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INVESTMENT ADVISERS

Investment Advisers and Private Funds Alert: SEC Adopts Rules On Exemptions to Registration and Reporting Requirements Pursuant to Dodd-Frank

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Introduction and Summary

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the ''Dodd-Frank Act'') made numerous changes to the registration, reporting and recordkeeping requirements of the Investment Advisers Act of 1940, as amended (the ''Advisers Act''). Most significantly, the Dodd-Frank Act eliminated the ''private adviser'' exemption that many investment advisers to private funds relied on and replaced it with several narrower exemptions. This article focuses on the rules adopted by the Securities and Exchange Commission (''SEC'') which implement these new exemptions from registration and certain amendments to the Advisers Act.

To the extent an adviser that relied on the private adviser exemption as of July 21, 2011, is unable to meet the requirements of these new exemptions, it is required to register with the SEC by March 30, 2012.[1] Since an initial application for registration may take up to 45 days for approval by the SEC, a registering adviser should file its Form ADV no later than February 14, 2012. Investment advisers that are registered with the SEC as of January 1, 2012, must file by March 30, 2012, an amendment to their Form ADV containing information necessary to identify whether they should transition to state registration.

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Exemptions from Registration

Foreign Private Advisers

Newly revised Section 203(b)(3) of the Advisers Act provides for an exemption from registration for foreign private advisers.[2] A foreign private adviser, as defined in Section 202(a)(30), is any investment adviser that (i) has no place of business[3] in the U.S., (ii) has, in total, fewer than 15 clients in the U.S. and investors in the U.S. in private funds (including those formed in non-

[1] July 21, 2011, is the effective date of the changes to the Advisers Act made by the Dodd-Frank Act. Advisers that do not rely on the private adviser exemption as of this date (because, for example, they are newly formed and are not yet engaged in an investment advisory business) must first register before engaging in an investment advisory business, unless such adviser meets an exemption or exclusion from registration.

[2] See Section II.C of the 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. IA-3222 (June 22, 2011), available at http://sec.gov/rules/final/2011/ia-3222.pdf (the ''Exemptions Release'').

[3] A ''place of business'' means any office where the investment 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 any such activities.

U.S. jurisdictions) advised by the adviser, (iii) has aggregate assets under management[4] attributable to clients in the U.S. and investors in the U.S. in private funds (including those formed in non-U.S. jurisdictions) advised by the adviser of less than $25 million and (iv) does not hold itself out generally to the public in the U.S. as an investment adviser nor acts as an investment adviser to any registered investment company or business development company.

Counting clients. In determining the number of clients and investors for purposes of the foreign private adviser exemption, an adviser is permitted to treat as a single ''client'' (i) an entity to which the adviser provides investment advice based on such entity's investment objectives, and (ii) two or more entities that have identical owners. The adviser is required to count both paying and non-paying clients. In addition to counting clients, this exemption requires the adviser to count the number of ''investors''[5] of an issuer that is a ''private fund''[6] managed by the adviser. Advisers must look through nominee and similar arrangements (*e.g.*, master-feeder structures or total return swap arrangements relating to private funds) to the underlying investors in the private fund. Holders of both equity and debt securities count as investors; however, knowledgeable employees[7] are not treated as investors. To avoid double-counting, a private fund would not be counted as a client if an investor in such fund is counted as an investor, and a person would not be counted as an investor if such person is counted as a client.

Defining U.S. status. The foreign private adviser exemption uses the term ''in the U.S.'' in several instances, in particular, with respect to the number of clients and investors, the amount of assets under management, the adviser's place of business, and where the adviser holds itself out to the public as an investment adviser. The definition of ''in the U.S.'' for purposes of this exemption generally incorporates the definition of a U.S. person and U.S. under Regulation S promulgated under the Securities Act of 1933, as amended. The adviser may also treat an investor as not being in the U.S. if the adviser reasonably believes that the investor is not in the U.S. A person who is in the U.S. may be treated as not being in the U.S. if the person was not in the U.S. at the time of becoming a client or, in the case of an investor in a private fund, each time the investor acquires securities issued by the fund.

It should be noted that a non-U.S. adviser with an affiliated registered broker-dealer in the U.S. may be considered as having a place of business in the U.S. due to its solicitation activities in the U.S., and therefore may be ineligible for the foreign private adviser exemption.

An adviser that qualifies for and relies on the foreign private adviser exemption would not be required to register under the Advisers Act, and would not be subject to the reporting or recordkeeping provisions thereunder, nor be subject to SEC examination. However, such adviser, to the extent it becomes ineligible to rely on this exemption due to an increase in the value of assets under management attributable to clients and investors in the U.S., would not be given a period within which to register with the SEC that is available to a non-U.S. adviser relying on the private fund adviser exemption.

Private Fund Advisers

Rule 203(m)-1 exempts an adviser that advises solely private funds and has assets under management in the U.S. of less than $150 million.[8] Under this rule, such adviser would not be required to register as long as (i) it has no client that is a U.S. person except for qualifying private funds,[9] and (ii) any assets managed by such adviser at a place of business in the U.S. are solely attributable to private fund assets[10] valued at less than $150 million.

In determining whether assets are managed at a place of business in the U.S., the SEC would look to an adviser's principal office and place of business as the location whether the adviser controls the management of private fund assets, although day-to-day management of certain assets may take place at another location. An adviser's principal office and place of business is the executive office of the adviser from which the officers, partners or managers of the adviser direct, control, and coordinate the activities of the adviser. Advisers relying on this private fund adviser exemption are ''exempt reporting advisers,'' and will be subject to certain reporting and recordkeeping requirements as described below under ''Reporting Requirements.''

If the adviser has any client that is a U.S. person, other than a qualifying private fund, it would be unable to rely on this private fund adviser exemption. Similarly, any assets managed from a U.S. place of business for clients other than private funds would make the exemption unavailable.

(i) Distinction between U.S. and Non-U.S. Advisers

An adviser with its principal office and place of business in the U.S. (a ''U.S. Adviser'') must count all private fund assets, including those from non-U.S. (offshore) clients toward the $150 million assets under management calculation. Any assets managed by a U.S. Adviser for clients other than qualifying private funds,

[4] Assets under management are calculated the same way as ''regulatory assets under management'' for purposes of Item 5 of Form ADV, as described further in this article.

[5] An ''investor'' is a person who would be included in determining the number of beneficial owners of the outstanding securities of a private fund under Section 3(c)(1) of the Investment Company Act of 1940, as amended (the ''Investment Company Act''), or whether the outstanding securities of a private fund are exclusively owned by qualified purchasers under Section 3(c)(7) of that Act, except that beneficial owners of short term paper issued by the private fund will also be included in determining the number of beneficial owners of the outstanding securities.

[6] A ''private fund'' is an issuer that relies (or is entitled to rely) on exemptions provided in Sections 3(c)(1) or 3(c)(7) of the Investment Company Act.

[7] See Rule 3c-5(a)(4) under the Investment Company Act.

[8] See Section II.B of the Exemptions Release.

[9] A qualifying private fund is any private fund (*i.e.*, an investment vehicle that relies on exemptions provided by Sections 3(c)(1) or 3(c)(7) of the Investment Company Act) that is not registered under the Investment Company Act and is not a business development company, as well as any fund that qualifies for an exclusion from the definition of an investment company under the Investment Company Act, even if it is not a 3(c)(1) or 3(c)(7) fund, as long as the fund is treated as a private fund under the Advisers Act for all purposes.

[10] ''Private fund assets'' means the investment adviser's assets under management attributable to a qualifying private fund.

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such as separately managed accounts,[11] would make the exemption unavailable.

An adviser with its principal office and place of business outside of the U.S. (a ''Non-U.S. Adviser'') needs to count only private fund assets it manages at a place of business in the U.S. toward the $150 million assets limit. The type or number of a Non-U.S. Adviser's non-U.S. clients[12] or the amount of assets it manages outside of the U.S. would not be taken into account. Hence, an adviser with no U.S. place of business and no U.S. clients other than qualifying private funds with less than $150 million of assets under management would qualify for this registration exemption regardless of the amount of capital under management from U.S investors in its non-U.S. private funds. In addition, unlike the foreign private adviser exemption, a Non-U.S. Adviser relying on this exemption may have a U.S. place of business so long as only qualifying private funds are managed from its U.S. places of business and it manages less than $150 million of assets under management from qualifying private funds from its U.S. places of business. Non-U.S. Advisers with a U.S. affiliate or U.S. office will need to determine whether they are managing assets in the U.S. for purposes of this exemption. Specifically, the SEC noted that providing research or conducting due diligence at a U.S. place of business would not be viewed as causing assets to be covered if a person outside of the U.S. makes independent investment decisions and implements those decisions.

(ii) Determination of Assets Under Management

In the Implementing Release,[13] the SEC revised the instructions to Form ADV to provide a uniform method to calculate assets under management for regulatory purposes. Assets under management include the value of any securities portfolios (*i.e.*, any portfolio at least 50% of the total value of which consists of securities) or any private fund for which the adviser provides continuous and regular supervisory or management services, regardless of the nature of the assets held by the portfolio and/or the fund. Advisers must include in their calculation any proprietary assets, assets managed without receiving compensation, uncalled capital commitments and assets of non-U.S. clients.[14] In addition, an adviser must determine the amount of its private fund assets based on the market value of those assets, or the fair value of those assets where market value is unavailable, and must calculate the assets on a gross basis, *i.e.*, without deducting liabilities, such as accrued fees and expenses or the amount of any borrowing.

An adviser must annually calculate the amount of the private fund assets it manages and report the amount in its annual updating amendments to its Form ADV. If an adviser has $150 million or more of private fund assets and therefore becomes ineligible to rely on this exemption, it will have 90 days after filing the annual updating amendment to register as an investment adviser with the SEC if it has complied with all SEC reporting requirements. However, this 90 day grace period is not available to advisers that have failed to comply with the applicable SEC reporting requirements or that have accepted a client that is not a private fund. In such a case, the adviser's registration must be approved prior to its acceptance of a non-private fund client.

Venture Capital/Family Office

Venture Capital Fund Advisers. Advisers solely to ''venture capital funds,'' regardless of their size, are not required to register.[15] A venture capital fund is defined as a private fund that (i) holds no more than 20 percent of the fund's aggregate capital commitments in non-qualifying investments[16] (other than short-term holdings); (ii) does not borrow, issue debt obligations, provide guarantees or otherwise incur leverage in excess of 15% of the fund's 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 certain guarantees of qualifying portfolio company obligations by the fund are not subject to the 120 calendar days limit); (iii) does not offer its investors redemption or other similar liquidity rights except in extraordinary circumstances; (iv) represents itself as pursuing a venture capital strategy to its investors and prospective investors; and (v) is not registered under the Investment Company Act, and is not a business development company. An existing private fund would be deemed to meet the definition of ''venture capital fund'' if it: (i) represented to investors and potential investors at the time the fund offered its securities that it pursues a venture capital strategy; (ii) has sold securities to one or more investors (that are not related persons) prior to December 31, 2010; and (iii) does not sell any securities to, including accepting any capital commitments from, any person after July 21, 2011. Similar to private fund advisers, advisers solely to venture capital funds are

[11] In the Exemptions Release, the SEC indicated that whether a fund with a single investor could be a ''private fund'' for purposes of the private fund exemption depends on the facts and circumstances. The SEC expressed concern that an adviser, in seeking to rely on this exemption, could convert separately managed accounts to single-investor funds. However, this could be viewed as a violation of Section 208(d) of the Advisers Act, which prohibits a person from doing indirectly, or through or by another person, any act or thing which it would be unlawful for such person to do directly.

[12] Importantly, a fund formed under non-U.S. law (*i.e.*, an ''offshore fund'') would be considered a non-U.S. client for this purpose.

[13] See Section II.A of the Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Act Release No. IA-3221 (June 22, 2011), available at http://sec.gov/rules/final/2011/ia-3221.pdf (the ''Implementing Release'').

[14] With respect to the foreign private adviser exemption, the non-U.S. adviser would only include assets under management that are attributable to clients in the U.S. and investors in the U.S. in private funds advised by the adviser.

[15] See Rule 203(l) of the Advisers Act in the Exemptions Release.

[16] ''Qualifying investments'' generally consist of equity securities issued by a qualifying portfolio company that is directly acquired by a qualifying fund and certain equity securities exchanged for the directly acquired securities. A qualifying portfolio company is any company that (i) is not a reporting or foreign traded company and does not have a control relationship 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 investment; and (iii) is not itself a fund (*i.e.*, is an operating company).

''exempt reporting advisers,'' and will be subject to certain reporting and recordkeeping requirements as described below under ''Reporting Requirements.''

Family Office Advisers. The Dodd-Frank Act provides that any ''family office'' does not fall within the definition of ''investment adviser'' as such term is defined in the Advisers Act and thus will not be subject to regulation under the Advisers Act. A ''family office'' is any company that: (i) provides investment advice only to family clients; (ii) is wholly owned by family clients and is exclusively controlled by family members and/or family entities; and (iii) does not hold itself out to the public as an investment adviser.[17] This family office exclusion applies only to family offices serving one family, and does not extend to multifamily offices. Family offices that obtained exemptive orders from the SEC will be able to continue operating under their existing exemptive orders.

Subadvisers and Advisory Affiliates

The SEC generally interprets advisers to include subadvisers. As a result, subadvisers may also rely on the exemptions described herein, provided that such subadvisers must satisfy the conditions for the applicable exemption. For a subadviser that has a contract with the primary adviser and not the fund, the subadviser may rely on the private fund adviser exemption if its services to the primary adviser relate solely to private funds, or rely on the venture capital exemption if its services relate solely to venture capital funds, and all other conditions of the applicable rules are satisfied. In determining the assets under management for the private fund adviser exemption, a subadviser counts only that portion of the private fund assets for which it has responsibility.

For advisers with advisory affiliates, the SEC will 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. In previous no action letters, the SEC has stated that it would not recommend enforcement if (i) a non-U.S. advisory affiliate of a registered adviser shares personnel with, and provides certain services through, such registered affiliate without such non-U.S. advisory affiliate registering under the Advisers Act and (ii) where such non-U.S. advisory affiliate provides advisory service to its non-U.S. clients.[18] The SEC has confirmed that the new rules in the Exemptions Release are not intended to withdraw any statements or views in such prior no action letters (which were developed in the context of the private adviser exemption, which has been repealed), but expects there will be further guidance regarding the application of such no action letters in the context of the new exemptions.

Small and Mid-Sized Advisers; State Registration

The Dodd-Frank Act reallocated the regulatory responsibility for smaller investment advisers to the state securities agencies in order to reduce the burden on the SEC that is expected to result from the elimination of the private adviser exemption. Previously, advisers with less than $25 million in assets under management generally were prohibited from registering with the SEC. The rules adopted by the Implementing Release raise this threshold for SEC registration to $100 million by creating a new category of advisers called ''mid-sized adviser,'' which is defined as an adviser that: (i) manages between $25 million and $100 million of assets; (ii) is required to be registered with the state in which it maintains its principal office and place of business; and (iii) would be subject to examination by that state, if so required to register. Minnesota, New York or Wyoming are states where state-registered mid-sized advisers would not be subject to examination. Therefore, mid-sized advisers having their principal office and place of business in Minnesota, New York or Wyoming will not switch to state registration. A mid-sized adviser may not register with the SEC unless: (i) it would be required to register in 15 or more states; or (ii) it is an adviser to a registered investment company or a business development company. Mid-sized advisers that are no longer eligible for SEC registration must withdraw the SEC registration by filing Form ADV-W by June 28, 2012, and complete the switch to state registration.

For advisers with close to $100 million in assets under management, the SEC has adopted a ''buffer'' 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. Advisers with greater than $100 million in assets under management but less than $110 million are permitted, but not required, to register with the SEC. Advisers that are registered with the SEC and have at least $90 million in assets under management need not withdraw their SEC registrations.

Reporting Requirements

Exempt Reporting Advisers

Advisers exempt from SEC registration in reliance on the private fund adviser exemption or the venture capital exemption are known as ''exempt reporting advisers.'' Exempt reporting advisers will not be required to register with the SEC but will be required to file, and periodically update, reports to the SEC by completing limited portions of Form ADV, Part 1A.[19] Such items include: Items 1 (Identifying Information), 2.B. (SEC Reporting by Exempt Reporting Advisers), 3 (Form of Organization), 6 (Other Business Activities), 7 (Financial Industry Affiliations and Private Fund Reporting) with Items 6 and 7 requiring disclosure of business activities that the adviser and its affiliates are engaged in, and information on the private funds they advise, 10 (Control Persons) which would require disclosure of ownership and control of the adviser and 11 (Disclosure Information) which would require disclosure of disciplinary history for the adviser and certain of its employees.

The initial filing of Form ADV must be made between January 1 and March 30, 2012. Unlike advisers registering under the Advisers Act that must initially submit Form ADV for approval over a 45-day period, the filing by an exempt reporting adviser is considered to be filed

[17] Rule 202(a)(11)(G)-1(b) under the Advisers Act.

[18] See, *e.g.*, Uniao de Bancos de Brasileiros S.A., SEC Staff No-Action Letter (July 28, 1992).

[19] See Appendix D of Implementing Release, available at http://sec.gov/rules/final/2011/ia-3221-appd.pdf.

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with the SEC upon receipt by the Investment Adviser Registration Depository (''IARD''). Form ADV filed with IARD would be publicly available on the SEC's website.[20] It is required to be amended at least annually, within 90 days of the end of the adviser's fiscal year, and more frequently under certain specific circumstances (*e.g.*, promptly if Items 1, 3 or 11 become inaccurate in any way, or if Item 10 becomes materially inaccurate).

The SEC is authorized under Section 204(a) of the Advisers Act to require an exempt reporting adviser to maintain records and provide reports, and to examine such adviser's records, which means an exempt reporting adviser's books and records would be subject to SEC inspection. The SEC currently does not intend to perform routine examinations of exempt reporting advisers, but it retains the authority to do so in its discretion.

Form ADV Amendments

The Implementing Release adopted a number of amendments to Form ADV which, among other things, requires advisers to provide additional information with respect to the advisers' (i) private funds, (ii) advisory business and business practices that may present significant conflicts of interest and (iii) non-advisory activities and financial industry affiliations.

(i) Private Fund Reporting

Amendments to Item 7.B and Schedule D of Form ADV expand the information advisers (both registered and exempt reporting advisers) must report about the private funds they advise. An adviser must file a separate Section 7.B.(1) (Parts A and B) for each private fund it manages, which requires the following information: (i) name of the fund, (ii) state or country of organization, (iii) identity of other persons involved in the fund's management, (iv) whether the fund is a master-feeder arrangement or fund of funds, (v) regulatory status of the fund, (vi) whether the fund is subject to a foreign regulatory authority, (vii) whether the fund relies on an exemption from registration under the Securities Act of 1933, (viii) type of investment strategy the fund employs, (ix) whether the fund invests in registered investment companies, (x) gross asset value of the fund and (xi) the fund's investors, including minimum required investment amount, approximate number of beneficial owners of the fund and approximate percentage beneficially owned by the adviser and its related persons, funds of funds and non-U.S. persons and the extent to which clients are solicited to invest. An adviser must also provide information concerning five types of service providers that act as ''gatekeepers'' for each private fund, including the auditors, prime brokers, custodians, administrators and marketers. The adviser must also complete a separate Schedule D for each private fund managed by the adviser, but is no longer required to report on funds of its related persons.[21]

(ii) Other ADV Amendments

Other amendments to Form ADV include (i) disclosure on the number and types of clients of the adviser, the approximate percentage of assets under management attributable to each client type, and additional types of advisory services provided by the adviser, (ii) expanding the list of types of financial services businesses that an adviser or its related person provides, (iii) additional disclosure of the adviser's other business or services other than investment advice, (iv) additional information on related persons, subject to certain exceptions, (v) disclosure by an adviser with discretionary authority to appoint brokers or dealers on whether such brokers or dealers are related persons, disclosure whether ''soft dollar benefits'' qualify for the safe harbor for eligible research or brokerage services, (vi) disclosure on whether its related persons receive direct or indirect compensation for client referrals, (vii) disclosure of total number of qualified custodians for the adviser's clients and (viii) disclosure on whether the adviser has $1 billion or more in total assets on its balance sheet to identify advisers that could be subject to rules regarding excessive incentive-based compensation arrangements.

Books and Records Requirements for Newly Registered Advisers

Advisers of private funds that are required to register with the SEC will be subject to recordkeeping requirements upon registration. Advisers that relied on the private adviser exemption who register by March 30, 2012, must comply with all Advisers Act provisions and rules by that date. These advisers would not be obligated to keep certain performance-related records for any period prior to their registration; however, to the extent such advisers preserved such records previously (even though not required to do so), they must continue to preserve them.

Conclusion

The SEC's adoption of the rules relating to registration and reporting by investment advisers provides greater clarity on the obligations imposed by the Dodd-Frank Act, although their effect on the private funds industry remains to be seen. The SEC is continuing to implement additional rules and provide interpretive guidance that affect investment advisers. It is advisable to continue to monitor the progress of these regulatory developments.

[20] The Investment Adviser Public Disclosure System, available at http://www.adviserinfo.sec.gov, allows the public to access Form ADVs, including those filed by an exempt reporting adviser.

[21] An adviser with a principal office and place of business outside the U.S. would not be required to complete Schedule D for any private fund that, during the adviser's last fiscal year, was not a U.S. person, was not offered in the U.S. and was not beneficially owned by any U.S. person.