and circumstances and in light of the Advisers Act and Company Act prohibitions not to do indirectly what it is unlawful to do directly.
  - Any person that is an investor in two or more private funds advised by the adviser may treated as a single investor.
  - "Investor" is defined as any person that would be included in determining the number of beneficial owners of the outstanding securities of a private fund under Section 3(c)(1), or whether the outstanding securities of a private fund are owned exclusively by qualified purchasers under Section 3(c)(7). This definition would prevent an adviser from aggregating investors into a single nominee account for purposes of circumventing the exemption's counting requirements.
  - Holders of either equity or debt securities (including short-term paper) are counted as investors.
  - In a change from the proposed rule, "knowledgeable employees" are not included in the definition of investors.
  - Depending on the facts and circumstances, a person other than the nominal holder of a security issued by a private fund may be counted as the beneficial owner under Section 3(c)(1) or may be required to be a qualified purchaser under Section 3(c)(7). An adviser relying on the exemption would have to count such a person as an investor.[34]

[34] For example, the adviser to a master fund in a master-feeder arrangement must treat as investors the holders of the securities of any feeder fund formed or operated for the purpose of investing in the master fund rather than the feeder funds, which act as conduits. An

- "*In the United States*." The rule defines "in the United States" generally by incorporating the definition of a "U.S. person" and "United States" under Regulation S.[35]
- *"Place of business*." "Place of business" means any office where the adviser regularly provides advisory services, solicits, meets with, or otherwise communicates with clients, and any location held out to the public as a place where the adviser conducts such activities. An adviser must determine whether it has a place of business in the United States in light of the relevant facts and circumstances.[36]
- *U.S. affiliates*. A non-U.S. adviser is not presumed to have a place of business in the United States solely because it is affiliated with a U.S. adviser. A non-U.S. adviser might be deemed to have a place of business in the United States, however, if the non-U.S. adviser's personnel regularly conduct activities at an affiliate's place of business in the United States.
- *"Assets under management*." The rule defines "assets under management" by reference to the new uniform method of calculating regulatory assets under management, included in the instructions to revised Form ADV (*see* "Calculating Assets Under Management" below).

Unlike venture capital fund advisers and private fund advisers relying on their respective exemptions, foreign private advisers are not subject to the additional reporting and recordkeeping requirements for exempt reporting advisers or to SEC examination.

Subadvisory Relationships and Advisory Affiliates

The SEC stated that although both a private fund and the fund's primary adviser may be viewed as a subadviser's clients, the subadviser is eligible to rely on Rule 203(l)-1 if its services to the primary adviser relate solely to venture capital funds or on Rule 203(m)-1 if its services to the primary adviser relate solely to private funds, provided the other conditions of the pertinent registration exemption are met.[37]

Commenters requested clarification regarding whether an adviser must take into account the activities of its advisory affiliates when determining eligibility for an exemption. The SEC states that generally a separately formed advisory entity that operates independently of an affiliate may be eligible for an exemption if it meets all of the criteria set forth in the relevant rule.[38] Whether the advisory businesses of two separately formed affiliates may be required to be integrated, however, is based on the facts and circumstances, and the existence of separate legal entities may not by itself be sufficient to avoid integration of the affiliated entities. Accordingly, the SEC indicated that it would treat as a single adviser two or more affiliated advisers that are separately organized but operationally integrated, which could result in a requirement for one or both advisers to register.[39]

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adviser also must count as an investor an owner of a total return swap on the private fund. Whether an owner of another type of instrument referencing a private fund would be counted as the beneficial owner under Section 3(c)(1), or be required to be a qualified purchaser under Section 3(c)(7), would depend on the facts and circumstances. *Exemptions Release* at 109-110.

[35] *See* note 25 above.

[36] For example, (i) any office from which an adviser regularly communicates with its clients, whether U.S. or non-U.S., would be a place of business; (ii) an office or other location where an adviser regularly conducts research would be a place of business because research is intrinsic to the provision of advisory services; but (iii) a place of business would not include an office where an adviser solely performs administrative services and back-office activities if they are not activities intrinsic to providing investment advisory services and do not involve communicating with clients. *Exemptions Release* at 121.

[37] *Exemptions Release* at 124.

[38] *Exemptions Release* at footnote 506.

[39] *See, e.g., Richard Ellis, Inc.*, SEC Staff No-Action Letter (Sept. 17, 1981) (discussing the staff's views of factors relevant to the determination of whether a separately formed advisory entity operates independently of an affiliate).

"Adviser Lite" and Participating Affiliates

The SEC affirmed the SEC staff's position, set forth in the *Unibanco* line of no-action letters,[40] that most of the substantive provisions of the Advisers Act do not apply to the non-U.S. clients of a non-U.S. adviser registered with the SEC (often referred to as "adviser lite").[41] In the *Unibanco* letters, the staff also agreed not to recommend enforcement action if a non-U.S. advisory affiliate of a registered adviser (a "participating affiliate") shares personnel with, and provides certain services through, the affiliated registered adviser, without the non-U.S. affiliate registering under the Advisers Act.[42] "Nothing in the rules we are today adopting … is intended to withdraw any prior statement of the SEC or the views of the staff as expressed in the *Unibanco* letters." The SEC also stated its expectation that the staff will provide guidance, as appropriate, based on facts that may be presented to the staff regarding the application of the *Unibanco* letters in the context of the new foreign private adviser exemption and the private fund adviser exemption.[43]

Reporting Requirements for "Exempt Reporting Advisers"

The Dodd-Frank Act directs the SEC to promulgate reporting and recordkeeping requirements regarding exempt reporting advisers as the SEC deems necessary or appropriate in the public interest or for the protection of investors. To implement this directive, the SEC adopted new Rule 204-4, substantially as proposed, to require exempt reporting advisers to file reports on Form ADV with the SEC through the Investment Adviser Registration Depository ("IARD"). These reports will be publicly available on the SEC's Investment Adviser Public Disclosure ("IAPD") website.

The SEC also amended Form ADV to improve its usefulness in risk assessment and revised the form to serve as both a reporting and a registration form. The SEC made several changes in the final rule from the proposed amendments to remove certain sub-items that it believed might result in the publication of competitively sensitive or proprietary information (*see* "Expanded Form ADV Information Requirements" below).

Applicable Form ADV items. Exempt reporting advisers will be required to complete the following subset of items in Form ADV Part 1A (along with the corresponding sections of Schedules A, B, C and D).

- Items 1 (Identifying Information), 2.B. (SEC Reporting by Exempt Reporting Advisers), 3 (Form of Organization) and 10 (Control Persons)—to elicit basic identification details such as name, address, contact information, form of organization and the adviser's owner(s);
- Items 6 (Other Business Activities) and 7.A. (Financial Industry Affiliations)—to facilitate identification of possible conflicts of interests with the adviser's clients;

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[40] *See, e.g.*, *ABA Subcommittee on Private Investment Entities*, SEC Staff No-Action Letter (Dec. 8, 2005); *Royal Bank of Canada*, SEC Staff No-Action Letter (June 3, 1998); *ABN AMRO Bank, N.V.*, SEC Staff No-Action Letter (July 1, 1997); *Murray Johnstone Holdings Limited*, SEC Staff No-Action Letter (Oct. 7, 1994); *Kleinwort Benson Investment Management Limited*, SEC Staff No-Action Letter (Dec. 15, 1993); *Mercury Asset Management plc*, SEC Staff No-Action Letter (Apr. 16, 1993); and *Uniao de Bancos de Brasileiros S.A.,* SEC Staff No-Action Letter (July 28, 1992); *see also* "Protecting Investors: A Half Century of Investment Company Regulation" (May 1992), *available at* http://www.sec.gov/divisions/investment/guidance/icreg50-92.pdf.

[41] *Exemptions Release* at 125-128.

[42] Generally, the staff has provided assurances that it will not recommend enforcement action in situations in which the participating affiliates and its registered affiliate are separately organized; the registered affiliate is staffed with personnel (located in the United States or abroad) who are capable of providing investment advice; all personnel of the participating affiliate involved in U.S. advisory activities are deemed "associated persons" of the registered affiliate; and the SEC has adequate access to trading and other records of the participating affiliate and to its personnel to the extent necessary to enable it to identify conduct that may harm U.S. clients or markets. *See* footnote 36 above.

[43] *Exemptions Release* at 128.

- Item 7.B. (Private Fund Reporting) and Schedule D Section 7.B.—to require exempt reporting advisers to report information regarding the private funds they advise (as discussed below, amendments to Form ADV substantially expand the required information regarding private funds); and
- Item 11 (Disclosure Information)—to require disclosure of the disciplinary history of the adviser and its employees.

Exempt reporting advisers will not be required to respond to any other items under Part 1A or to prepare Form ADV Part 2A or B (the "brochure" and "brochure supplements," respectively). The information collected will provide the SEC with information "as to whether these advisers or their activities might present sufficient concerns to warrant our further attention in order to protect their clients, investor, and other market participants" and "will also provide the public with some basic information about these advisers and their businesses."[44]

Timing and transition. Exempt reporting advisers may file the initial report on Form ADV beginning January 1, 2012 and must file the initial report no later than March 30, 2012. After March 30, 2012, a new adviser that is an exempt reporting adviser must submit its initial Form ADV report within 60 days of relying on the applicable exemption from registration, and existing advisers that are transitioning from status as an exempt reporting adviser to a registered adviser, or the reverse, must carefully observe various transition requirements.

A private fund adviser that has complied with all of its reporting obligations as an exempt reporting adviser may continue advising private fund clients for up to 90 days after filing an annual updating amendment indicating that it has private fund assets of $150 million or more before filing its final report and application for registration. This transition period is designed to accommodate events that may be beyond the adviser's control, such as an increase in the value of the adviser's assets under management, but it is not available to an adviser that otherwise would not qualify for the exemption provided by Rule 203(m)-1 (*e.g.,* an adviser accepting a managed account). The transition period also is not available to advisers relying on the venture capital adviser exemption in Section 203(l) of the Advisers Act. Advisers relying on that exemption must register under the Advisers Act before accepting a client that is not a venture capital fund.[45]

Amendments. The SEC amended Rule 204-1, which addresses when and how advisers must amend their Form ADV, to require an exempt reporting adviser, like a registered adviser, to amend its reports on Form ADV:

- At least annually, within 90 days of the end of the adviser's fiscal year; and
- More frequently, if required by the instructions to Form ADV.

An exempt reporting adviser, like a registered adviser, also must update promptly Items 1 (Identification Information), 3 (Form of Organization) and 11 (Control Persons) if the Item becomes materially inaccurate.

SEC majority view. According to the *Implementing Release*, the SEC believes that requiring exempt reporting advisers to complete the identified subset of Form ADV items "strikes an appropriate balance" with respect to the SEC's need for information in light of the exemptions Congress provided in the Dodd-Frank Act. The release also notes that the SEC has not sought to apply "most of the prophylactic rules we have adopted for registered advisers" and indicates "we do not anticipate that our staff will conduct compliance examinations of these advisers on a regular basis"[46] but "will conduct cause examinations where there are indications of wrongdoing (*e.g.,* those examinations prompted by tips, complaints and referrals)."[47]

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[44] *Implementing Release* at 45-46.

[45] *See* Form ADV amended General Instructions 13 and 15 for information regarding how to switch from a registered adviser to an exempt reporting adviser and vice versa.

[46] *Implementing Release* at 47-48.

[47] *Implementing Release* at footnote 188.

Dissenting view. Commissioners Kathleen Casey and Troy Paredes voted against adopting the amendments and rules in the *Implementing Release,* expressing strong concern that some of the amendments and rules exceed Congress' intent, particularly with respect to the requirements imposed on venture capital fund advisers and other "exempt" reporting advisers. Commissioner Casey noted that by exempting venture capital advisers from registration in the Dodd-Frank Act, Congress acknowledged the unique contribution of venture capital advisers to the U.S. economy and therefore sought to relieve them of many of the costs and demands on resources placed on registered advisers. Further, she stated:

> [T]he [Implementing [R]elease] … provides no substantiated justification on public interest or investor protection grounds for the decision to impose these reporting requirements. Given that Congress instructed us to make these kind of findings before imposing additional requirements on the exempt advisers, the presumptions contained in the release as to the usefulness of the required information are entirely insufficient to meet our statutory obligations."[48]

Both dissenting Commissioners emphasized their beliefs that certain proposals in the *Implementing Release* inappropriately collapsed the distinction between exempt reporting advisers and registered advisers, set the stage for additional future regulation and would have an unwarranted and negative impact on capital formation and economic growth.[49]

Reallocation of Regulatory Responsibility Between the SEC and the States

Mid-sized adviser definition. Unless they otherwise qualify to register with the SEC, private fund advisers that are required to register must meet a threshold level of assets under management to qualify for SEC registration. The Dodd-Frank Act raised the threshold for SEC registration from $25 million to $100 million and created a new category of "mid-sized advisers." A mid-sized adviser, which generally may not register with the SEC and will be subject to state registration, is defined as an adviser that:

- Has between $25 million and $100 million in assets under management;
- Is required to be registered in the state where it maintains its principal office and place of business; and
- Would be subject to examination by the state.

These amendments to the Advisers Act shift primary responsibility for regulatory oversight of many advisers to the state securities authorities. As a result, a significant number of advisers currently registered with the SEC will be required to withdraw their SEC registrations and register with one or more states. State securities authorities remain responsible, as before the Dodd-Frank Act, for regulating most advisers with less than $25 million in assets under management.[50]

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[48] Speech by SEC Commissioner Kathleen L. Casey, "Statement at SEC Open Meeting—Rules Implementing Amendments to the Investment Advisers Act of 1940; Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers" (June 22, 2011), *available at* http://www.sec.gov/news/speech/2011/spch062211klc-items1-2.htm.

[49] *Id.*; Speech by SEC Commissioner Troy A. Paredes, "Statement at Open Meeting to Adopt Final Rules Regarding Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers and Final Rules Implementing Amendments to the Investment Advisers Act of 1940" (June 22, 2011), *available at* http://www.sec.gov/news/speech/2011/spch062211tap-items-1-2.htm.

[50] A small adviser may register with the SEC only if it:

- Advises (or subadvises) a registered investment company,
- Has its principal office and place of business in a state that does not regulate advisers (currently, only Wyoming), or

Eligibility determination. The Dodd-Frank Act does not specify how to determine whether a mid-sized adviser is "required to be registered" with, or is "subject to examination" by, a particular state securities authority. The SEC adopted the following clarifications:

- *Advisers subject to state exemption*. A mid-sized adviser that can and does rely on an exemption under the law of the state in which it has its principal office and place of business such that it is "not required to be registered" with the state securities authority must register with the SEC, unless an exemption from SEC registration is otherwise available. Currently, certain states exempt advisers from registration if they are exempt from SEC registration pursuant to the private adviser exemption under the Advisers Act. In light of the impending elimination of the private adviser exemption, many of those states have amended or are considering amending their exemptive rules to delete the reference to the private adviser exemption.[51]
- *State adviser examination programs*. A mid-sized adviser that has a principal office and place of business in a state that does not certify that advisers are subject to examination likewise must register with the SEC, unless an exemption is otherwise available. A list of those states is posted on IARD. In response to an SEC survey, regulators in Minnesota, New York and Wyoming did not advise the SEC staff that advisers registered with them are subject to examination; therefore, mid-sized advisers in these states will continue to register with the SEC.[52]

Eligibility for SEC (versus state) registration will continue to be determined annually as part of an adviser's annual updating amendment. Changes to Form ADV require a mid-sized adviser filing with the SEC to affirm, upon application and annually thereafter, that it is not required to be registered as an adviser in the state where it maintains its principal office and place of business. An adviser reporting that it is no longer able to make such an affirmation would have 180 days from its fiscal year end to register with the pertinent states(s) and then withdraw from SEC registration.

AUM "buffer." The final amended rule is designed to prevent an adviser from having to switch frequently between state and SEC registration as a result of changes in the value of its assets under management or the departure of one or more clients. Unlike the November 19 Proposals, the final rule includes a buffer for mid-sized advisers with assets under management close to $100 million to determine whether and when to switch between state and SEC registration. The rule raises the threshold above which a mid-sized investment adviser must register with the SEC to $110 million; once registered with the SEC, an adviser need not withdraw its registration until it has less than $90 million in assets under management.

Transition to state registration. The SEC adopted new Rule 203A-5 to provide for an orderly transition to state registration for mid-sized advisers that will no longer be eligible to register with the SEC. Additionally, Form ADV is amended to include a special one-time instruction for a transition filing for SEC-registered advisers.

The new rule requires each adviser that is registered with the SEC on January 1, 2012 to file an amendment to its Form ADV no later than March 30, 2012, reporting the market value of its assets under management, determined within 90 days (not 30 days as proposed) prior to the date of filing the Form ADV. This filing will require each adviser to determine whether it meets the revised eligibility criteria for SEC registration. An adviser that is no longer eligible for SEC registration will be required to register in the pertinent state(s) and withdraw its SEC registration by filing Form ADV-W, as well as to arrange for its associated persons (as necessary) to register as investment adviser representatives,

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- May avail itself of the multi-state exemption (or another exemption) from the prohibition on SEC registration or has obtained an SEC order permitting it to register with the SEC.

[51] For example, we understand that California and Connecticut are working to address this issue among others. *See* note 53 below and accompanying text.

[52] *Implementing Release* at p. 39. According to the Release, based on IARD data as of April 7, 2011, there were 63 advisers with assets under management between $25 million and $90 million and a principal office and place of business in Minnesota, 286 in New York, and one in Wyoming.

no later than June 28, 2012. During the period that an adviser is registered with both the SEC and one or more state securities authorities, the Advisers Act and applicable state law will apply to the adviser's advisory activities.

Until July 21, 2011, mid-sized advisers applying for registration with the SEC may register with the SEC or the appropriate state securities authority. Thereafter, all such advisers are prohibited from registering with the SEC and must register with the state securities authorities. Mid-sized advisers registered with the SEC as of July 21, 2011 must remain registered with the SEC (unless an exemption from SEC registration is available) until January 1, 2012, to allow for completion of the IARD programming to accept the revised From ADV and to allow mid-sized advisers additional time to switch to state registration.

State securities authorities and state legislatures are under pressure to provide a framework to ensure an orderly transition for mid-sized advisers to state registration and regulation. The North American Securities Administrators Association ("NASAA") states on its website under "Switch Resource Center" that "State securities regulators are working diligently to ensure a seamless, comprehensive and effective switching process."[53] The issues to be resolved range from setting reasonable deadlines for registration to a more thorough revision of applicable rules and statutes. For example, some states provide exemptions from registration that specifically reference the federal Section 203(b)(3) exemption for these advisers. Such states must take measures quickly to ensure that advisers relying on these exemptions are not in violation of state securities laws on July 21, 2011 when the federal private adviser exemption is repealed. In California, for example, regulators have proposed an emergency rule that is expected to be adopted prior to July 21, 2011, which removes the reference in the current rule to "Section 203(b)(3)," inserts the specific requirements of Section 203(b)(3) and effectively preserves the exemption for such private advisers until January 21, 2012, by which time the Department of Corporations expects to have adopted permanent rules regarding these advisers.

The SEC amended Form ADV Part 1A Item 2.A. to implement the new prohibition on registration for mid-sized advisers and reflect the new statutory threshold for registration.[54]

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[53] *Available at* http://www.nasaa.org/industry___regulatory_resources/investment_advisers/13183.cfm.

[54] As amended, Item 2.A. requires each adviser registered with the SEC (and each applicant for registration) to identify whether it is eligible to register with the SEC because it:

- Is a large adviser that has $100 million or more of regulatory assets under management (or $90 million or more if an adviser is filing its most recent annual updating amendment and is already registered with the SEC),
- Is a mid-sized adviser that does not meet the criteria for state registration or is not subject to examination,
- Has its principal office and place of business in Wyoming or outside the United States,
- Meets the requirements for one or more of the revised exemptive rules under section 203A,
- Is an adviser (or subadviser) to a registered investment company,
- Is an adviser to a business development company and has at least $25 million of regulatory assets under management, or
- Received an order permitting the adviser to register with the SEC.

Each adviser must check at least one of these items or indicate that the adviser is no longer eligible to remain registered with the SEC. The IARD will prevent an applicant from registering with the SEC, and an adviser from remaining registered, unless it represents on Form ADV that it meets at least one of the specific eligibility criteria set forth.

Calculating Assets Under Management

Form ADV amendments, adopted substantially as proposed, implement a uniform method for calculating "regulatory assets under management"[55] for multiple purposes, including:

- Determining eligibility for the new registration exemptions;
- Determining eligibility for SEC registration; and
- Reporting assets under management on Form ADV Part 1A (assets under management may be calculated differently for purposes of disclosure in Form ADV Part 2).

This uniform method is designed to foster a more coherent application of Advisers Act regulatory requirements and more consistent reporting across the industry.

Among other points, the newly adopted uniform methodology requires that an adviser calculate its regulatory assets under management on a gross basis and clarifies and expands the assets to be included in the calculation. For example:

- Regulatory assets under management are to be calculated without deduction of "any outstanding indebtedness or other accrued but unpaid liabilities."[56]
- All securities portfolios for which an adviser provides continuous and regular supervisory or management services (including private funds with uncalled capital commitments) must be included, regardless of whether the assets are proprietary assets,[57] assets managed for no compensation or assets of non-U.S. clients (all of which currently may be excluded).
- The value of any private fund over which an adviser exercises continuous and regular supervisory or management services must be included, regardless of the nature of the assets held by the fund.
- Private fund assets under management must be calculated based on market value, or the fair value of private fund assets where market value is unavailable, including with respect to illiquid or hard to value assets. The SEC indicated that this requirement is designed to ensure more meaningful and reliable valuation of private fund assets.

Although the SEC requested comment regarding whether to require the valuation of assets to be done in accordance with U.S. generally accepted accounting principles ("GAAP") or other international accounting standards, the SEC did not propose such a requirement and declined in the final rule to require determination of fair value in accordance with GAAP. If, however, an adviser calculates its fair value in accordance with GAAP or another basis of accounting for

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[55] Additionally, Section 404 of the Dodd-Frank Act gives the SEC authority to impose on SEC-registered advisers reporting and recordkeeping requirements for systemic risk assessment purposes. The SEC has proposed rules that will require registered advisers that meet a certain threshold of assets under management to submit systemic risk data pursuant to this authority.

[56] The staff expressed concern that the use of net assets to calculate regulatory assets under management could

- Permit advisers utilizing investment strategies with highly leveraged positions to avoid registration with the SEC even though the activities of such advisers may have national significance.
- Allow advisers to large and highly leveraged funds to avoid systemic risk reporting under the proposed systemic risk reporting rules.

The SEC stated, however, that an adviser may disclose its net assets under management in its brochure or marketing materials. *Implementing Release* at 23.

[57] Some commenters took the position that including proprietary assets and assets managed without receiving compensation was inconsistent with the statutory definition of an "investment adviser." The SEC responded that although a person is not an "investment adviser" for purposes of the Advisers Act unless it receives compensation for providing advice to others, once a person meets that definition (by receiving compensation from *any* client to which it provides advice), the person is an adviser, and the Advisers Act applies to the relationship between the adviser and any of its clients (whether or not the adviser receives compensation from them). *Implementing Release* at 21.

financial reporting purposes, the adviser should use the same method for determining its regulatory assets under management.[58]

Expanded Form ADV Information Requirements

Amendments to Form ADV require registered advisers to provide expanded information regarding:

- Types of clients they advise, their employees and their advisory activities;
- Business practices that may present significant conflicts of interest (such as the use of affiliated brokers, soft dollar arrangements and compensation for client referrals); and
- Non-advisory activities and financial industry affiliations.

Private fund information. Both registered and exempt reporting advisers will be required to provide expanded information about the private funds they advise in response to Item 7.B. and Schedule D Section 7.B. According to the *Implementing Release*, the information will permit the SEC to better target its examination program, help the SEC identify private fund advisers and practices that present investors with greater compliance or other risks, facilitate earlier discovery of potential misconduct and deter adviser fraud.[59] Among other things, private fund advisers (but not their related persons) specifically would be required to report about each of their pooled investment vehicles, however such vehicles are organized:

- Basic organizational, operational and investment characteristics of the fund;
- Gross assets;
- Whether the fund is part of a master-feeder arrangement or a fund of funds;
- Within seven broad categories,[60] the type of investment strategy the fund employs;
- Limited information regarding the fund investors including;
    - The minimum amount that investors are required to invest;
    - The approximate number of beneficial owners of the fund and the approximate percentage of the fund beneficially owned by the adviser and its related persons, funds of funds and non-U.S. persons; and
    - The extent to which clients of the adviser are solicited to invest, and have invested, in the fund;
- Information that would be verifiable by the SEC and investors regarding the identity and location of five types of "gatekeepers":
    - Auditors (with information as to whether the auditor issued an unqualified opinion);
    - Prime brokers (with information as to whether the prime broker has custody of fund assets);
    - Custodians;
    - Administrators; and
    - Marketers.

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58 *Implementing Release* at footnote 99.

59 *Implementing Release* at 193.

60 The categories, which are defined in the Instructions for Part 1A, include: (i) hedge fund; (ii) liquidity fund; (iii) private equity fund; (iv) real estate fund; (v) securitized asset fund; (vi) venture capital fund; and (vii) other private fund. *Implementing Release* at footnote 231.

In response to commenters' concerns that certain proposed questions would result in the publication of potentially sensitive information, the SEC declined to adopt certain proposed amendments to Form ADV that would have required advisers to:

- Disclose net assets;
- Report private fund assets and liabilities by class and categorization in the fair value hierarchy established under GAAP; and
- Specify the precise percentage of each fund owned by particular types of beneficial owners.

Amendments to the "Pay to Play" Rule

In response to changes made by the Dodd-Frank Act, the SEC amended the "pay-to-play" rule under the Advisers Act. The rule generally restricts an adviser's ability to seek to influence government officials or candidates that may be in a position to award advisory contracts to the adviser. The amendments:

- Amend the scope of the rule to include exempt reporting advisers and foreign private advisers (currently the pay-to-play rule applies to advisers either registered with the SEC or unregistered in reliance on the "private adviser" exemption under Section 203(b)(3) of the Advisers Act);
- Expand the definition of a "regulated person" to include registered municipal advisors in addition to registered broker-dealers and investment advisers, allowing them to solicit government entities on behalf of investment advisers provided that the Municipal Securities Rulemaking Board ("MSRB") adopts a pay-to-play rule that is at least as stringent as the investment adviser pay-to-play rule; and
- Extend the date by which advisers must comply with the limitation on third-party solicitation from September 13, 2011 to June 13, 2012, due to the fact the SEC modified its proposal and expanded the definition of "regulated persons."

The SEC expects the extension to provide time for the MSRB and the Financial Industry Regulatory Authority ("FINRA") to adopt pay-to-play rules if they choose to do so and give third-party solicitors additional time to come into compliance with such rules.

Significant Dates

December 31, 2010	• Venture capital funds that will not qualify for exemption but seek to rely on the new Section 203(l) "grandfathering provision" must have sold securities to one or more investors prior to this date
July 20, 2011	• Advisers relying on the Section 203(b)(3) exemption as of this date may delay registration with the SEC until March 30, 2012. [Note: advisers relying on the 203(b)(3) exemption that may be required to switch to state registration because they manage less than $100 million in assets must look to the law of the applicable state(s) to determine their registration obligations (if any).]
July 21, 2011	• Dodd-Frank Act Title IV Effective Date • An investment adviser that commences operations after this date will be required to register immediately unless it qualifies for an exemption (*i.e.,* postponement of registration deadline does not apply to new advisers) • Venture capital funds that will not qualify for exemption but seek to rely on the Section 203(l) "grandfathering provision" must stop selling securities and accepting capital commitments

August 31, 2011	• Non-profit and charitable organizations advised by family offices must not accept additional funding from non-family clients after this date, aside from donations in fulfillment of earlier pledges, in order to remain eligible family clients within the family office exemption
January 1, 2012	• Mid-sized SEC-registered investment advisers that must transition to state registration must remain SEC-registered until this date • Exempt reporting advisers may begin filing Form ADV
February 14, 2012	• All advisers newly required to register as a result of the repeal of the private adviser exemption should file Form ADV by this date
March 30, 2012	• All advisers newly required to register with the SEC as a result of the repeal of the private adviser exemption must be registered • All SEC-registered investment advisers must file an amendment to Form ADV to identify mid-sized advisers no longer eligible to remain registered with the SEC • Exempt reporting advisers must file first reports on Form ADV by this date
June 13, 2012	• Compliance date for pay-to-play restrictions on third-party solicitation
June 28, 2012	• Mid-sized advisers no longer eligible must withdraw their SEC registrations
December 31, 2013	• Non-profit and charitable organizations advised by family offices that continue to accept non-family client donations will cease being eligible family clients within the family office exemption

If you have any questions regarding this update, please contact the Sidley lawyer with whom you usually work.

The Investment Management Practice of Sidley Austin LLP

Sidley has a premier, global practice in structuring and advising investment funds and advisers. We advise clients in the formation and operation of all types of alternative investment vehicles, including hedge funds, fund-of-funds, commodity pools, venture capital and private equity funds, private real estate funds and other public and private pooled investment vehicles. We also represent clients with respect to more traditional investment funds, such as closed-end and open-end registered investment companies (*i.e.*, mutual funds) and exchange-traded funds (ETFs). Our advice covers the broad scope of legal and compliance issues that are faced by funds and their boards, as well as investment advisers to funds and other investment products and accounts, under the laws and regulations of the various jurisdictions in which they may operate. In particular, we advise our clients regarding complex federal and state laws and regulations governing securities, commodities, funds and advisers, including the Investment Company Act of 1940, the Investment Advisers Act of 1940, the Securities Act of 1933, the Securities Exchange Act of 1934, the Commodity Exchange Act, the USA PATRIOT Act and comparable laws in non-U.S. jurisdictions. Our practice group consists of approximately 150 lawyers in New York, Chicago, Los Angeles, San Francisco, London, Hong Kong and Singapore.