A Closer Look

The Dodd-Frank Wall Street Reform and Consumer Protection Act

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Part of an ongoing series

Impact on Asset Managers

SEC Adopts Final Rules Requiring Many Advisers to Private Funds to Register with the SEC, Establishing Exemptions and New Reporting Requirements

July 2011

On June 22, 2011, the Securities and Exchange Commission ("SEC") adopted final rules as mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank," or "the Act") to require many advisers to private funds—which were previously exempt from registration—to become registered as investment advisers with the SEC. The final rules also establish new exemptions from the adviser registration rules. The deadline for advisers to register is March 30, 2012. In addition, the final rules will require advisers to submit new information to the SEC periodically—even those advisers that are exempt from registration. These final rules, while anticipated, will have significant impact on advisers to private funds. This *A Closer Look* describes the final rules and their impact on investment advisers.

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The final rules were adopted largely as proposed, but with some notable exceptions, as we describe in detail in this A Closer Look. The SEC authorized the registration rules in a 3–2 vote. In voting to adopt the rules, Chairman Mary Schapiro said that the rules "will fill a key gap in the regulatory landscape. In particular, our proposal will give the [SEC], and the public, insight into hedge fund and other private fund managers who previously conducted their work under the radar and outside the vision of regulators."[1]

As anticipated, the SEC also extended the registration deadline for advisers that do not qualify for an exemption until March 30, 2012. Advisers should plan to file Form ADV by February 14, 2012, to allow time for the SEC to deem the initial registration effective by the deadline.

While the SEC adopted final rules requiring advisers to report new information on Form ADV, as described in this Closer Look, still to come are the SEC's final rules on Form PF - the reporting form for private funds, anticipated later this year.

As we have outlined in earlier A Closer Looks, becoming registered as an investment adviser entails significant obligations, and subjects advisers to examination by the SEC. Advisers who are required to register should use the additional time prior to February 14, 2012, to ensure that they are fully compliant with the Investment Advisers Act of 1940 ("Advisers Act") including, among other things, by ensuring that they have implemented an effective compliance program with written policies and procedures designed to prevent and detect violations, and can demonstrate this program's effectiveness. In addition, advisers should review disclosures—particularly of conflicts of interest—to ensure that they are adequate and to assure compliance with the Advisers Act's Custody Rule and other requirements for SEC-registered advisers.

Background

Title IV of Dodd-Frank repealed the "private adviser exemption" contained in Section 203(b)(3) of the Advisers Act, on which many advisers to private funds relied to avoid registration with the SEC. The exemption applied to advisers with fewer than 15 clients – and allowed advisers to count each fund as a client, as opposed to each investor in a fund. In eliminating the exemption, Congress generally extended the registration requirements under the Advisers Act to private fund advisers.

Dodd-Frank also created new narrow exemptions for advisers to certain types of private funds, e.g., venture capital funds, funds with less than $150 million in assets, and certain foreign advisers without a place of business in the United States. The Act also authorized the SEC to adopt rules requiring advisers to submit reports to the SEC that it determines to be "necessary or appropriate in the public interest."

On November 19, 2010, the SEC proposed new rules and amendments to existing rules under the Advisers Act for public comment, and on June 22, 2011, in several releases, the SEC adopted final rules to implement these provisions.

[1] http://sec.gov/news/speech/2011/spch062211mls-items-1-2.htm

Summary

The SEC's final rules:

- Define three new exemptions from Advisers Act registration requirements for:
  - Advisers solely to venture capital funds;
  - Advisers solely to private funds with less than $150 million in assets under management in the United States; and
  - Certain foreign advisers without a place of business in the United States.
- Raise the assets under management ("AUM") threshold for SEC registration to $100 million and amend Form ADV to facilitate the transition of "mid-sized advisers" from SEC to state registration. Advisers that are no longer eligible for SEC registration will have until June 28, 2012, to complete the switch to state registration.
- Require certain advisers to private funds that are exempt from registration under the Advisers Act to submit certain periodic reports. Exempt reporting advisers must make their first filing to the SEC no later than March 30, 2012.
- Create new reporting requirements for hedge fund and other investment advisers on Form ADV, including:
  - *For private fund advisers.* Basic organizational and operational information about each fund they manage, such as the type of private fund (e.g., hedge fund, private equity fund, or liquidity fund), information about the size and ownership of the fund, general fund data, the nature of the adviser's services to the fund, and identification of five categories of "gatekeepers" (i.e., auditors, prime brokers, custodians, administrators, and marketers).
  - *For all advisers.* Information regarding their advisory business, including the types of clients they advise, their employees, and their advisory activities, any business practices that may present significant conflicts of interest (such as the use of affiliated brokers, soft dollar arrangements, and compensation for client referrals), their non-advisory activities, and their financial industry affiliations.
- Amend the pay to play rule so that it applies to exempt reporting advisers and foreign private advisers.
- Define "family offices" that are excluded from the definition of adviser under the Advisers Act, and thus not required to register or to comply with other Advisers Act requirements.

It will be critical for advisers to accurately assess whether they will be required to register with the SEC or are exempt from registration. To meet the deadline, advisers who will be required to register should be taking steps now to come into compliance with the Advisers Act, and to implement effective compliance programs and train firm employees. Firms required to register should also prepare for the SEC's examination oversight.

Even if exempt from registration, advisers will need to accurately assess whether they are subject to reporting obligations as "exempt reporting advisers." These firms will also be subject to the SEC's examination authority, and will likely have new recordkeeping obligations as well.

All advisers should take steps now to ensure they have the procedures and resources to meet the new reporting requirements, which may require new steps to assure the collection of timely and accurate information. In addition, advisers should take stock of existing compliance programs and codes of conduct and implement improvements where needed.

New exemptions

The final rules provide exemptions from registration for the following types of advisers:

- Advisers to venture capital funds
- Advisers solely to private funds
- Foreign private advisers

Each exemption is described below and shown in the flow charts at the end of this paper.

Exemption for venture capital funds

In sum, to qualify as a venture capital fund for purposes of the exemption, a private fund must:

- Hold no more than 20% of the fund's capital commitments in non-qualifying investments (other than short-term holdings);
- Not borrow or otherwise incur leverage (other than limited short-term borrowing) in excess of 15% of the venture capital fund's capital contributions and uncalled committed capital, with non-renewable terms of no longer than 120 calendar days (excluding certain guarantees of qualifying portfolio obligations by the fund);
- Not offer its investors redemption or other similar liquidity rights except in extraordinary circumstances;
- Represent itself as pursuing a venture capital strategy to its investors and prospective investors; and
- Not be registered under the Investment Company Act of 1940 ("Investment Company Act") and not have elected to be treated as a "business development company."

Qualifying venture capital funds may also invest in cash and cash equivalents[2], US Treasuries with a remaining maturity of 60 days or less, and, in a departure from the proposed rules, shares of registered money market funds. Under the final rules, a qualifying fund need not include its investments in these short-term holdings when determining whether it satisfies the 20% limit for non-qualifying investments. Venture capital funds may hold other longer-term or higher-yielding instruments through the non-qualifying basket.

[2] "Cash and cash equivalents" are defined by reference to Rule 2a51-1(b)(7) under the Investment Company Act. The rule provides that cash and cash equivalents include foreign currencies "held for investment purposes" and "(i) bank deposits, certificates of deposit, bankers acceptances and similar bank instruments held for investment purposes; and (ii) [t]he net cash surrender value of an insurance policy."

The SEC noted that Congress sought to distinguish between advisers to "venture capital funds" that Congress intended to exempt from adviser registration requirements and advisers to "private equity funds" that Congress did not intend to exempt. The SEC stated that, in contrast to private equity funds, venture capital funds typically make long-term investments in smaller companies or early-stage companies that are held privately, with the goal of eventually selling the companies or taking them public. Venture capital funds are typically not leveraged, contribute capital to companies that are not leveraged, and are less connected to the public markets, and thus present less potential systemic risk.

Responding to concerns that its proposed definition of "venture capital fund" was too difficult to meet given the proposal's detailed criteria, the SEC changed the definition to allow each fund the flexibility to invest up to 20% of its committed capital in investments that would not meet the criteria of a venture fund ("non-qualifying basket"). Commenters had expressed concern that a venture capital fund might, on occasion, deviate from its typical investing pattern and that the fund could not satisfy all the detailed criteria of the proposed rule with respect to each investment all of the time, leading to inadvertent violations of the rule.

Qualifying investments

A "qualifying investment" is generally any equity security[3] 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 defined as 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 private fund (i.e., is an operating company).

Capital used for operating and business expenses

One feature of venture capital funds that distinguishes them from other private funds is that they invest capital directly in portfolio companies for the purpose of expanding and developing those companies' business activities. The SEC had proposed that, in order to meet the exemption, at least 80% of a fund's investment in each portfolio company had to be acquired directly from the company, in effect limiting a venture capital fund's ability to acquire secondary market shares to 20% of the fund's investment in each company.

In response to commenters' concerns, the SEC eliminated the 20% limit for secondary market transactions in favor of the broader 20% limit for assets that are not qualifying investments, discussed below. Second, the SEC revised the final rules to define qualifying investments as including equity securities issued by the qualifying portfolio company that are received in exchange for directly acquired equities issued by the same qualifying portfolio company. This revision addresses a number of commenters' suggestion that the rules enable a qualifying fund to participate in the reorganization of the capital structure of

[3] The final rules incorporate the Exchange Act's broad definition of equity security. Accordingly, "equity security" includes common stock as well as preferred stock, warrants, and other securities convertible into common stock, in addition to limited partnership interests. The broad definition includes various securities in which venture capital funds typically invest and provides venture capital funds with flexibility to determine which equity securities in the portfolio company capital structure are appropriate for the fund. See Exchange Act Section 3(a)(11).

a portfolio company, which may require the fund, along with other existing security holders, to accept newly issued equity securities in exchange for previously issued equity securities.

The rule similarly treats as a qualifying investment any equity security issued by another company in exchange for directly acquired equities of a qualifying portfolio company, provided that the qualifying portfolio company becomes a majority-owned subsidiary of the other company or is a predecessor company. This provision enables a qualifying fund to acquire securities in connection with the acquisition (or merger) of a qualifying portfolio company by another company, without jeopardizing the fund's ability to satisfy the definition of venture capital fund.

Twenty percent investment in non-qualifying baskets

To meet the definition of venture capital fund, the fund must hold no more than 20% of its total capital commitments in investments that would not otherwise satisfy all the elements of the rule. Thus, a qualifying fund could invest without restriction up to 20% of the fund's capital commitments in non-qualifying investments and still fall within the venture capital fund definition. A qualifying fund, however, could not purchase additional non-qualifying investments until the value of its then-existing non-qualifying investments fell below 20% of the fund's committed capital.

To determine compliance with the 20% limit, a venture capital fund would, immediately after the acquisition of any non-qualifying investment, calculate the total value of all the fund's assets held at that time, excluding short-term holdings, that are invested in non-qualifying investments, as a percentage of the fund's total capital commitments.[4]

Limits on leverage

As noted above, the final rules prohibit a venture capital fund from incurring leverage in excess of 15% of the fund's aggregate capital contributions and uncalled committed capital with non-renewable terms of no longer than 120 days. In practice, this means that a qualifying fund could leverage an investment transaction up to 100% when acquiring equity securities of a particular portfolio company as long as the leverage amount does not exceed 15% of the fund's total capital commitments.

While the SEC adopted the 15% leverage threshold as proposed, it modified the leverage criterion to exclude from the 120-day calendar limit any guarantee of qualifying portfolio company obligations by the qualifying fund, up to the value of the fund's investment in the qualifying portfolio company.

[4] The 20% test is determined based on the qualifying fund's non-qualifying investments after taking into account the acquisition of any newly acquired non-qualifying investment. Funds may use either the historical cost or fair value of the investment, as long as the same method is applied to all investments of a qualifying fund in a consistent manner during the term of the fund.

Of note, the SEC did not adopt a managerial assistance requirement as originally proposed. The SEC had proposed that advisers seeking to rely on the rule have a significant level of involvement in developing a fund's portfolio companies. Acknowledging commenters' concerns as to the difficulties of applying the managerial assistance criterion and in particular the issues associated with a qualifying fund proving compliance when it participates in a syndicated transaction involving multiple funds, the SEC did not require this in its final rules.

Grandfathering provision

Advisers to private funds that do not meet all the conditions to qualify as a venture capital fund may nonetheless qualify for the exemption under the grandfathering provision. The final rules provide that an investment adviser may treat any existing private fund as a venture capital fund for purposes of the Advisers Act if the fund:

- Represented to investors and potential investors at the time the fund offered its securities that it pursues a venture capital strategy ("holding out" criterion);
- Sold securities to one or more investors prior to December 31, 2010; and
- Does not sell any securities to, including accepting any capital commitments from, any person after July 21, 2011.

A grandfathered fund would thus include any fund that has accepted all capital commitments by July 21, 2011 (including capital commitments from existing and new investors), even if none of the capital commitments has been called by such date. The calling of capital after July 21, 2011, would be consistent with the grandfathering provision, as long as the investor became obligated by July 21, 2011, to make a future capital contribution.

A fund that seeks to qualify under the rule should examine all of the statements and representations made to investors and prospective investors to determine whether the fund has satisfied the "holding out" criterion as incorporated into the grandfathering provision.

Application to non-US advisers

A non-US adviser, as well as a US adviser, may rely on the venture capital exemption provided that such adviser solely advises venture capital funds that satisfy all the elements of the rule or satisfy the grandfathering provision. A non-US adviser may rely on the venture capital exemption if all of its clients, whether US or non-US, are venture capital funds. In addition, a non-US adviser may treat as a venture capital fund any non-US fund that is not offered through the use of US jurisdictional means but that would be a private fund if the fund conducted a private offering in the United States and met the rules' other criteria.

Exemption for certain private advisers

Section 408 of Dodd-Frank amended the Advisers Act to exempt from registration any adviser that solely advises private funds that have less than $150 million in total assets under management in the United States ("private fund adviser exemption"). The requirements for this exemption are outlined below.

Advises solely private funds

The final rules limit the use of the exemption to those advisers that solely advise "private funds" as defined in the Advisers Act.[5] An adviser may advise an unlimited number of qualifying private funds, provided the aggregate value of the assets of the private funds is less than $150 million.

In the case of a non-US adviser (one with a principal office and place of business outside the United States), the exemption is available as long as all the adviser's clients that are United States persons are qualifying private funds. Consequently, a non-US adviser may enter the US market and take advantage of the exemption without regard to the type or number of its non-US clients or the amount of assets it manages outside of the United States.[6]

According to the SEC, the determination of whether a fund with a single investor could be a "private fund" for purposes of the exemption depends on the facts and circumstances. While the SEC recognizes that there are circumstances where it may be appropriate for an adviser to treat a single-investor fund as a private fund for purposes of the rules, it indicated concern that an adviser simply could convert client accounts to single investor funds in order to avoid registering under the Advisers Act.

The SEC did expand the scope of "qualifying private fund" in the final rules to allow an investment adviser to treat as a private fund an issuer that qualifies for an exclusion from the definition of investment company under Section 3 of the Investment Company Act (such as a real estate fund under Section 3(c)(5)), in addition to those provided by Section 3(c)(1) or 3(c)(7), provided that the adviser treats the issuer as a private fund under the Advisers Act and the accompanying rules, such as complying with the requirements of Form ADV.

How and when to calculate private fund assets

Advisers must calculate the value of private fund assets pursuant to the instructions in Form ADV, which provide a uniform method of calculating "regulatory assets under management," described in more detail below.

Advisers will calculate assets under management using the market value of those assets, or the fair value of those assets where the market value is unavailable. The SEC states that although an adviser will be required to use gross (rather than net) assets for the purposes of determining whether it is eligible for the private fund adviser exemption, among other purposes, an adviser would not be precluded from holding itself out to clients as managing a net amount of assets.[7]

Contrary to the proposed rules, the final rules do not require advisers relying on the private fund adviser exemption to calculate their private fund assets on a quarterly basis. Rather,

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[5] Section 202(a)(29) of the Advisers Act defines the term "private fund" as an issuer that would be an investment company, as defined in Section 3 of the Investment Company Act of 1940, but for Section 3(c)(1) or 3(c)(7) of that Act.

[6] The SEC noted that non-US activities of non-US advisers do not substantially implicate US regulatory interests.

[7] In response to commenters seeking clarification of the application of the gross assets calculation to mutual funds, short positions, and leverage, the SEC stated that it expects that advisers will continue to calculate their gross assets as they do today, even if they currently only calculate gross assets as an intermediate step to compute their net assets.

advisers will be required to annually calculate the amount of private fund assets they manage and report the amount in their annual updating amendments to Form ADV.

An adviser who no longer meets the private fund adviser exemption will have a 90-day transition period from the filing of its annual updating amendment to Form ADV to register with the SEC, unless it qualifies for another exemption. This transition period will only be available to advisers that complied with the applicable reporting requirements.

Assets managed in the United States

All private fund assets of an adviser with a principal office and place of business in the United States are considered to be "assets under management in the United States," even if the adviser has offices outside of the United States. A non-US adviser, however, need only count private fund assets it manages at a place of business in the United States toward the $150 million asset limit under the exemption.

The final rules deem all of the assets managed by an adviser to be managed "in the United States" if the adviser's "principal office and place of business" is in the United States. This is the location where the adviser controls, or has ultimate responsibility for, the management of private fund assets, and therefore is the place where all the adviser's assets are managed, although day-to-day management of certain assets may also take place at another location.

Application to non-US advisers

If a non-US adviser relying on the exemption has a place of business in the United States, all of the clients whose assets the adviser manages at that place of business must be private funds and the assets managed at that place of business must have a total value of less than $150 million. A "place of business" is defined in the rules 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 conducts any such activities.

Whether a non-US adviser has a place of business in the United States depends on the facts and circumstances. The SEC notes, however, that the analysis frequently will turn not on whether a non-US adviser has a US place of business, but on whether the adviser manages assets, or has "assets under management," at such a US place of business. The Advisers Act defines "assets under management" as the securities portfolios for which an adviser "provides continuous and regular supervisory or management services." The SEC states that it would not view providing research or conducting due diligence to be "continuous and regular supervisory or management services" at a US place of business if a person outside of the United States makes independent investment decisions and implements those decisions. Non-US advisers relying on the private fund adviser exemption will remain subject to the Advisers Act's antifraud provisions and will become subject to the requirements applicable to exempt reporting advisers.

As described above, non-US advisers solely to private funds may qualify for this exemption provided the adviser manages assets of less than $150 million from a US place of business. Non-US advisers that have neither a "principal office" nor "place of business" in the US would not need to register, as assets managed from non-US locations are not counted toward the $150 million threshold. Thus, non-US advisers that have no US operations would be exempt from registration with the SEC unless they have US clients that are not private funds.

Foreign private adviser exemption

Section 403 of Dodd-Frank provides an exemption for foreign private advisers. To qualify for the foreign private adviser exemption, the final rules require that an adviser must:

- Have no place of business in the United States;
- Have, in total, less than 15 clients in the United States *and* investors in the United States in private funds advised by the adviser;
- Have less than $25 million in aggregate assets under management attributable to clients in the United States and investors in the United States in private funds advised by the adviser; and
- Not hold itself out generally to the public in the United States as an investment adviser.

The final rules, which are substantially similar as those proposed, define certain terms for use by advisers seeking to avail themselves of the foreign private adviser exemption, including: (i) "investor," (ii) "in the United States," (iii) "place of business," and (iv) "assets under management."[8] The rules also include the safe harbor and many of the client counting rules that appeared in the now-repealed private adviser exemption.

How to count clients and private fund investors

Clients

The final rules include a safe harbor for advisers to count clients for the purposes of the definition of "foreign private adviser." Under the rules, an adviser may treat as a single client a natural person and:

- That person's minor children (whether or not they share the natural person's principal residence);
- Any relative, spouse,[9] or relative of the spouse of the natural person who has the same principal residence;
- All accounts of which the natural person and/or the person's minor child or relative, spouse, or relative of the spouse who has the same principal residence are the only beneficiaries;
- All trusts of which the natural person and/or the person's minor child or relative, spouse, or relative of the spouse who has the same principal residence are the only primary beneficiaries;
- A corporation, general partnership, limited partnership, limited liability company, trust, or other legal organization to which the adviser provides investment advice based on the legal organization's investment objectives; and
- Two or more legal organizations that have identical shareholders, partners, limited partners, members, or beneficiaries.

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[8] "Assets under management" and "place of business" have the same definitions as used in the private fund adviser exemption (see above).

[9] The rules apply to a person's spousal equivalent.

As proposed, the final rules provide that clients from whom the adviser receives no compensation must be counted as "clients" if the adviser provides advisory services to those clients. The rules also include two provisions that clarify that advisers need not double-count private funds and their investors under certain circumstances.[10]

Investors

The final rules define an "investor" in a private fund as any person who would be included in determining the number of beneficial owners under Sections 3(c)(1) or 3(c)(7) of the Investment Company Act.

Advisers must "look through" nominee and similar arrangements to the underlying holders of private fund-issued securities to determine whether they have fewer than 15 clients and private fund investors in the United States. The SEC states that depending on the facts and circumstances, persons other than the nominal holder of a security issued by a private fund may be counted as a beneficial owner or qualified purchaser. For example, the adviser to a master fund in a master-feeder arrangement would have to 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. In addition, an adviser would need to count as an investor an owner of a total return swap on the private fund because that arrangement effectively provides the risks and rewards of investing in the private fund to the swap owner. To avoid double-counting, the rules clarify that an adviser may treat as a single investor any person who is an investor in two or more private funds advised by the investment adviser.

In addition, a beneficial owner of short-term paper issued by the private fund also is an "investor," notwithstanding that holders of short-term paper issued by the private fund need not be counted for purposes of Section 3(c)(1). The final rules, however, do not include knowledgeable employees in the definition of "investor," as originally proposed.

In the United States

The final rules define "in the United States" as had been proposed, generally by incorporating the definition of a "US person" and "United States" under Regulation S of the Securities Act of 1933. However, the final rules treat as persons "in the United States" for purposes of the foreign private adviser exemption certain persons that would not be considered "US persons" under Regulation S. For example, the final rules treat as "in the United States" any discretionary account owned by a US person and managed by a non-US affiliate of the adviser. According to the SEC, this will discourage non-US advisers from creating such discretionary accounts with the goal of circumventing the exemption's limitation with respect to advising assets of persons in the United States.

The final rules also specify that an adviser may treat a person as not being "in the United States" if such person is not in the United States at the time the person becomes a client or at the time the fund investor acquires securities. The adviser need not check periodically to see whether the client or investor has subsequently become a "US person."

[10] Under the rules, an adviser is not required to count a private fund as a client if the adviser (i) counts any investor (as that term is defined in the rules) in that private fund as an investor in the United States in that private fund, and (ii) counts any person (as that term is defined in the rules) in a private fund the adviser advises if it counts such person as a client in the United States. Thus, a client who is also an investor in a private fund advised by the adviser would only be counted once.

Under the new rule, an adviser will determine the number of investors in a private fund based on the facts and circumstances and in light of the applicable prohibition not to do indirectly, or through or by any other person, what is unlawful to do directly. The SEC states that an adviser may have a "reasonable belief" to conclude that an investor is the actual investor, and that an investor is not "in the United States."

The SEC does not provide guidance as to what constitutes "reasonable belief" for purposes of this rule, nor does it provide a means as to how to evaluate the pertinent facts and circumstances when counting clients and investors. The SEC does note its understanding that non-US private funds currently count or qualify their US investors in order to avoid regulation under the Investment Company Act, and that a non-US adviser would need to count the same US investors (except for holders of short-term paper with respect to a fund relying on Section 3(c)(1)) in order to rely on the foreign private adviser exemption.

Subadvisers: Eligibility for exemptions

The SEC considers subadvisers to be advisers, and will therefore permit subadvisers to rely on each of the new exemptions. The SEC recognized that in many subadvisory relationships, a subadviser has contractual privity with a private fund's primary adviser rather than the private fund itself, and that the fund's primary adviser may be viewed as a client of the subadviser. The SEC stated that it would consider a subadviser eligible to rely on the private fund adviser exemption if the subadviser's services to the primary adviser relate solely to private funds and other conditions of the rule are met. Similarly, a subadviser may also be eligible to rely on the venture capital fund exemption if a subadviser's services to the primary adviser relate solely to venture capital funds and the other conditions of the rule are met.

Regulation Lite

The SEC makes clear in the release that the *Unibanco* line of no-action letters ("*Unibanco* letters") are not rescinded. In these letters (also known as "Regulation Lite"), the SEC staff provided guidance with respect to a non-US unregistered adviser affiliated with an SEC-registered adviser. The staff agreed not to recommend enforcement action if a non-US advisory affiliate of a registered adviser shares personnel with, and provides certain services through, the registered adviser, without such affiliate registering under the Advisers Act.[11] The letters also provided assurances that the staff would not enforce substantive provisions of the Advisers Act to the non-US clients of a non-US adviser registered with the SEC.

The SEC stated that it expects 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 private fund adviser exemption.

[11] The SEC also states in the release 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.

In any event, given the benefits that Regulation Lite confers as set forth above, non-US advisers may continue to avail themselves of the approach and organize their affairs to conform to the Unibanco letters' guidance. Registered investment advisers should continue to monitor the SEC for future guidance and clarification.

Determining eligibility for an exemption or registration: Calculation of regulatory assets under management

The final rules implement a uniform method for advisers to calculate their assets under management used to assess whether an adviser is eligible to register with the SEC (i.e., $100 million or more in AUM) or meet one of the exemptions from registration discussed above. The SEC calls this uniform AUM calculation "regulatory assets under management." Advisers must include in their regulatory assets under management securities portfolios for which they provide continuous and regular supervisory or management services, regardless of whether these assets are family or proprietary assets, assets managed without receiving compensation, or assets of foreign clients.

The revised instructions to Form ADV also clarify that an adviser must calculate its regulatory assets under management on a gross basis—that is, without deduction of any outstanding indebtedness or other accrued but unpaid liabilities.[12]

Further, the instructions provide guidance regarding how an adviser that advises private funds determines the amount of assets it has under management:[13]

> *Funds.* First, an adviser must include in its calculation of regulatory assets under management the value of any private fund over which it exercises continuous and regular supervisory or management services, regardless of the nature of the assets held by the fund. A subadviser to a private fund would include in its regulatory assets under management only that portion of the value of the portfolio for which it provides continuous and regular supervisory or management services. Advisers that have discretionary authority over fund assets, or a portion of fund assets, and that provide ongoing supervisory or management services over those assets would exercise continuous and regular supervisory or management services.
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> *Uncalled capital.* Second, an adviser must include the amount of any uncalled capital commitments made to a private fund managed by the adviser.
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> *Market value.* Third, advisers must use the market value of private fund assets, or the fair value of private fund assets, where market value is unavailable. According to the SEC, this instruction would prevent, for example, an adviser electing to value its assets based on their cost (which could be significantly lower than the value of the assets based on their fair value), thus permitting the adviser to avoid registration with or reporting to the SEC. It is designed to prevent inconsistent application of the Advisers Act to advisers managing the same amount of assets.

The SEC notes that while many advisers will calculate fair value of their private funds in accordance with US generally accepted accounting principles or another international

[12] Consequently, an adviser cannot deduct accrued fees, expenses, or the amount of any borrowing.

[13] See generally, amended Form ADV: Instructions for Part 1 A, instruction 5.

accounting standard, other advisers acting consistently and in good faith may utilize another fair valuation standard.

An adviser must determine its regulatory assets under management based on the current market value of assets, as determined within 90 days prior to filing Form ADV.

Exempt reporting advisers: reporting requirements

Even if exempt from registration, many advisers will nonetheless need to submit regular reports to the SEC. Advisers relying on either of two exemptions—as advisers (i) to venture capital funds or (ii) to private funds with less than $150 million in assets under management (as described above)—will be considered "exempt reporting advisers." Advisers relying on the third exemption, available to certain foreign advisers without a place of business in the United States, will not need to submit regular reports to the SEC.

Exempt reporting advisers will be required to submit regular reports, containing a subset of the information that all registered advisers report on Form ADV. (Form ADV is both a reporting and registration form.) Exempt reporting advisers must make their first filing to the SEC no later than March 30, 2012. Information reported on Form ADV Part 1 will be publicly available.

In addition to regular reporting, the SEC signaled other obligations with respect to exempt reporting advisers. For example, it stated that it will address recordkeeping requirements for exempt reporting advisers in a separate release. And, while the SEC stated that it does not anticipate that its staff will conduct regular compliance examinations of exempt advisers, it said that the staff will conduct cause examinations where there are indications of wrongdoing (e.g., prompted by tips, complaints, and referrals). [14]

Exempt reporting advisers will be required to complete the following seven items on Form ADV:

- *Item 1: Identifying Information*. An adviser must provide basic identification details such as name, address, and contact information.
- *Item 2.B: SEC Reporting by Exempt Reporting Advisers*. An adviser must indicate its eligibility for registration and identify the exemption(s) on which it is relying.
- *Item 3: Form of Organization.* An adviser is required to disclose its form of organization, including in what month its fiscal year ends.
- *Item 6: Other Business Activities.* An adviser must identify other business activities in which it engages. This item is discussed below.
- *Item 7: Financial Industry Affiliations and Private Fund Reporting*. Item 7A requires an adviser to provide information about its financial industry affiliations and activities, including foreign affiliates. Item 7.B and Section 7.B of Schedule D require information regarding private funds managed by an adviser. These items are discussed below.

[14] Under Section 204(a) of the Advisers Act, the SEC has the authority to examine records, unless the adviser is specifically exempted from the requirement to register pursuant to Section 203(b) of the Advisers Act. Investment advisers that are exempt from registration in reliance on Section 203(l) (venture capital funds) or 203(m) (funds with less than $150 million) of the Advisers Act are not "specifically exempted" from the requirement to register pursuant to Section 203(b).

- *Item 10: Control Persons*. An adviser must identify every person that, directly or indirectly, controls the adviser.
- *Item 11: Disclosure Information*. An adviser is required to provide information about its disciplinary history and the disciplinary history of all its advisory affiliates. The SEC uses this information, among other things, to identify potential problem areas to focus on during on-site examinations.

In addition, exempt reporting advisers must also complete corresponding sections of Schedules A, B, C, and D.

An adviser will be required to file updating amendments to reports filed on Form ADV on an annual basis within 90 days of the end of the adviser's fiscal year. Exempt reporting advisers, like registered advisers, must promptly update Items 1 (Identifying Information), 3 (Form of Organization), and 11 (Disclosure Information) if they become inaccurate in any way, and update Item 10 (Control Persons) if it becomes materially inaccurate.

Some commenters had argued that requiring exempt reporting advisers to submit reports to the SEC was inconsistent with the new exemptions; others argued that the SEC's proposed reporting for exempt advisers required too much information. Two commissioners appear to have agreed, and declined to support the new rule, arguing that the obligations of exempt and registered advisers would be so similar as to nearly drain the exemptions of meaning.

The SEC believes that the public reporting by exempt advisers will (i) provide a level of transparency to help it to identify practices that may harm investors, (ii) aid investors in conducting their own due diligence, and (iii) deter fraud by advisers and facilitate earlier discovery of potential misconduct.

Advisers to venture capital funds and those with less than $150 million in fund assets, while exempt from registration, nonetheless have significant new reporting obligations, with the attendant need to collect timely and accurate information. And, recordkeeping obligations are on the horizon, as well as SEC examinations if a problem arises.

Amendments to Form ADV

The final rules adopt a number of amendments to Form ADV intended to improve the SEC's ability to oversee investment advisers.

Form ADV will require advisers to provide additional information about three areas of their operations:

- Information about private funds they advise;
- Data relating to advisers' advisory business (including data about the types of clients they have, their employees, and their advisory activities), as well as their 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
- Additional information about advisers' non-advisory activities and their financial industry affiliations.

Private fund reporting

The final rules, while expanding the information advisers must report about the private funds they advise, differ from the proposal in certain respects, discussed below. Of note, the final rules do not require, as proposed, an adviser to (i) disclose each private fund's net assets, (ii) report private fund assets and liabilities by class and categorization in the fair value hierarchy established under US generally accepted accounting principles, and (iii) specify the percentage of each fund type owned by particular types of beneficial owners. This is a significant change, and reflects many commenters' concerns about the breadth of information to be submitted.

Item 7.B and Section 7.B of Schedule D require an adviser to provide basic information regarding the size and organizational, operational, and investment characteristics of each private fund that it advises. As part of its response, the adviser must indicate whether the fund is part of a master feeder arrangement or is a fund of funds, and must provide information about the fund's regulatory status (i.e., the exclusion from the Investment Company Act on which the fund relies). The adviser must also identify the types of strategies employed by the fund and information regarding the fund's investors, and report the gross asset value of the fund. In addition, the adviser must identify "gatekeepers" for the fund, including auditors, prime brokers, custodians, administrators, and marketers.

According to the SEC, this new information will provide the agency with a more complete understanding of private funds and help enhance its assessment of advisers for the purposes of targeting its examinations. In addition, the information will improve the SEC's ability to identify practices that could harm investors and help expose and deter fraud and misconduct. Both registered and exempt advisers are required to complete Item 7.B.

While the SEC made changes in the final rules, these new filing obligations are still significant, particularly for advisers to private funds, who would file information that would be publicly accessible concerning:

- *The size and organizational, operational, and investment characteristics of each private fund (whether the fund is part of a master feeder arrangement or is a fund of funds, and to provide information about the fund's regulatory status (i.e. the exclusion from the Investment Company Act on which the fund relies);*
- *The types of strategies employed by the fund and information regarding the fund's investors; and*
- *The "gatekeepers" for the fund, including prime broker, auditors, custodians, administrators, and marketers.*

Advisers will also have to report:

- *Item 1.O: Reporting $1 Billion in Total Assets*. An adviser must indicate whether it had $1 billion or more in total assets shown on its balance sheet as of the last day of the most recent fiscal year. This information will be used to identify those advisers that could be subject to rules regarding certain excessive incentive-based compensation arrangements as required by the Dodd-Frank Act.[15]

[15] For a discussion of the SEC and other federal agencies' proposal regarding excessive incentive-based compensation, see our recent article *A Closer Look: Incentive-Based Compensation Requirements for Certain Firms*, available at http://www.pwc.com/us/en/financial-services/regulatory-services/publications/assets/closer-look-incentive-based-compensation-arrangements.pdf.

- *Item 5: Advisory Business Information*. An adviser is required to provide basic information concerning its business, including the scope of its business, types of services it provides, and types of clients to whom it provides those services. Item 5 also requires the adviser to indicate the number of its employees, including how many are registered as investment adviser representatives or are licensed insurance agents.
- *Items 6 and 7: Other Business Activities and Financial Industry Affiliations*. Items 6.A and 7.A require advisers, including exempt reporting advisers, to report those financial services the adviser or a related person is actively engaged in providing, from lists of financial services set forth in the items. In particular, the final rules expand the lists of types of financial services in both items. As a result, an adviser must also report whether it or a related person is a trust company, registered municipal advisor, registered security-based swap dealer, or a major security-based swap participant.
- *Item 8: Participation in Client Transactions*. An adviser is required to report, among other things, (i) whether it has discretionary authority to determine the brokers or dealers for client transactions or whether it recommends brokers or dealers to clients, (ii) compensation received for client referrals, and (iii) information concerning soft dollar benefits and whether they qualify for safe harbor under Section 28(e) of the Exchange Act.
- *Item 9: Custody*. An adviser is required to indicate the total number of persons that act as qualified custodians for the adviser's clients in connection with advisory services provided to its clients. An adviser will be required to provide an approximate amount of client assets for which it has custody. The adviser must also include an approximate amount of client assets for which a related person has custody.

The amendments also include a number of additional technical changes unrelated to Dodd-Frank that are intended to improve the SEC's ability to assess compliance risks, including the requirement that an adviser must provide contact information for its chief compliance officer.

This expanded set of information will be public.

All advisers will have to submit significant amounts of new information. The SEC views the data collected from Form ADV as critically important to its regulatory program and its ability to protect investors. The SEC indicates that the information reported by advisers on Form ADV is used for a number of purposes, such as to identify common business activities; create risk profiles of investment advisers; and permit examiners to better prepare for, and more efficiently conduct, their examinations. Moreover, the SEC states that the information in Form ADV will allow the SEC to better understand the investment advisory industry and to evaluate the implications of policy choices it makes in administering the Advisers Act.

Eligibility for registration with the SEC

Section 410 of the Dodd-Frank Act creates a new category of "mid-sized advisers," those with assets under management between $25 million and $100 million, and shifts primary responsibility for their regulatory oversight to the states. The final rules prohibit a mid-sized adviser from registering with the SEC if the mid-sized adviser is regulated or is required to be regulated by the state in which it has its principal office and place of business, unless the mid-sized adviser:

- Does not meet the criteria for state registration; or
- Is not subject to state examination.

The SEC also amended Item 2.A of Form ADV Part 1 to reflect the new statutory threshold for registration. An adviser is required to identify in Item 2.A whether it is eligible to register with the SEC because it:

- Is a large adviser that has $100 million or more regulatory assets under management;
- Has its principal office and place of business in Wyoming (which does not regulate advisers) or outside the United States;
- 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;
- Meets the requirements for one or more of the revised rules providing exemptions from prohibition on registration (e.g., the adviser is a pension consultant with plan assets of $200 million or more);
- Received an order permitting it to register with the SEC; or
- Would be required to register as an investment adviser with 15 or more states.

These rules effectively transfer primary oversight of approximately 3,200 smaller advisers to the states and allow the SEC to focus its oversight resources on larger advisory firms. For efficiency and convenience, advisers that would have to register with more than 15 states may register with the SEC.

Amendments to the pay to play rule

The final rules also amend the pay to play rule to address certain consequences arising from Dodd-Frank's amendments to the Advisers Act and the Exchange Act. The rules:

- Amend the scope of the existing pay to play rule so that it applies to exempt reporting advisers and foreign private advisers;
- Add registered municipal advisors to the categories of registered entities, referred to as "regulated persons," excepted from the rule's prohibition on advisers paying third parties to solicit government entities; and
- Permit advisers to compensate persons that are "regulated persons" for soliciting government entities if they are subject to restrictions at least as stringent as the pay to play rule.

The rules also extend the date by which advisers must comply with the ban on third-party solicitation from September 13, 2011, to June 13, 2012, due to the fact that the SEC modified its proposal and expanded the definition of regulated persons. PwC recently provided an update on the pay to play rule, available at http://www.pwc.com/us/en/financial-services/regulatory-services/publications/briefs/FS-Reg-Brief-pay-to-play.jhtml.

Family offices

Finally, the SEC unanimously approved a new rule to define "family offices" that will be excluded from the definition of an investment adviser under the Advisers Act. Historically, many family offices that fell outside the now-repealed private adviser exemption sought and obtained individual exemptive orders from the SEC declaring those offices not to be investment advisers.

Recognizing this past practice, Dodd-Frank and the SEC's final rule state that a family office will be exempt from the definition of an investment adviser under the Advisers Act (and thus not subject to registration with the SEC) if it:

- Provides investment advice only to "family clients," as defined in the rule;
- Is wholly owned by family clients and is exclusively controlled by family members and/or family entities; and
- Does not hold itself out to the public as an investment adviser.

The rule also incorporates a "grandfathering" provision that includes in the definition of family office those advisers who would otherwise meet the rule's requirements but provided investment advice to certain clients before January 1, 2010, such as (i) natural persons who, at the time of their investment, are officers, directors or employees of the family office who have invested with the family office before January 1, 2010 and are accredited investors; and (ii) any company owned exclusively and controlled by one or more family members.

Effective and compliance dates

A list of relevant dates appears below.

Family offices. The rule becomes effective August 29, 2011. Family offices that do not meet the terms of the exclusion will have to register with the SEC or with applicable state regulatory authorities by March 30, 2012.[16]

Exemptions from registration. The new exemptions for advisers to venture capital funds, advisers to solely private funds, and foreign private advisers become effective July 21, 2011.

Private adviser registration. As discussed above, the SEC has extended the deadline for advisers to register to March 30, 2012. Advisers should, however, register by February 14, 2012, to allow the SEC time to deem the initial filing effective.

Withdrawing from registration. An adviser who does not meet the new criteria must withdraw from SEC registration by filing Form ADV-W by June 28, 2012.

Exempt adviser disclosures. Exempt reporting advisers must make their initial Form ADV filings no later than March 30, 2012.

Amendments to Form ADV and the pay to play rule. Amendments to Form ADV, the pay to play rule, and other conforming and technical amendments become effective September 19, 2011.

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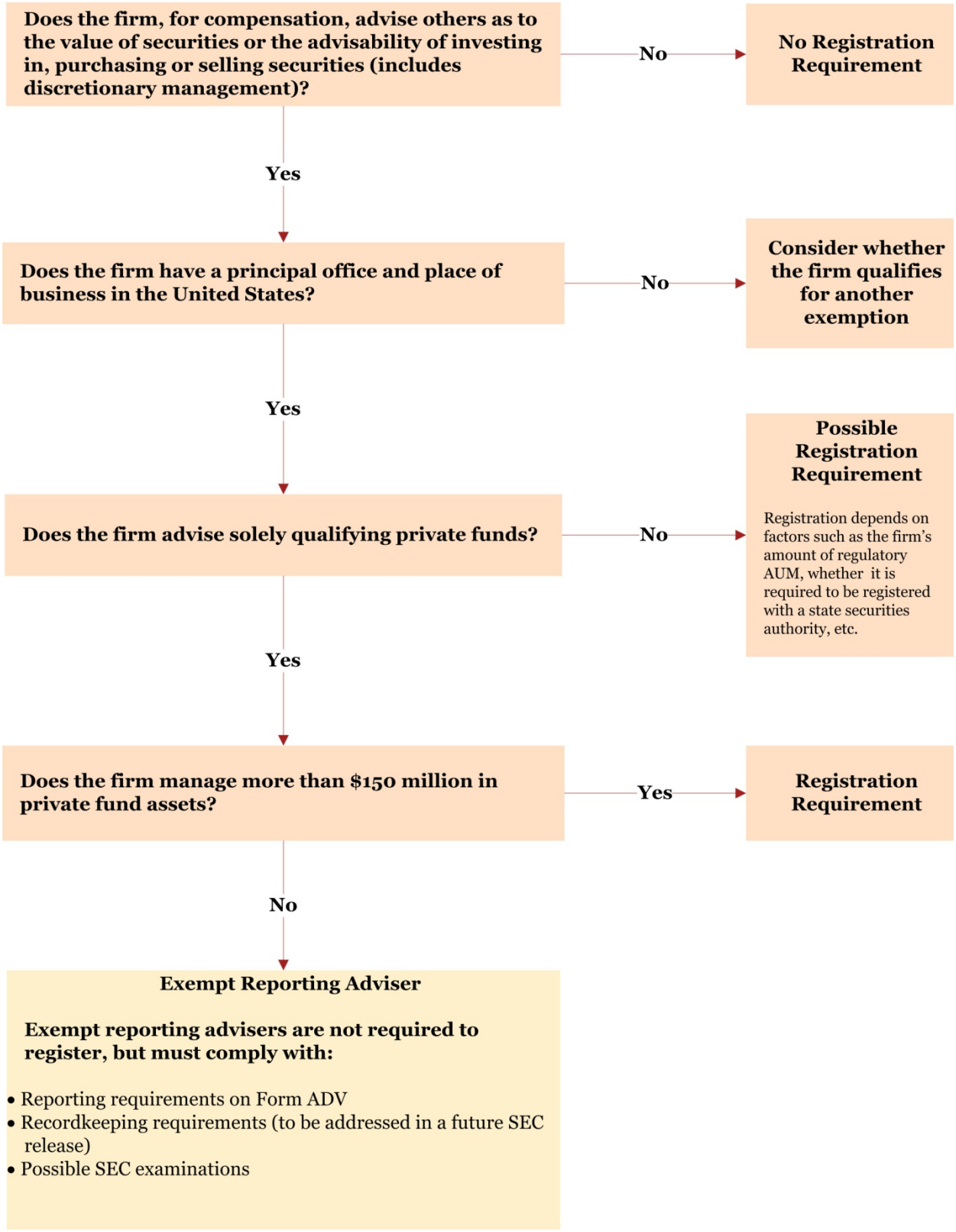
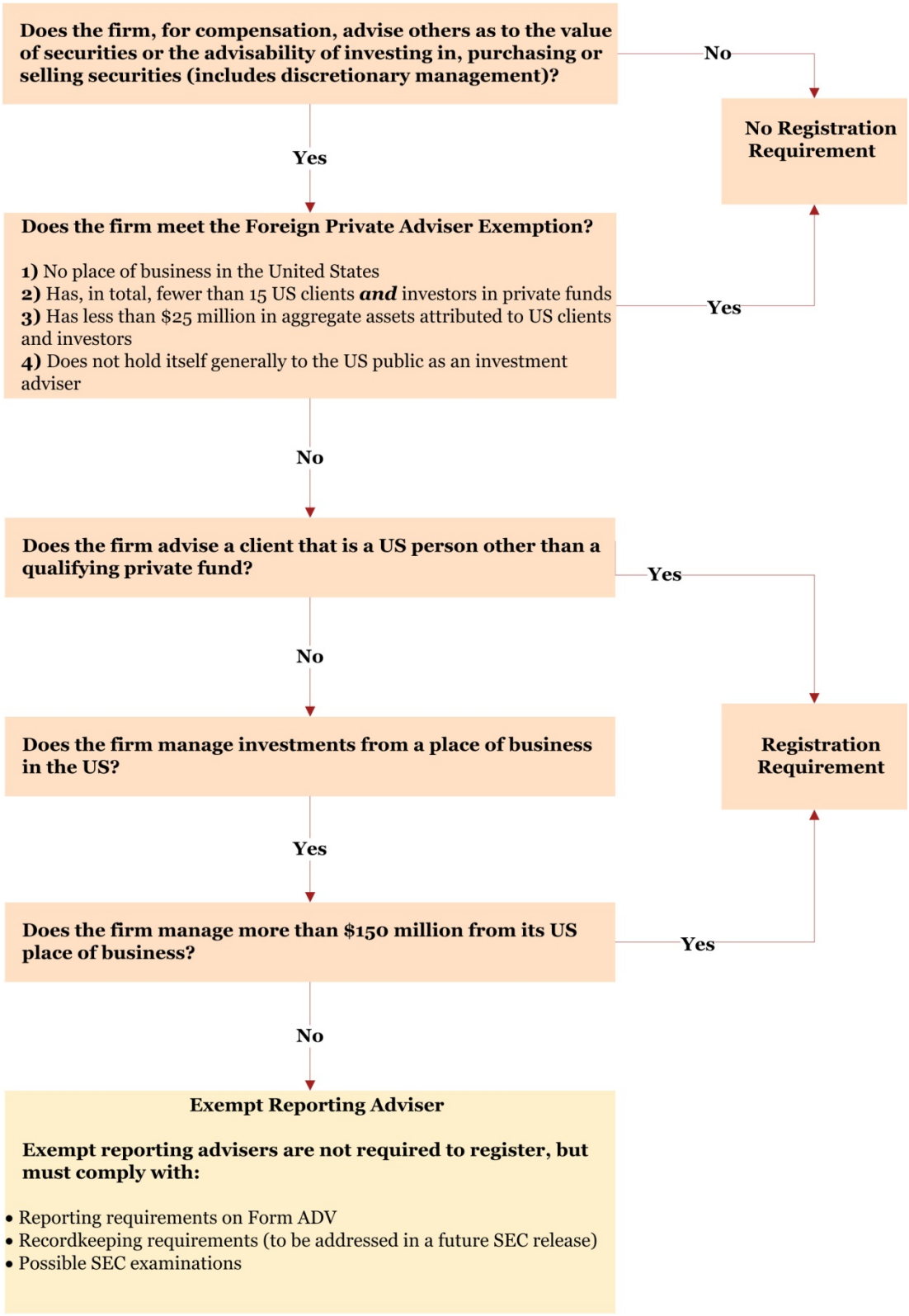
[16] Any company existing on July 21, 2011, that would qualify as a family office but for it having as a client one or more non-profit or charitable organizations that have received funding from one or more non-family clients will have until December 31, 2013, to comply with the terms of the exclusion.

US advisers to private funds: Determining whether registration is required



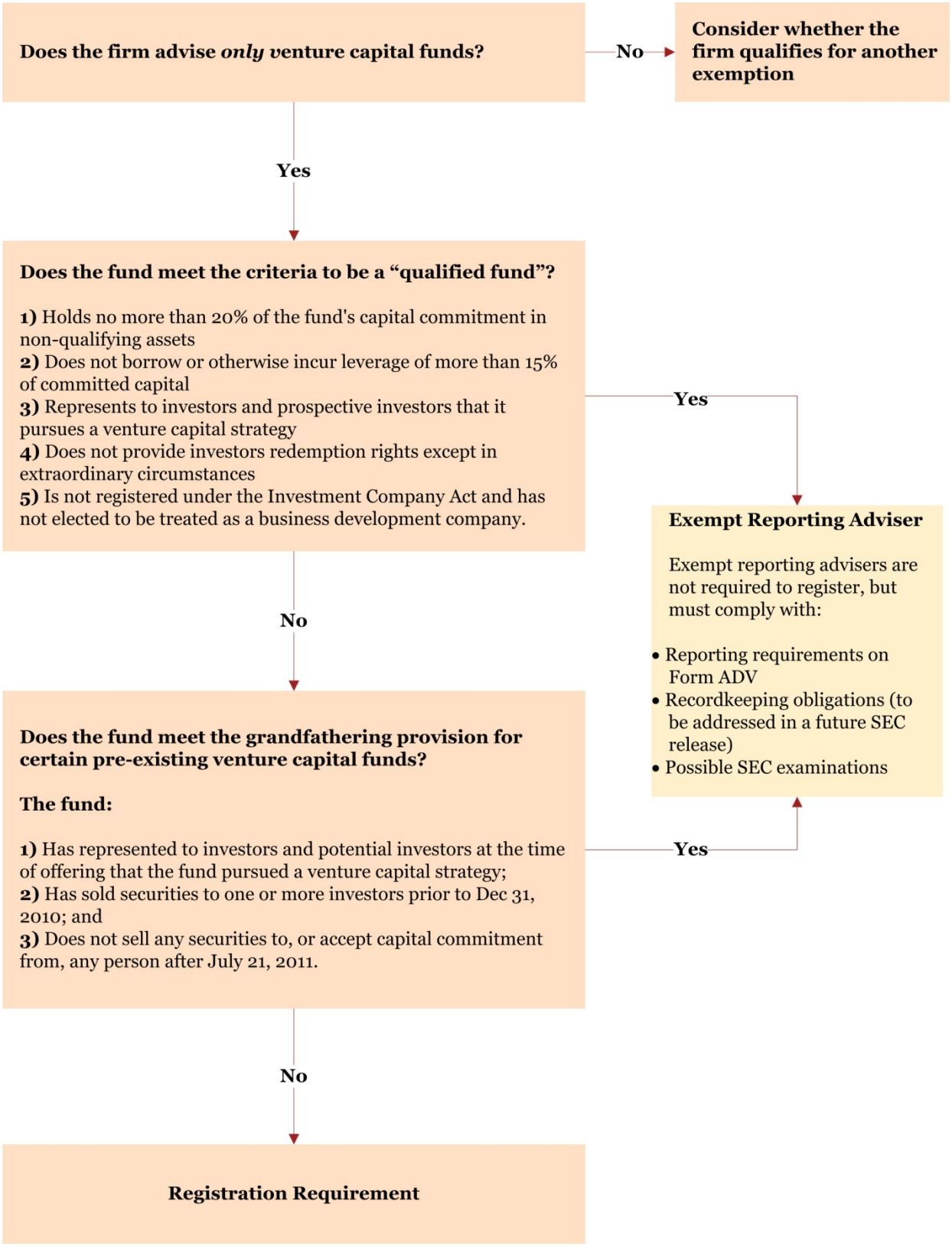
*These charts are provided to show the regulatory requirements. For legal advice on their application, we recommend you consult counsel.

Non-US advisers to private funds: Determining whether registration is required



*These charts are provided to show the regulatory requirements. For legal advice on their application, we recommend you consult counsel.

Advisers to venture capital funds: Determining whether registration is required



*These charts are provided to show the regulatory requirements. For legal advice on their application, we recommend you consult counsel.

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