



SEC Proposes Rules Implementing Investment Adviser Provisions of Dodd-Frank Act

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Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”), the Private Fund Investment Advisers Registration Act of 2010, amends the Investment Advisers Act of 1940 (“Advisers Act”) in various ways described below, effective, generally, on or before July 21, 2011.¹ The SEC has proposed rules to implement these amendments in two releases, Release IA-3110 (“Implementation Release”)² and Release IA -3111 (“Exemptions Release”).³

The rules proposed in the Implementation Release are discussed in Part I of this memorandum. They would (i) give effect to the increased threshold of assets under management that an investment adviser must have for purposes of Section 203A of the Advisers Act to register as an adviser with the SEC; (ii) require advisers to hedge funds and other “private funds” to register with the SEC; (iii) effect changes in certain of the SEC’s exemptions from the prohibition on federal registration by advisers with less than the threshold amount of assets under management contemplated by Section 203A of the Advisers Act; (iv) require reporting by certain advisers that are exempt from registration with the SEC; and (v) amend the SEC’s “pay to play” rule under the Advisers Act.

The rules proposed in the Exemptions Release are discussed in Part II of this memorandum. They would (i) define “venture capital fund” for purposes of an exemption that Dodd-Frank directs the SEC to afford to advisers to such funds; (ii) exempt from registration with the SEC advisers to private funds that have less than \$150 million in assets under management in the United States; and (iii) implement the new exemption available for advisers that qualify as “foreign private advisers.”

¹ Pub. L. No. 111-203, 124 Stat. 1376 (2010).

² See “Rules Implementing Amendments to the Investment Advisers Act of 1940”, Release No. IA-3110 Nov. 19, 2010), 75 FR 77052 (Dec. 10, 2010).

³ See “Exemptions for Advisers to Venture Capital Funds, Private Fund Issuers With Less Than \$150 Million in Assets Under Management, and Foreign Private Advisers,” Release No. IA-3111 (Nov. 19, 2010), 75 FR 77190 (Dec. 10, 2010).

Part I: Rules Proposed in the Implementation Release

Registration and Section 203A of the Adviser Act

Section 203A(a)(1) of the Adviser Act requires any investment adviser that is not “regulated or required to be regulated” as an investment adviser in the state in which it has its principal office and place of business (“domicile state”) to register with the SEC without regard to the amount of assets under management, and, conversely, prohibits an investment adviser that is so “regulated or required to be regulated” in its domicile state from registering with the SEC, unless the adviser meets one of several exceptions.⁴ One of the exceptions allows federal registration to investment advisers with assets under management of \$30 million or more.⁵

Mid-Sized Advisers and Minimum Threshold For Registration Change

Section 410 of Dodd-Frank amends Section 203A of the Advisers Act to prohibit any investment adviser that has assets under management between \$25 million and \$100 million (“Mid-Sized Adviser”) and that is registered as an adviser in its domicile state from registering as an investment adviser with the SEC. This effectively raises the minimum amount of assets under management by an adviser required to register with the SEC from \$25 million to \$100 million, except in the case of a Mid-Sized Adviser that is an adviser to a registered investment company or a company that has elected to be a business development company under the Investment Company Act of 1940 (“Company Act”). In addition, unlike smaller advisers, a Mid-Sized Adviser may register with the SEC if (i) it is

⁴ See, e.g., Advisers Act Rules 203A-1 and 203-2. Investment advisers that do not meet one of the exceptions to the prohibition against registering with the SEC are required to comply with domicile state investment adviser registration provisions and regulations. The states are preempted from requiring the registration of federally registered investment advisers (but not their associated persons), although the anti-fraud provisions of the Advisers Act nevertheless apply.

⁵ While Section 203A(a)(1) currently sets the threshold for federal registration at \$25 million in assets under management, Advisers Act Rule 203A-1 increases the mandatory threshold for federal registration to \$30 million, thereby providing a “buffer” for advisers whose assets might fluctuate in value during the year, triggering unnecessary and burdensome shuttling between federal and state registration. This problem is now proposed to be resolved differently, permitting advisers to use as a reference point for this purpose assets under management as reported at year-end regardless of intra-year changes. The existing “buffer” is proposed to be eliminated. Rule 203A-1 also provides that certain investment advisers with assets under management of at least \$25 million but not more than \$30 million may, but generally are not required to, register with the SEC.

not required to be registered in its domicile state, (ii) even if it was so registered, it would not be subject to examination by the securities commissioner (or similar authority) of the domicile state, or (iii) it would be required to register with 15 or more states.⁶

A Mid-Sized Adviser that relies on an exemption under the laws of its domicile state to avoid registration in that state must instead register with the SEC, unless an exemption from federal registration is available. The SEC will rely on state securities regulators to determine whether advisers in their states are subject to examination. A Mid-Sized Adviser will be required to affirm, when filing its original Form ADV and annually thereafter, that it is not required to be registered as an adviser with its domicile state.

The SEC estimates that, as a result of these changes, 4,100 SEC-registered advisers will be required to withdraw their federal registrations and re-register with the various states. To facilitate this, the SEC proposes to require each adviser to file an amendment to its Form ADV by August 20, 2011, stating the market value of the adviser's assets under management to enable the SEC and the states to determine registration eligibility. Advisers no longer eligible for federal registration would be required to file Form ADV-W no later than October 19, 2011. The grace period provided for the transition from federal to state registration is proposed to be reduced to 90 days from the current 180 days under Rule 203A-1(b)(2).

"Regulatory Assets Under Management"

All investment advisers will be required to state in their Forms ADV whether, under amended Section 203A of the Advisers Act and the rules thereunder, they are eligible to register with the SEC and why. The SEC states that it expects to modify the IARD system to prevent applicants from registering with the SEC unless they meet applicable eligibility criteria.

The SEC also proposes to amend the instructions to Form ADV to implement a uniform method of calculating "assets under management" for the purpose of ascertaining whether an adviser is eligible for federal registration. This change is intended to eliminate an

⁶ See discussion of proposed changes to Rule 203A-2, *infra* at section entitled "Proposed Changes to Rule 203A-2."

adviser's ability to decide between federal and state regulation by including or excluding various asset classes in calculating their "assets under management." This would be achieved by requiring the amount of such assets to be determined by reference to what the SEC proposes to define as "regulatory assets under management."⁷

"Regulatory assets under management" would include all securities portfolios for which an adviser provides continuous and regular supervisory or management services regardless of whether they are proprietary assets, assets managed without receiving compensation, or assets of foreign clients. Advisers would not be permitted to subtract outstanding indebtedness and other accrued but unpaid liabilities from the market value of such assets in fixing their value. In addition, "regulatory assets under management" would include the value of any private fund over which the adviser exercises continuous and regular supervisory or management services regardless of the nature of the assets held by the fund and would include the amount of any uncalled capital commitments made to the fund. The SEC proposes to instruct advisers that they must use the fair value of private fund assets for this purpose rather than an alternative measure (*e.g.*, "cost").⁸

Proposed Changes to Rule 203A-2

Advisers Act Rule 203A-2 sets forth six exemptions that, in effect, allow advisers meeting the terms of those exemptions to register with the SEC. Among other things, the proposed amendments to this Rule would increase the assets under management threshold for pension consultants in Rule 203A-2(b) from \$50 million to \$200 million, and align the multi-state adviser exemption with the Dodd-Frank requirements for Mid-Sized Advisers. Regarding the latter, current Rule 203A-2(e) allows an investment adviser required by the laws of 30 or more states to register as an investment adviser to register with the SEC, and

⁷ See proposed Rules 203(m)-1(a)(2), 203(m)-1(b)(2), and 203(m)-1(e)(1) and proposed Item 5.F of Form ADV, Part IA.

⁸ The value of such assets, the SEC acknowledges, is not always calculated today in accordance with U.S. generally accepted accounting principles ("GAAP") or other international accounting standards, and the SEC does not propose to require this. The SEC further observes that some private funds do not now use fair value methodologies for this purpose today, perhaps because such methodologies can be difficult to apply when a fund holds illiquid or other types of assets that are not traded on organized markets (*e.g.*, "distressed debt" or emerging market securities not readily marketable). The proposed amendments to the instructions for preparation of Form ADV, however, would explicitly require the adviser to determine the "current market value (or fair value)" of the assets of private funds when calculating "regulatory assets under management."

the adviser is not required to withdraw its federal registration until it is required to register in fewer than 25 states. In the SEC's view, Congress determined that adviser registration in 15 or more states constituted a sufficient regulatory burden to permit federal registration of Mid-Sized Advisers, and the SEC proposes to extend that same standard to all advisers. The SEC, however, also proposes to eliminate any cushion so that, if an investment adviser is not required to register in 15 states, it will no longer be eligible for this exemption.

Reporting Requirements for Certain Exempt Advisers

As noted in Part II, below, while Section 203(l) of the Advisers Act exempts from registration an adviser that advises solely venture capital funds and Section 203(m) exempts any adviser that acts solely as an adviser to private funds and has assets under management in the United States of less than \$150 million, those advisers are nevertheless subject to books and records requirements and must submit such reports to the SEC as it "determines necessary or appropriate in the public interest." The SEC has proposed that these exempt advisers be required to submit, and periodically update, a subset of the items on Form ADV. These items would include identifying information as well as information relating to the form of the adviser's organization, its other business activities, its financial industry affiliations and private fund reporting, its control persons, and disciplinary history of the adviser and its associated persons. These reports would be submitted through IARD, advisers would be required to pay a filing fee, and the reports would be publicly available through the SEC's Web site.

Amendments to Form ADV

To implement the various statutory changes and rule proposals discussed herein, the SEC is proposing to amend Form ADV in numerous ways. For instance, it proposes to modify the scope of current Item 7 such that an adviser to a private fund is required to complete Section 7.B of Schedule D only for those private funds that the adviser, and not a related person, advises.⁹ This change will require advisers to report on pooled investment vehicles no matter how they are organized. Furthermore, sub-advisers will be able to exclude private funds for which an adviser is reporting on its Schedule D, and advisers sponsoring master-feeder arrangements would be permitted to submit a single Schedule D for the

⁹ Currently, Item 7 requires advisers to complete Section 7.B for any "investment-related limited partnership" that the adviser or a related person advises.

master fund and all of the feeder funds that otherwise would be submitting substantially similar information. Foreign advisers would be permitted to omit Schedule D for a private fund not organized in the United States and that is not offered to, or owned by, U.S. persons. The SEC also is proposing to significantly expand the types and amount of information that must be disclosed pursuant to Section 7.B of Schedule D (*e.g.*, assets and liabilities held by class and categorization in the fair value hierarchy established by GAAP, and information concerning service providers to private funds, such as auditors, prime brokers, administrators, and marketers).

In addition, the SEC has proposed to expand Item 5 of Part 1A of Form ADV – which requires information about the number of employees, assets under management, the number and type of the adviser’s clients, and the types of advisory services offered – in order to help it, and the public, better understand the operations of advisers. Additional disclosures are to be required under Items 6 and 7 of Schedule D, such as the disclosure of other lines of business engaged in by the adviser under another name (*e.g.*, an insurance business) and the provision of identifying information and details about the relationship for any related persons listed in Item 7.A (not just those that are investment advisers or broker-dealers, as required under the current rules). Item 8 – which requires an adviser to report on its transactions with clients and whether it has discretionary authority to determine, or make recommendations regarding, the broker-dealers for client transactions – is to be amended to, among other things, require additional disclosure as to whether any of the broker-dealers are related persons of the adviser and require an adviser that receives soft dollar benefits to report whether those benefits fall within the safe harbor found in Section 28(e) of the Exchange Act.

Amendments to the “Pay to Play” Rule

The SEC has proposed to amend Advisers Act Rule 206(4)-5, which generally prohibits registered and certain unregistered advisers from engaging directly or indirectly in pay to play practices set forth in the Rule, to conform to Dodd-Frank. First, the rule is to be expanded to apply to exempt reporting advisers and foreign private advisers. Second, an adviser is to be permitted under the Rule to pay any “regulated municipal advisor” to solicit

government entities on its behalf.¹⁰ Finally, the term “covered associate” is to be amended to make clear that a legal entity, in addition to a natural person, that is a general partner or managing member of an investment adviser would fall within the definition.

Part II: Rules Proposed in the Exemptions Release

Amendments to Advisers Act’s Private Adviser Exemption

Dodd-Frank repealed Section 203(b)(3) of the Advisers Act, effective July 21, 2011, which currently exempts any investment adviser from registration if the investment adviser (i) has had fewer than 15 clients in the preceding 12 months, (ii) does not hold itself out to the public as an investment adviser, and (iii) does not act as an investment adviser to a registered investment company or a business development company (“private adviser exemption”).¹¹ Advisers exempted pursuant to Section 203(b) are not currently subject to reporting or recordkeeping obligations and are not subject to examination by SEC staff.

By repealing Section 203(b)(3), Congress intended to require advisers to “private funds”¹² (*i.e.*, hedge funds, private equity funds, and other pooled investment vehicles that are exempted from the definition of “investment company” under Sections 3(c)(1) or 3(c)(7) of the Company Act)¹³ to register under the Advisers Act.¹⁴ As stated above, unless another

¹⁰ A “regulated municipal advisor” under the proposed rule would be a person registered under Section 15B of the Exchange Act and subject to MSRB pay to play rules. Section 957 of Dodd-Frank creates a new category of persons called “municipal advisors,” which includes persons engaged in soliciting municipal entities (*e.g.*, third party solicitors, registered investment advisers and broker-dealers), which are subject to MSRB rules. The MSRB is considering making such persons subject to MSRB pay to play rules. The SEC proposes to remove the reference to FINRA in Rule 206(4)-5 and replace it with a reference to the MSRB, since all such “regulated municipal advisors” will be subject to MSRB rules.

¹¹ See Section 403 of Dodd-Frank.

¹² 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.”

¹³ Section 3(c)(1) of the Company Act exempts funds that do not publicly offer the securities they issue and have 100 or fewer beneficial owners of their outstanding securities. Section 3(c)(7) exempts funds that do not publicly offer their securities and limit owners of their outstanding securities to “qualified purchasers.” Section 2(a)(51) of the Company Act defines the term “qualified purchaser” to include: (i) natural persons who, with their spouse, own not less than \$5 million in investments; (ii) any company that owns not less than \$5 million in investments and is owned by two or more persons related as siblings or spouse (including former spouse), direct lineal descendants of

exemption applies, advisers to private funds will have to register as investment advisers with the SEC, effective July 21, 2011.

Statutory Exemptions from Registration as Investment Adviser

Dodd-Frank created three new exemptions from registration under the Advisers Act. These exemptions apply to (i) advisers solely to venture capital funds, without regard to the number of such funds or the aggregate dollar amount of such funds; (ii) advisers solely to private funds with less than \$150 million in assets under management in the United States, without regard to the number or type of funds advised; and (iii) non-U.S. advisers with less than \$25 million in aggregate assets under management from U.S. clients and private fund investors, and fewer than 15 such clients and investors.¹⁵

Definition of Venture Capital Fund

Proposed Rule 203(l)-1 under the Advisers Act would define a “venture capital fund” as a private fund that: (i) invests in equity securities¹⁶ of private companies in order to provide operating and business expansion capital (“qualifying portfolio companies”) and at least

such persons by birth or adoption, spouses of such persons, or foundations, charitable organizations, or trusts established by or for the benefit of such persons; (iii) any trust not included in clause (ii) and that was not formed for the specific purpose of acquiring the securities offered, as to which the trustee or other person authorized to make decisions with respect to the trust, and each settler or other person who has contributed to the trust is described in clauses (i), (ii) or (iv); and (iv) any person acting for its own account or the accounts of other qualified purchasers who in the aggregate owns and invests on a discretionary basis, not less than \$25 million in investments.

¹⁴ Prior to 2004, when the SEC took action to compel registration of most hedge fund managers, each of these types of private funds advised by an adviser typically qualified as a single client for purposes of the private adviser exemption, permitting such advisers to form up to 14 exempted funds without needing to register under the Advisers Act. Upon adoption of Rules 203(b)(3)-1(d) and 203(b)(3)(2) under the Advisers Act (“Hedge Fund Rules”), however, hedge fund managers were required to register as investment advisers if, after counting each investor in the fund as a “client” for purposes of the private adviser exemption, the manager could no longer rely on that exemption. The Hedge Fund Rules were vacated by the DC Circuit Court of Appeals in 2006. See *Goldstein v. Securities and Exchange Commission*, 451 F. 3d 873 (D.C. Cir. June 23, 2006). Dodd-Frank reversed this result and belatedly the SEC now proposes to rescind the Hedge Fund Rules.

¹⁵ See Section 402 of Dodd-Frank.

¹⁶ A fund would not qualify as a venture capital fund if it invested in debt instruments of a portfolio company or otherwise lent money to a portfolio company. The proposed rule would use the definition of “equity security” in Section 3(a)(11) of the Securities Exchange Act of 1934 (“Exchange Act”) and Exchange Act Rule 3a11-1 thereunder, which include common stock, preferred stock, warrants and other securities convertible into equity securities, as well as limited partnership interests.

80% of each company's securities are owned by the fund and were acquired directly from the qualifying portfolio company; (ii) directly or through its investment advisers, offers or provides significant managerial assistance to, or controls, the qualifying portfolio company; (iii) does not borrow or otherwise incur leverage (other than limited short-term borrowing); (iv) does not offer its investors redemption or other similar liquidity rights except in extraordinary circumstances; (v) represents itself as a venture capital fund to investors; and (vi) is not a registered investment company or a business development company.¹⁷

Elements of Venture Capital Fund Definition

Qualifying Portfolio Company. Qualifying portfolio companies are defined generally to include any company that (i) is not publicly traded;¹⁸ (ii) does not incur leverage in connection with the investment by the private fund;¹⁹ (iii) uses the capital provided by the fund for operating or business expansion purposes rather than to buy out other investors;²⁰ and (iv) is not itself a fund.²¹ In addition to equity securities, venture capital funds would

¹⁷ See proposed Rule 203(1)-1(a). The SEC also proposed to grandfather existing venture capital funds if they satisfy certain criteria under the grandfathering provision, discussed below. An adviser would be eligible to rely on the exemption under Section 203(l) of the Advisers Act only if it advised solely venture capital funds that met all of the elements of the proposed definition or if it were grandfathered.

¹⁸ At the time of each investment by the venture capital fund, the qualifying portfolio company could not be publicly traded, nor could it control, be controlled by, or be under common control with a publicly traded company. A venture capital fund, however, could continue to hold securities of a qualifying portfolio company that subsequently becomes public.

¹⁹ The proposed exemption would exclude companies that borrow in connection with a venture capital fund's investment, but would not exclude companies that borrow in the ordinary course of their business (*e.g.*, to finance inventory or capital equipment, manage cash flows, and meet payroll). The proposal would generally view any financing or loan (unless it met the definition of equity security) to a portfolio company that was provided by, or was a condition of a contractual obligation with, a fund or its adviser as part of the fund's investment as being "in connection with" the fund's investment.

²⁰ The SEC believes this condition is necessary to distinguish venture capital funds that provide capital to portfolio companies for operating and business purposes, from leverage buyout funds, which acquire controlling interests in companies from the buy out of existing shareholders. Therefore, in addition to the requirement that the fund does not redeem or repurchase securities from shareholders, the qualifying portfolio company may not distribute company assets to other security holders in connection with a venture capital fund's investments in the company. Also, unlike many hedge funds and private equity funds, venture capital funds invest capital directly into portfolio companies for the purposes of expansion and business development of the company's business, rather than buying out existing shareholders or leveraging the capital investment with debt financing.

²¹ The proposed exemption would exclude investments in other private funds or pooled vehicles.

be permitted to hold cash (and cash equivalents)²² and U.S. Treasury securities with a remaining security of 60 days or less.

Managerial Assistance or Control. The SEC stated that managerial assistance generally takes the form of active involvement in the business, operations or management of the portfolio company, or less active forms of control of the portfolio company, such as through board representation or similar voting rights. Because the nature of managerial assistance may change over time as the needs of qualifying portfolio companies change, the proposed rule does not specify that managerial assistance has a fixed character.

The SEC modeled its approach to managerial assistance, in part, on existing provisions under the Advisers Act and the Company Act dealing with business development companies. In contrast to Rule 2(a)(47) of the Company Act, however, which defines “making available significant managerial assistance” by a business development company, proposed Rule 203(l)-1 does not specifically define “managerial assistance” by referring to a fund’s directors, officers, employees or general partners or address how managerial assistance is determined for funds that invest as a group. Where venture capital funds invest as a group, proposed Rule 203(l)-1 would require that each fund (or its adviser) offer, and if accepted, provide, managerial assistance or instead exercise control over the portfolio company.

Borrowing or Leverage. Under proposed Rule 203(l)-1, an exempt 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, and any such borrowing, indebtedness, guarantee or leverage must be for a non-renewable term of no longer than 120 calendar days. This criterion regarding leverage at the fund level is in addition to the conditions relating to a qualifying portfolio company’s debt issuances in connection with the fund’s investment, to prevent a fund from avoiding the borrowing restrictions at the company level by incurring leverage at the fund level.

Under the proposal, a venture capital fund could issue commercial paper, since the rule does not specify the types of instruments the fund may issue. The SEC seeks comment on

²² The proposed venture capital exemption would define “cash and cash equivalents” by reference to Company Act Rule 2a51-1. The proposed exemption would not look to whether the cash was held specifically for investment purposes.

whether it should specifically exclude or otherwise limit the use of commercial paper to prevent funds from using repeated short-term commercial paper issuances to effectively create long-term debt issuances.

Redemption Rights Solely in Extraordinary Circumstances. Proposed Rule 203(I)-1 would limit venture capital funds to funds that “[o]nly issue[] securities, the terms of which do not provide a holder with any right, except in extraordinary circumstances, to withdraw, redeem or require the repurchase of such securities, but may entitle holders to receive distributions made to all holders pro rata.” They also may provide extraordinary rights for an investor to withdraw from the fund under foreseeable but unexpected circumstances or rights to be excluded from particular investments due to regulatory or other legal requirements. For example, changes in law or corporate mergers might require a redemption of securities where the legal or other change prohibits the investor’s participation in the fund’s investments in particular countries or industries. The trigger for these events typically would be beyond the control of the fund’s adviser. A fund that permitted quarterly or other periodic withdrawals would be considered to have granted investors redemption rights in the ordinary course even if those rights may be subject to an initial lock-up or suspension or restrictions on redemption. Note, however, that the proposed rule does not specify a minimum investment period.

Represents Itself As Venture Capital Fund. A private fund could satisfy this requirement by, for example, describing its investment strategy as venture capital investing or as a fund that is managed in compliance with the elements of the proposed rule. An adviser to a venture capital fund that is otherwise relying on the proposed rule could not identify the fund as a hedge fund or a multi-strategy fund (*i.e.*, venture capital is one of the strategies used to manage the fund) or include in the fund a hedge fund database or hedge fund index.

Treatment of Non-U.S. Advisers

The SEC also seeks comment on whether investment advisers with their principal office and place of business outside the United States (“non-U.S. Advisers”) should be able to rely on the exemption even if they advise funds that do not meet the proposed definition of venture capital fund. For example, a non-U.S. Adviser currently may rely on the private adviser exemption if it meets the conditions of Advisers Act Section 203(b)(3), including that it

advises not more than 14 clients. For this purpose, a private fund incorporated outside the United States is not considered a U.S. resident. In this regard, the SEC seeks comment specifically on whether a non-U.S. Adviser may avail itself of the venture capital fund exemption even if it advises clients other than venture capital funds, provided such other clients are non-U.S. persons.²³ Should the non-U.S. Adviser be able to do so, even if it advises those non-U.S. persons from within the United States? Should a non-U.S. fund be considered a private fund under the proposed rule if the non-U.S. fund would be deemed a private fund upon conducting a private offering in the United States in reliance on Sections 3(c)(1) or 3(c)(7) of the Company Act?

Grandfathering Provision

The SEC also proposed to include in the definition of “venture capital fund” any private fund that: (i) represented to investors and potential investors at the time the fund offered its securities that it is a venture capital fund; (ii) has sold securities to one or more investors prior to December 31, 2010; and (iii) does not sell any securities to, including accepting any additional capital commitments from, any person after July 21, 2011 (“Grandfathering Provision”).²⁴

Exemption for Investment Advisers Solely to Private Funds with Less than \$150 Million in Assets under Management

Section 203(m) of the Advisers Act directs the SEC to exempt from registration any investment adviser solely to private funds that has less than \$150 million in assets under management in the United States. Pursuant to this requirement, the SEC proposed Rule 203(m) under the Advisers Act to implement the exemption (“private fund adviser exemption”) and address certain interpretive questions raised by new Advisers Act Section 203(m).

Proposed Rule 203(m)-1 would limit the exemption to an adviser advising “private funds” as that term is defined in Section 202(a)(29) of the Advisers Act. An adviser could advise an

²³ The SEC proposes to apply the Regulation S definition of United States, as discussed *infra* at section entitled “Definition of ‘In the United States.’”

²⁴ The Grandfathering Provision would include any fund that has accepted capital commitments by the specified dates even if none of the commitments have been called.

unlimited number of private funds, provided that its aggregate assets under management in the United States is less than \$150 million. Non-U.S. Advisers could rely on the private fund adviser exemption, provided that all of the adviser's clients that are United States persons are qualifying private funds. As a result, a non-U.S. Adviser could enter the U.S. market and take advantage of the exemption without regard to the number or type of its non-U.S. clients.

Proposed Rule 203(m)-1 would require an adviser to aggregate the value of all assets of private funds it manages in the United States to determine if the adviser remains below the \$150 million threshold. The proposed rule would require the adviser to calculate the value of private fund assets by reference to Form ADV, under which the SEC proposed a uniform method of calculating assets under management for regulatory purposes under the Advisers Act, as discussed above.²⁵ In the case of a sub-adviser, it would have to count only that portion of the private fund assets for which it has responsibility. Under the proposed rule, each adviser would have to determine the amount of its private fund assets quarterly, based on the fair value of assets at the end of the quarter.²⁶

Proposed Rule 203(m)-1 would consider all of the private fund assets of an adviser with a principal office and place of business in the United States to be "assets under management in the United States," even if the adviser has offices outside the United States.²⁷ A non-U.S. Adviser, however, would need only count private fund assets its manages from a place of business in the United States toward the \$150 million asset limit under the exemption.²⁸ The SEC asked for comment on whether it should adopt a different approach that more

²⁵ See discussion, *supra* at text accompanying notes 7-8.

²⁶ See note 8, *supra*.

²⁷ An adviser's principal office and place of business would be the location where the adviser controls, or has ultimate responsibility for the management of private fund assets, and therefore as 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. The SEC considered but rejected an approach that would presume that a non-U.S. Adviser to private funds offered in the United States would have no assets managed from a location in the United States if its principal office and place of business were not in the United States. Such an approach, the SEC believes, would permit an adviser engaging in substantial advisory activities in the United States to escape the SEC's regulatory oversight, merely because the adviser's principal office and place of business are outside the United States.

²⁸ Moreover, any assets managed from a U.S. place of business for clients other than private funds would make the exemption unavailable.

broadly makes available the private fund adviser exemption to U.S. advisers. For example, it could treat both U.S. and non-U.S. Advisers alike, in which case, a U.S. adviser could exclude assets it manages through non-U.S. offices.²⁹

Under proposed Rule 203(m)-1(e)(8), the SEC proposed to define the term “U.S. person” generally by incorporating the definition of U.S. person in Regulation S under the Securities Act of 1933.³⁰ That definition looks generally to the residence of an individual to determine whether the individual is a U.S. person, and also addresses the circumstances under which a legal person, such as a trust, partnership or a corporation is a U.S. person. Regulation S generally treats legal partnerships and corporations as U.S. persons if they are organized or incorporated in the United States, and trusts by reference to the residence of the trustee. It treats discretionary accounts as U.S. persons if the fiduciary is a resident of the United States.³¹

Proposed Rule 203(m)-1(d) would give an adviser three months to register with the SEC after becoming ineligible to rely on the exemption due to an increase in the value of its private fund assets. Because qualification for the exemption depends on remaining below the \$150 million threshold on a quarterly basis, an adviser could exceed the limit based on market fluctuations without any new investments from existing or new investors. The three month period would be intended to enable the adviser to take steps to register and otherwise come into compliance with the requirements of the Advisers Act applicable to registered investment advisers, including the adoption and implementation of compliance

²⁹ Alternatively, the SEC asks if it should interpret “assets under management in the United States” by reference to the source of the assets. Under that approach, a non-U.S. Adviser would count assets of private funds attributable to U.S. investors towards the \$150 million threshold, regardless of the location from which it manages the private funds. This approach could have the result that fewer non-U.S. Advisers would be eligible for the exemption, if there are significant assets of U.S. investors in those funds that the non-U.S. Adviser manages from a non-U.S. location. It also would mean that a U.S. adviser managing assets from the U.S. could manage substantially in excess of \$150 million in assets of one or more private funds as long as the investors in those funds were not U.S. persons.

³⁰ 17 CFR 230.902(k)(1) and (2).

³¹ Proposed Rule 203(m)-1(e)(8) contains a special rule for discretionary accounts maintained outside the United States for the benefit of U.S. persons. Under the proposed rule, the adviser must treat a discretionary account or other fiduciary account as a U.S. person if the account is held for the benefit of a U.S. person by a non-U.S. fiduciary who is a related person of the adviser. An adviser could not rely on the exemption if it established discretionary accounts for the benefit of U.S. clients with an offshore affiliate that would then delegate the actual management of the account back to the adviser.

policies and procedures. It would be available solely to an adviser that has complied with all applicable SEC reporting requirements.

Foreign Private Advisers

Section 403 of Dodd-Frank replaces the current private adviser exemption from registration under the Advisers Act with a new exemption for “foreign private advisers,” as defined in Advisers Act Section 202(a)(30). Under Section 202(a)(30), a foreign private adviser is any investment adviser that: (i) has no place of business in the United States; (ii) has, in total, fewer than 15 clients in the United States and investors in the United States in private funds advised by the investment adviser; (iii) has aggregate assets under management attributable to clients in the United States and investors in the United States in private funds advised by the adviser of less than \$25 million; and (iv) does not hold itself out generally to the public in the United States as an investment adviser.³²

For purposes of counting clients, proposed Rule 202(a)(30)-1 would include the safe harbor for counting clients contained in current rule 203(b)(3)-1, as modified to account for its use in the foreign private adviser context and to eliminate a provision allowing advisers not to count clients from which they receive no compensation. The foreign private adviser exemption therefore provides a much more limited exemption than current Rule 203(b)(3)-1 because it requires an adviser to count investors of an issuer that is a private fund. Proposed Rule 202(a)(30)-1 would define certain terms in the foreign private adviser exemption, including: (i) “client;” (ii) “investor;” (iii) “in the United States;” (iv) “place of business;” and (v) “assets under management.”

Definition of “Client”

Proposed Rule 202(a)(30)-1 would allow an adviser to treat as a single client a natural person and: (i) that person’s minor children (whether or not they share the natural person’s principal residence); (ii) any relative, spouse, or relative of the spouse of the natural person who has the same principal residence; (iii) 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 primary beneficiaries; and (iv) all trusts of which the natural

³² Section 202(a)(30) provides the SEC with the authority to increase the \$25 million threshold “in accordance with the purposes of” the Advisers Act.

person and/or the natural person's minor child or relative, spouse or relative of the spouse who has the same principal residence are the only primary beneficiaries. Proposed Rule 202(a)(30)-1 would also retain other provisions of current Rule 203(b)(3)-1 that permit an adviser to treat as a single "client" (i) a corporation, general partnership, limited partnership, limited liability company, trust, or other legal organization to which the adviser provides investment advice based on the organization's investment objectives; and (ii) two or more legal organizations that have identical shareholders, partners, limited partners, members, or beneficiaries.³³ As mentioned above, the proposed rule would not permit the adviser to exclude persons for whom the adviser provides investment advisory services without compensation.³⁴ Finally, the SEC proposes to add a provision that would avoid double-counting private funds and their investors by advisers. The provision would specify that an adviser need not count a private fund as a client if the adviser counted any investor, as defined in the rule, in that private fund for purposes of determining the availability of the exemption.

Definition of "Investor"

Section 202(a)(30) of the Adviser Act also provides that a "foreign private adviser" eligible for the new registration exemption cannot have more than 14 clients or "investors in the United States in private funds" advised by the adviser. Proposed Rule 202(a)(30)-1 would define "investor" in a private fund as any 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 Company Act, or determining whether the outstanding securities of a private fund are owned exclusively by qualified purchasers under Section 3(c)(7) of the Company Act. To avoid double counting, an adviser would be permitted to treat as a single investor

³³ In addition, proposed Rules 202(a)(30)-1(b)(1) through (3) would retain the following related "special rules:" (i) an adviser must count a shareholder, partner, limited partner, member, or beneficiary (each, an "owner") of a corporation, general partnership, limited partnership, limited liability company, trust or other legal organization, as a client if the adviser provides investment advisory services to the owner separate and apart from the legal organization; (ii) an adviser is not required to count an owner as a client solely because the adviser, on behalf of the legal organization, offers, promotes, or sells interests in the legal organization to the owner, or reports periodically to the owners as a group solely with respect to the performance of or plans for the legal organization's assets or similar matters; and (iii) any general partner, managing member or other person acting as an investment adviser to a limited partnership or limited liability company must treat the partnership or limited liability company as a client.

³⁴ The SEC proposes to require advisers to include the assets of those clients in their "regulatory assets under management."

any person who is an investor in two or more private funds advised by the investment adviser.³⁵ Moreover, under the proposed rule, an adviser would 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. In this regard, the SEC would “look through” to determine whether a person should be counted as an investor under the foreign private adviser exemption.³⁶

The SEC also stated that it would treat as investors beneficial owners: (i) who are “knowledgeable employees” with respect to the private fund, and certain other persons related to such employees³⁷ (collectively, “knowledgeable employees”); and (ii) of “short-term paper”³⁸ issued by the private fund, even though those persons are not counted as beneficial owners for purposes of Sections 3(c)(1) or 3(c)(7) of the Company Act.

³⁵ In defining the term “investor” by reference to Sections 3(c)(1) and 3(c)(7) of the Company Act, the SEC proposes to make clear that the definition would apply to holders of both debt and equity securities. Moreover, it makes clear that advisers would have to “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.

³⁶ In the following circumstances, for example, an adviser relying on the exemption would have to count as an investor a person who is not the nominal owner of a private fund’s securities. First, 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. Second, an adviser would need to count as an investor any holder of an instrument, such as a total return swap, that effectively transfers the risk of investing in the private fund from the record owner of the private fund’s securities. The record owner of private fund securities could enter into a total return swap transaction to transfer to a third party any profits or losses that the record owner could incur as a result of its investment in the private fund. Thus, even though the record owner would remain the nominal owner of private fund securities, the associated risks of an investment in the securities would have been transferred to the third party who has made the determination to invest in the private fund indirectly through the record owner. In such a case, the third party would be counted as a beneficial owner under Section 3(c)(1), or be required to be a qualified purchaser under Section 3(c)(7). Accordingly, the third party would be counted as an investor in the private fund for purposes of the foreign private adviser exemption.

³⁷ For example, a company exclusively owned by knowledgeable employees and certain persons who acquire an interest in the securities through knowledgeable employees, such as through a gift or bequest.

³⁸ The SEC proposes to apply the Company Act Section 2(a)(38) definition of “short-term paper,” which includes any note, draft, bill of exchange, or bankers acceptance payable on demand or having a maturity at the time of issuance not exceeding nine months, exclusive of days of grace, or any renewal thereof payable on demand or having a maturity likewise limited; and such other classes of securities, of a commercial rather than an investment character, as the SEC may designate by rule or regulation.

Definition of “In the United States”

Section 202(a)(30) of the Advisers Act employs the term “in the United States” in several contexts, including: (i) limiting the number of — and assets under management attributable to — an adviser’s “clients” in the United States and “investors” in the United States in private funds advised by the adviser; (ii) exempting only those advisers without a place of business in the United States; and (iii) exempting only those advisers that do not hold themselves out to the public in the United States as an investment adviser. Proposed Rule 202(a)(30)-1 would define the term “in the United States,” by incorporating the definitions of “U.S. person” and “United States” under Regulation S. In particular, the SEC would define “in the United States” to mean: (i) with respect to any place of business located in the “United States,” as that term is defined in Regulation S; (ii) with respect to any client or private fund investor in the United States, any person that is a “U.S. person” as defined in Regulation S, except that 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 would be deemed “in the United States” if the dealer or other professional fiduciary is deemed “in the United States,” if the dealer or other professional fiduciary is a related person of the investment adviser relying on the exemption; and (iii) with respect to the public in the “United States” as that term is used in Regulation S. The SEC also proposed to add a note to paragraph (c)(2)(i) of the proposed rule specifying that for purposes of the definition, a person that is “in the United States” may be treated as not being “in the United States” if such person was not “in the United States” at the time of becoming a client, or in the case of an investor in a private fund, the investor acquiring the securities issued by the fund.³⁹

Definition of “Place of Business”

Proposed Rule 202(a)(30)-1, by reference to proposed Rule 222-1, would define “place of business” to mean 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. The proposed rule would also define “assets under management” by reference to the calculation of

³⁹ This note is intended to alleviate the unintended burden on foreign advisers from needing to monitor the location of clients on an ongoing basis, or choosing between terminating a client relationship or registering with the SEC as an investment adviser because a client moved to the United States from offshore.

“regulatory assets under management” for Item 5 of Form ADV, as described above. As mentioned above, this would allow the SEC to impose a uniform calculation of assets under management for several purposes under the Advisers Act, including the foreign private adviser exemption.

Applicability of New Exemptions to Sub-Advisers

The SEC clarified in the proposing release that because it generally interprets advisers as including sub-advisers, it believes it would be appropriate to permit sub-advisers to rely on each of the new exemptions, provided the sub-advisers satisfy all the terms and conditions of the applicable proposed rules. The SEC stated it is aware that in many instances, the sub-adviser has contractual privity with the private fund’s primary adviser, rather than with the fund itself. Although both the private fund and the fund’s primary adviser may be viewed as clients of the sub-adviser, the SEC would consider a sub-adviser eligible to rely on the Section 203(m) exemption if the sub-adviser’s services to the primary adviser relate solely to private funds and the other conditions of the exemptions are met. Similarly, a sub-adviser may be eligible to rely on Section 203(l) if the sub-adviser’s services to the primary adviser relate solely to venture capital funds and the other conditions of the rule are met.

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If you have any questions concerning this advisory or the application of the SEC's proposed exemptions from Advisers Act registration to your business operations, please call any of the following members of our Securities and Futures Regulation Group:

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