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CURRENT ISSUES RELEVANT TO OUR CLIENTS JUNE 29, 2011

SEC Adopts Final Dodd-Frank Investment Adviser Rules

The Dodd-Frank Wall Street Reform and Consumer Protection Act makes numerous changes to the registration, reporting, and recordkeeping requirements of investment advisers. One significant change is that the Dodd-Frank Act eliminates the exemption from registration under the Investment Advisers Act of 1940 (the "Advisers Act") for private advisers with fewer than 15 clients. Absent an exemption, the Dodd-Frank Act changes require many hedge fund, private equity fund, and non-US advisers to register with the Securities and Exchange Commission ("SEC") by July 21, 2011. In November 2010, the SEC proposed new rules addressing new exemptions under the Advisers Act for venture capital fund advisers, non-US advisers, and smaller private fund advisers and also proposed changes to the registration, reporting, and recordkeeping obligations of registered investment advisers and exempt reporting advisers. The SEC recently adopted final rules in these areas. The rules implement a "private adviser" transitional exemption period so that affected advisers generally do not have to register until March 30, 2012. The SEC final rules are available at http://sec.gov/rules/final/2011/ia-3221.pdf and http://sec.gov/rules/final/2011/ia-3222.pdf. For details on the original SEC proposals, see our Client Alerts available at http://www.chapman.com/media/news/media.896.pdf.

If you are interested in learning more about the impact of the Dodd-Frank Act on the asset management industry, see our summary titled "Dodd-Frank: Impact on Asset Management" available at http://www.chapman.com/media/news/media.901.pdf. This summary is updated periodically to reflect recent Dodd-Frank Act rulemaking.

Overview

The recent SEC rulemaking includes:

- *Private Adviser Transition Rule*—effectively extends the current Advisers Act Section 203(b)(3) registration exemption until March 30, 2012 (rather than July 21, 2011)
- *Venture Capital Fund Definition Rule*—defines "venture capital fund" for purposes of the new registration exemption for advisers solely to venture capital funds
- *Foreign Private Adviser Exemption Rules*—provides definitions and clarification regarding the new registration exemption for non-US advisers with fewer than 15 clients in the US and under $25 million in US assets under management
- *Smaller Private Fund Adviser Exemption Rule*—provides a registration exemption for advisers solely to "private funds" that have US assets under management under $150 million
- *Other Issues Applicable to Registered and Exempt Reporting Advisers*—addresses dollar amount thresholds of and eligibility for SEC vs. state registration; Form ADV amendments; and various recordkeeping and reporting requirements for registered advisers, exempt venture capital fund advisers, and exempt smaller private fund advisers

Private Adviser Transition Rule—Registration Requirement Delayed to March 30, 2012

Effective July 21, 2011, the Dodd-Frank Act eliminates the Advisers Act Section 203(b)(3) exemption from registration for advisers with fewer than 15 clients that neither hold themselves out generally to the public as an investment adviser nor act as an investment adviser to any registered investment company or business development company. The SEC recently adopted rules implementing a transitional exemption period so that private advisers newly required to register do not have to do so until March 30, 2012. Newly adopted Rule 203-1 under the Advisers Act provides that advisers that are exempt from registration with the SEC and are not registered in reliance on Section 203(b)(3) of the Advisers Act are exempt from registration with the SEC until March 30, 2012, provided that such adviser:

- during the course of the preceding twelve months had fewer than fifteen clients;
- neither holds itself out generally to the public as an investment adviser to any registered investment company or business development company.

This transitional exemption generally means that affected managers of hedge funds, private equity funds, and other private funds do not have to register under the Advisers Act and comply with requirements applicable to registered advisers until March 30, 2012. Absent this transition rule, the Dodd-Frank Act would require these affected advisers to register by July 21, 2011.

Venture Capital Fund Advisers

The Dodd-Frank Act provides for a new exemption from Advisers Act registration for investment advisers that advise only "venture capital funds" as defined by the SEC. The Dodd-Frank Act also requires that the SEC require these advisers to maintain such records and provide reports to the SEC as the SEC determines necessary or appropriate in the public interest or for the protection of investors. The SEC recently adopted new rules defining "venture capital fund" for purposes of this new exemption and to provide for certain requirements regarding recordkeeping, reporting, and examination of venture capital fund advisers.

How Does an Adviser Qualify for the Venture Capital Adviser Exemption?

Effective July 21, 2011, Advisers Act Section 203(l) provides an exemption from Advisers Act registration to investment advisers that act solely as advisers to one or more venture capital funds. Advisers who advise only "venture capital funds" as defined in Rule 203(l)-1 under the Advisers Act qualify for the exemption.

What is a "Venture Capital Fund"?

Under the recently adopted rule, a venture capital fund is a type of private fund. Effective July 21, 2011, the Advisers Act defines a "private fund" as an issuer that would be an investment company under Section 3 of the Investment Company Act of 1940 but for Sections 3(c)(1) or 3(c)(7) of that Act. Newly adopted Advisers Act Rule 203(l)-1 defines a "venture capital fund" as a private fund that has the following characteristics:

- *Represents itself as pursuing a venture capital strategy.* The fund must represent itself to investors and potential investors as pursuing a venture capital strategy. This is a change from the originally proposed rule which required that a fund hold itself out as a venture capital fund. In adopting the final rule, the SEC clarified that the determination for analyzing whether a qualifying fund has satisfied this characteristic depends on all of the statements (and omissions) made by the fund to its investors and prospective investors. While this includes the fund name, it is only part of the analysis.
- *Invests primarily in qualifying investments.* Immediately after the acquisition of any asset, the fund must hold no more than 20 percent of the amount of the fund's aggregate capital contributions and uncalled committed capital in assets that are not "qualifying investments" valued at cost or fair value (other than "short-term holdings").
  - "Qualifying investments" generally consist of any equity security issued by a "qualifying portfolio company" that is directly acquired by the fund and certain equity securities exchanged for the directly acquired securities. "Qualifying portfolio companies" are described in greater detail in the following section.
  - "Short-term holdings" include cash and cash equivalents and US Treasuries with a remaining maturity of 60 days or less.

This characteristic provides significantly more flexibility in investment choices than under the proposed rule which permitted only investments in equity securities of "qualifying portfolio companies" and "short-term holdings." The final rule provides venture capital funds with the flexibility to invest up to 20 percent of a fund's capital commitments in non-qualifying investments such as shares of other venture capital funds, non-convertible debt, or publicly-traded securities while still falling within the venture capital fund definition.

The final rule broadly defines equity securities as defined under Section 3(a)(11) of the Exchange Act and Rule 3a11-1 thereunder, which includes common stock as well as preferred stock, warrants, and other securities convertible into common stock in addition to partnership interests.

- *Very limited use of borrowing.* The fund must not borrow, issue debt obligations, provide guarantees, or otherwise incur leverage in excess of 15 percent of the fund's aggregate capital contributions and uncalled committed capital, and any such borrowing, indebtedness, guarantee, or leverage must be for a non-renewable term of no longer than 120 calendar days (excluding 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). The exclusion of these guarantees was a modification from the originally proposed rule.

- *No investor withdrawal rights.* The fund must only issue securities the terms of which do not provide a holder with any right to withdraw, redeem, or require the repurchase of such securities, except in extraordinary circumstances. This requirement does not prohibit a fund from granting investors a right to receive distributions made to all holders pro rata. The "extraordinary circumstances" where withdrawals would be allowed could include foreseeable events as long as they are unexpected in their timing or scope. A lock-up for less than the full life of a fund would appear not to satisfy this requirement. The term "pro rata" is not defined and could lead to some ambiguity in light of the typical allocation and distribution waterfalls which often include preferred returns to limited partners (over a general partner), general partner "catch-up" allocations/distributions, and 80/20 carried interest splits. In the adopting release, the SEC staff seems to make reference to this issue in a brief, roundabout way and appears to have concluded that the phrase "extraordinary circumstances" is sufficiently clear to address these and other apparent ambiguities.

- *Not a registered investment company.* Although this condition would appear to effectively be duplicative of the opening language of Rule 203(1)-1(a) that defines a venture capital fund as a "private fund" (having the characteristics described in this list), the fund must not be registered under section 8 of the Investment Company Act of 1940 and may not have elected to be treated as a business development company under that Act. This condition might suggest that a fund that qualifies for the Investment Company Act Section 3(c)(1) or 3(c)(7) exclusions from the definition of "investment company" can voluntarily register under the Investment Company Act (*i.e.*, become a registered "private fund"). The SEC staff has taken the position in certain no-action letters in the past that funds that qualify for exclusions or exemptions cannot voluntarily register under the Investment Company Act (for example, where a fund has sought to voluntarily register in order to qualify for "regulated investment company" tax treatment under subchapter M of the Internal Revenue Code).

The original proposed rule would have required that a venture capital fund either have an arrangement whereby the fund or the adviser offers to provide, and if accepted, does so provide, significant guidance and counsel concerning the management, operations, or business objectives and policies of each qualifying portfolio company or control the qualifying portfolio company. This requirement was not adopted as part of the final rule. As a result, a qualifying venture capital fund is not required to offer (or provide) managerial assistance to, or control, any qualifying portfolio company in order to satisfy the definition. The final rule also does not define a venture capital fund as a fund advised by a US adviser. Thus, a non-US adviser as well as a US adviser may rely on the venture capital exemption provided that such adviser satisfies all elements of the rule or the grandfathering provision.

What is a "Qualifying Portfolio Company"?

A "qualifying portfolio company" is any company that:

- is not a company (a) subject to reporting under the Section 13 or 15(d) of the Securities Exchange Act of 1934 (the "Exchange Act") or (b) having a security listed or traded on a foreign exchange or organized market (and does not have a control relationship with such a company);

- does not borrow or issue debt obligations in connection with the fund's investment in such company and distribute to the private fund the proceeds of such borrowing or issuance in exchange for the private fund's investment; and

- is not itself an investment company, a private fund, an issuer that would be an investment company but for the exemption provided by Investment Company Act Rule 3a-7 (regarding asset-backed security issuers), or a commodity pool.

The first prong of this definition in the original proposed rule would have required that the company not be "publicly traded" at the time of the fund's investment and not be in a control relationship with a "publicly traded" company. The final rule modifies this prong to refer to Exchange Act reporting companies and foreign traded companies. The final rule also modifies the second prong of this definition slightly from the proposed rule to only exclude companies that borrow in connection with a venture capital fund's investment and distribute such borrowing proceeds to the venture capital fund in exchange for the investment but not exclude companies that borrow in the ordinary course of their business (*e.g.*, to finance inventory or capital equipment, manage cash flows, meet payroll, etc.) and to properly distinguish between venture capital funds and leveraged buyout funds.

Grandfathering

The newly adopted rule provides a grandfathering provision for certain pre-existing venture capital funds. A private fund will be included within the definition of a venture capital fund if the fund (1) has represented to investors at the time the fund offered its securities that it pursues a venture capital strategy (rather than holding itself out as a venture capital fund as required in the proposed rule); (2) has sold securities to one or more investors prior to December 31, 2010 (that are not investors related to the fund's adviser); and (3) does not sell any securities to or accept any additional commitments from any person after July 21, 2011. The provision would cover a fund that has accepted capital commitments by the specified dates even if such commitments have not been called.

Reporting, Recordkeeping, and Exam Requirements

In addition to providing for a venture capital fund adviser exemption, the Dodd-Frank Act also provides that the SEC must require exempt venture capital fund advisers to maintain such records and provide reports to the SEC as the SEC determines necessary or appropriate in the public interest or for the protection of investors. Accordingly, the SEC has adopted rules making advisers relying on the venture capital fund adviser exemption or the smaller private fund adviser exemption ("exempt reporting advisers") subject to certain recordkeeping and reporting requirements. As a result, exempt venture capital fund advisers, although not registered, would be required to file a Form ADV and pay the relevant filing fee (currently ranging from $40 to $225). Exempt venture capital fund advisers would only be required to provide the information relating to certain items in Part 1A of the Form ADV along with the schedules corresponding to such items. These requirements are described in greater detail below under "Issues Applicable to Registered and Exempt Reporting Advisers".

The SEC has also explicitly noted that exempt reporting advisers are subject to examination by the SEC and subject to certain recordkeeping requirements. The SEC has indicated that recordkeeping requirements for exempt reporting advisers will be addressed in a future release. No clarification is provided as to what an examination of an exempt reporting adviser could include, but exempt reporting advisers should at least be prepared to produce records and provide documentation backing up their exemption from registration and all information reported to the SEC on Form ADV.

Sub-Advisory Relationships, Advisory Affiliates, and Unanswered Questions

While use of sub-advisors is not necessarily prevalent for venture capital funds, the SEC has stated that a sub-advisor may be eligible to rely on the rule and related exemption even if the sub-advisor's advisory agreement is with the primary adviser and not the fund itself, if the sub-advisor's services to the primary adviser relate solely to venture capital funds, and if the other conditions of the rule are met. The SEC has not addressed other interpretive issues relating to affiliated sub-advisers or affiliated personnel. The SEC stated in the adopting rule release that it "anticipate[s] that an adviser with advisory affiliates will encounter interpretative issues as to whether it may rely on any of the exemptions discussed in this Release without taking into account the activities of its affiliates." The SEC also noted that the staff may provide guidance, as appropriate, based on facts that may be presented to the staff.

Foreign Private Advisers

The Dodd-Frank Act replaces the current Advisers Act Section 203(b)(3) exemption with a new exemption for any investment adviser that is a "foreign private adviser". The SEC has adopted new Rule 202(a)(30)-1 under the Advisers Act to provide clarity regarding this registration exemption.

What is the Foreign Private Adviser Exemption?

Effective July 21, 2011, Advisers Act Section 202(a)(30) will define a "foreign private adviser" as any investment adviser who:

- has no place of business in the US;
- has, in total, fewer than 15 clients and investors in the US in private funds advised by the adviser;
- has aggregate assets under management attributable to clients in the US and investors in the US in private funds advised by the adviser of less than $25 million (or such higher amount as determined by the SEC); and
- neither holds itself out generally to the public in the US as an investment adviser nor acts as an adviser to a registered investment company or a business development company.

As a practical matter, many unregistered non-US advisers will likely be required to register under the new provisions because non-US advisers will need to count US investors in non-US funds they manage, and their related assets, for purposes of the fewer than 15 clients and the $25 million assets under management tests listed above. The Dodd-Frank Act changes do not directly require the SEC to adopt rules related to this statutory exemption, however, the new rule provides important clarifications regarding application of this exemption.

Determining the Number of Clients

For purposes of determining the number of clients for the "fewer than 15 clients" test listed above, the rule provides certain safe harbors for determining what constitutes a single client. The rule would allow an adviser to treat the following as a single client:

- a natural person and that person's minor children.
- a natural person and any relative, spouse, spousal equivalent, or relative of the spouse or spousal equivalent of the person who has the same principal residence. "Spousal equivalent" was added in the final rule and defined by reference to Rule 202(a)(11)(G)-1(d)(9) as "a cohabitant occupying a relationship generally equivalent to that of a spouse." (Rule 202(a)(11)(G)-1 is another newly adopted rule regarding an exclusion from the definition of "investment adviser" for family offices.)
- a natural person and all trusts and accounts where the only primary beneficiaries are the natural person and/or other persons included in the first two bulletpoints of this list.
- any legal organizations to which the adviser provides investment advice based on the organization's investment objectives (rather than individual owner objectives). The term "legal organization" includes including any corporation, general partnership, limited partnership, limited liability company, trust, or other legal organization.
- any legal organizations that have identical shareholders, partners, limited partners, members, or beneficiaries.

The rule also provides that an adviser is not required to count a private fund as a client if the adviser counts any investor in that private fund as an investor in the US in a private fund advised by the adviser for purposes of determining the availability of the exemption. The final rule also contains an additional provision that clarifies that an adviser is not required to count a person as an investor in the US in a private fund if the adviser counts such person as a client in the US for purposes of the rule. Thus, a client in the US who is also an investor in a private fund advised by the adviser would only be counted once.

Determining the Number of Private Fund Investors

For purposes of determining the number of investors in the US in private funds for the "fewer than 15 clients" test listed above, the new rule defines "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 Investment Company Act, or whether the securities of a private fund are owned exclusively by qualified purchasers under Section 3(c)(7) of Investment Company Act. Under those Sections, beneficial ownership by a company is generally deemed to be beneficial ownership by one person, except that if the company is itself a 3(c)(1) or 3(c)(7) fund and owns 10 percent or more of the outstanding voting securities of the private fund, then an adviser must “look through” that company and beneficial ownership is deemed to be that of the holders of such company’s outstanding securities. By defining “investor” by reference to Sections 3(c)(1) and 3(c)(7), the rule also effectively incorporates a variety of interpretive authority regarding other situations where an adviser must “look through” entities, arrangements, or instruments, such as master-feeder arrangements, entities “formed for the purpose” of investing in a fund and total return swaps on a fund. The rule also treats as investors beneficial owners of “short-term paper” issued by the private fund even though such parties would not be counted for purposes of Sections 3(c)(1) and 3(c)(7). Contrary to the proposed rule, the final rule does not include “knowledgeable employees” and certain related persons as investors in a fund.

Determining Whether a Client or Investor is “in the United States” and Related Issues

The exemption for “foreign private advisers” uses the term “in the United States” in a number of instances including (1) 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, (2) exempting only advisers without a place of business “in the United States,” and (3) exempting only advisers that do not hold themselves out to the public “in the United States” as investment advisers. For purposes of the foreign private adviser definition, “in the United States” is defined as follows:

- with respect to determining whether a client or private fund investor is “in the United States”, this term would include any person that is a “US person” as defined in Regulation S (except that any discretionary or similar account held for the benefit of a person in the United States by a dealer or other professional fiduciary is deemed “in the United States” if the dealer or professional fiduciary is a related person of the investment adviser and is not organized, incorporated, or resident in the United States);

- with respect to any place of business located “in the United States”, this term would be as defined in Regulation S; and

- with respect to the public “in the United States” (*i.e.*, holding out as an investment adviser to the public in the US) this term would be as defined in Regulation S.

Regulation S defines “United States” as the United States of America, its territories and possessions, any state of the United States, and the District of Columbia. Subject to certain exclusions, Regulation S generally defines “US Person” to include a natural person resident in the US, a partnership or corporation organized under US laws, an estate of which any executor or administrator is a US person, a trust of which any trustee is a US person, an agency or branch of a foreign entity located in the US, an non-discretionary account or similar account held by a dealer or other fiduciary for the benefit or account of a US person, a discretionary account or similar account held by a dealer or other fiduciary organized or resident in the US, and certain foreign organized partnerships or corporations formed by a US person for the purpose of investing in securities not registered under the Securities Act. In addition to the foregoing, a person “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, each time the investor acquires the securities issued by the fund. The rule also clarifies that an adviser will not be deemed to be holding itself out generally to the public in the US as an investment adviser solely because the adviser participates in a non-public offering in the US of securities issued by a private fund under the Securities Act of 1933.

Determining Place of Business

The foreign private adviser exemption is only available to an adviser who has no place of business in the US. The new rule defines “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 SEC clarified that any office or other location where an adviser regularly conducts research would be a place of business but an office where an adviser solely performs administrative services and back-office activities (if they are not activities intrinsic to advisory services) would not be a place of business for purposes of this definition.

Determining Assets Under Management

The foreign private adviser exemption is only available to an adviser that has assets under management attributable to clients in the US and US investors in private funds of less than $25 million (or such higher amount adopted by the SEC). This value would be calculated as all “regulatory assets under management” as determined under Item 5.F of Form ADV, Part 1A. The instructions to Form ADV provide a uniform method to calculate assets under management for regulatory purposes. These assets include the securities portfolios for which an adviser provides "continuous and regular supervisory or management services". A "securities portfolio" is generally an account that has at least 50 percent of its total value represented by "securities", with cash and cash equivalents treated as "securities" solely for this purpose. For private funds, this generally includes uncalled capital commitments and all assets of a private fund, even if such assets are not "securities". The instructions to Form ADV also clarifies that advisers must determine the amount of its private fund assets based on the market value of those assets, or the fair value of those assets where market value is unavailable and must calculate the assets on a gross basis (*i.e.*, without deducting liabilities such as accrued fees and expenses or the amount of any borrowing).

Advisory Affiliates and Unanswered Questions

The SEC has not addressed certain other interpretive issues relating to affiliated sub-advisers or affiliated personnel. The SEC stated in the rule release that it "anticipate[s] that an adviser with advisory affiliates will encounter interpretative issues as to whether it may rely on any of the exemptions discussed in this Release without taking into account the activities of its affiliates." The SEC staff noted that an adviser might, for example, have advisory affiliates that are registered or that provide advisory services that the adviser itself could not provide while relying on an exemption. In its original proposal, the SEC requested comment on whether rules should provide that an adviser must take into account the activities of its advisory affiliates when determining eligibility for an exemption, by having the rule specify that the exemption is not available to an affiliate of a registered investment adviser. The SEC stated 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. Some commenters acknowledged this, but urged that, in the case of a non-US advisory affiliate, the SEC affirm the positions taken in the *Unibanco* line of no-action letters where the SEC staff provided assurances that it would not recommend enforcement action, subject to certain conditions, against a non-US unregistered adviser that is affiliated with a SEC-registered adviser, despite sharing personnel and resources. Among other things, the SEC staff agreed not to recommend enforcement action if a non-US advisory affiliate of a SEC-registered adviser (often referred to as a "participating affiliate") shares personnel with, and provides certain services through, the SEC-registered adviser affiliate, without such non-US advisory affiliate registering under the Advisers Act. Questions arose because the *Unibanco* letters were developed by the SEC staff in the context of the private adviser exemption, which is being repealed by the Dodd-Frank Act. The SEC has confirmed that nothing in the final rules is intended to withdraw any prior statement of the SEC or the views of the staff as expressed in the *Unibanco* letters. The SEC has stated that it expects that the SEC staff will provide guidance, as appropriate, based on facts that may be presented to the staff regarding the application of the *Unibanco* letters in the context of the new foreign private adviser exemption and the smaller private fund adviser exemption.

Smaller Private Fund Adviser Exemption

The SEC also adopted new Rule 203(m)-1 under the Advisers Act to provide a registration exemption for certain advisers that provide investment advice solely to smaller hedge funds, private equity funds, and other private funds, and to provide for certain requirements regarding recordkeeping, reporting, and examination of those advisers. The rule was adopted pursuant to the Dodd-Frank Act requirement that the SEC provide for a new exemption from Advisers Act registration for advisers that provide investment advice solely to private funds that have assets under management in the US of less than $150 million.

How Does an Adviser Qualify for the Smaller Private Fund Adviser Exemption?

Rule 203(m)-1 provides an exemption from Advisers Act registration for the following investment advisers:

- US Advisers—an investment adviser with its principal office and place of business in the US if the investment adviser (1) acts solely as an investment adviser to one or more qualifying private funds and (2) manages private fund assets of less than $150 million.

- Non-US Advisers—an investment adviser with its principal office and place of business outside of the US if (1) the investment adviser has no client that is a US person except for one or more qualifying private funds and (2) all assets managed by the investment adviser from a place of business in the US are solely attributable to private fund assets, the total value of which is less than $150 million.

Principal Office and Place of Business in the US

Advisers that have their "principal office and place of business" in the US may rely on the exemption only if they advise only qualifying private funds. On the other hand, advisers with their principal office and place of business outside of the US may have clients that are not qualifying private funds as long as they are not "US persons", provided that any assets managed from a "place of business" in the US must be attributable to private funds. The "principal office and place of business" of an adviser is the executive office of the adviser from which the officers, partners, or managers of the adviser direct, control, and coordinate the activities of the adviser. The rule defines "United States" (by reference to Regulation S) as the United States of America, its territories and possessions, any state of the United States, and the District of Columbia. For purposes of determining whether a non-US adviser is managing assets from a place of business in the US, the rule defines "place of business" by reference to existing Rule 222-1(a) to mean an office at which the adviser regularly provides investment advisory services, solicits, meets with, or otherwise communicates with clients and any other location that the adviser holds out to the general public as a location at which it provides those services or conducts those activities.

What is a US Person?

Even if an adviser has its principal office and place of business outside of the US, the adviser must not have any client that is a "US person" other than qualifying funds. The rule defines "US person" by reference to Regulation S as described above in the "Foreign Private Adviser" section. A note was added to the final rule clarifying that a client will not be considered a US person if the client was not a US person at the time of becoming a client of the adviser.

What is a "Qualifying Private Fund"?

The new rule limits advisers relying on the exemption to advisers solely to "qualifying private funds". A "qualifying private fund" is defined as any "private fund" that is not registered under the Investment Company Act of 1940 and has not elected to be treated as a business development company under that Act. "Private fund" is defined as an issuer that would be an investment company as defined in Section 3 of the Investment Company Act but for the exceptions in Section 3(c)(1) or Section 3(c)(7) of that Act. The final rule clarifies that for purposes of the exception, advisers may treat as private funds any issuer that qualifies for an exclusion from the definition of an "investment company" as defined in Section 3 of the Investment Company Act in addition to those provided by Section 3(c)(1) or Section 3(c)(7) of that Act provided that the investment adviser treats the issuer as a private fund under the Advisers Act and the rules thereunder for all purposes. This was done to ensure that certain real estate funds structured as 3(c)(1) or 3(c)(7) funds but also qualify for certain other exclusions from the Investment Company Act would be eligible for the exemption from registration. An adviser that acquires even one non-qualifying private fund client would have to register under the Advisers Act absent the availability of some other exemption.

Determining Assets Under Management

Under the rule, an adviser would have to aggregate the value of all assets of private funds it manages in the United States to determine whether the adviser remains below the $150 million threshold. This value would be calculated as all "regulatory assets under management" determined as described above in the "Foreign Private Adviser" section.

A sub-advisor would only be required to count that portion of private fund assets for which it has responsibility. In addition to assets appearing on a private fund's balance sheets, this would require advisers to also include any uncalled capital commitments. Advisers would be required to determine this amount quarterly based on the fair value of the assets at the end of the quarter. As a result, an adviser could cross the $150 million threshold without taking on any additional investors or funds simply through the appreciation of the value of assets. All private fund assets of an adviser with a principal office and place of business in the US would be considered to be "assets under management in the United States," even if the adviser has offices outside of the US. Advisers with a principal office and place of business outside the US would only need to count private fund assets it manages from a place of business in the US toward the $150 million assets under management limit.

Transition Rule

The final rule requires an adviser to annually calculate the amount of private fund assets it manages and report the amount in its annual updating amendments. If an adviser reports in its annual updating amendment that it has $150 million or more of private fund assets under management, the adviser is no longer eligible for the private fund adviser exemption. The originally proposed rule required advisers to calculate private assets and determine eligibility quarterly. The rule as adopted includes a provision giving advisers 90 days after filing the annual updating amendment in which they become ineligible to rely on the exemption due to having $150 million or more in private fund assets. This ultimately gives advisers 180 days after the end of their fiscal years in which they no longer qualify for the exemption to register. This transition period would only be available to advisers in compliance with all applicable SEC reporting requirements.

Reporting, Recordkeeping, and Exam Requirements

In addition to requiring the SEC to adopt a the smaller private fund adviser exemption, the Dodd-Frank Act also provides that the SEC require exempt private fund advisers to maintain such records and provide reports to the SEC as the SEC determines necessary or appropriate in the public interest or for the protection of investors. Accordingly, the SEC has adopted rules making advisers relying on this exemption or the venture capital fund adviser exemption ("exempt reporting advisers") subject to certain recordkeeping and reporting requirements. As a result, exempt private fund advisers, although not registered, would be required to file a Form ADV and pay the relevant filing fee (currently ranging from $40 to $225). Exempt private fund advisers would only be required to provide the information relating to certain items in Part 1A of the Form ADV along with the schedules corresponding to such items. These requirements are described in greater detail below under "Issues Applicable to Registered and Exempt Reporting Advisers".

The SEC has also explicitly noted that exempt reporting advisers are subject to examination by the SEC and subject to certain recordkeeping requirements. The SEC has indicated that recordkeeping requirements for exempt reporting advisers will be addressed in a future release. No clarification is provided as to what an examination of an exempt reporting adviser could include, but exempt reporting advisers should at least be prepared to produce records and provide documentation backing up their exemption from registration and all information reported to the SEC on Form ADV.

Sub-Advisory Relationships, Advisory Affiliates, and Unanswered Questions

For information regarding these matters, please refer to the related sections on sub-advisory relationships, advisory affiliates, and unanswered questions appearing under "Venture Capital Fund Advisers" and "Foreign Private Advisers" above.

Issues Applicable to Registered and Exempt Reporting Advisers

The SEC adopted new rules to provide for transitions between state and SEC registration for affected advisers, include changes to the statutory thresholds for adviser registration with the SEC, additional exclusions from the prohibition from registration for advisers not meeting statutory thresholds, amendments to Form ADV, reporting and recordkeeping obligations for certain advisers, and certain other rule amendments including changes to the SEC's "pay-to-play" rule.

The Dodd-Frank Act Changes to the Threshold for SEC Registration

Under current law, investment advisers with less than $25 million in assets under management ("AUM") are generally not permitted to register as investment advisers with the SEC as long as the adviser is regulated or required to be regulated as an investment adviser in the state in which it maintains its principal office and place of business. These advisers generally must register with one or more states. Under current SEC rules, advisers with between $25 and $30 million in AUM may generally register with the SEC or applicable states. Effective July 21, 2011, the Dodd-Frank Act effectively increases the AUM dollar amount threshold for SEC investment adviser registration to $100 million from the current $25 million. In doing so, however, the Dodd-Frank Act generally creates two classes of advisers:

- *Small Advisers*—advisers with AUM of less than $25 million that are regulated or required to be regulated as investment advisers in the state in which the adviser maintains its principal office and place of business; and
- *Mid-Sized Advisers*—advisers with AUM of between $25 million and $100 million that are required to be registered as an investment adviser in the state in which the adviser maintains its principal office and place of business *and, if registered, would be subject to examination as an investment adviser by such state*.

Under the Dodd-Frank Act changes, these small and mid-sized advisers are generally not permitted to register with the SEC but will register with one or more states, subject to certain exceptions and exemptions. Investment advisers that are advisers to registered investment companies or to business development companies are excluded from this prohibition and must register with the SEC.

For advisers that maintain their principal office and place of business in most states, the distinction between small advisers and mid-sized advisers does not matter for purposes of determining eligibility for state or SEC registration. The distinction only matters for states that (1) require investment adviser registration but (2) do not have an investment adviser examination program. Based on current SEC guidance, this appears to be the case only in Minnesota and New York. Wyoming is the sole state that does not require investment adviser registration or examination and all advisers that maintain their principal office and place of business in Wyoming will continue to be eligible for SEC registration. The Dodd-Frank Act also makes a distinction between small advisers and mid-sized advisers in that under the statutory changes mid-sized advisers that are required to register with 15 or more states as a result of the statutory prohibition are permitted to register with the SEC. Under current SEC rules small adviser that is required to register with 30 or more states is permitted to register with the SEC. However, the SEC is essentially eliminating this distinction in its new rules. As a result, advisers that maintain their principal office and place of business in states other than Minnesota, New York and Wyoming can generally treat the Dodd-Frank Act and related rules as raising the current $25 million threshold to $100 million and ignore the distinction between small and mid-sized advisers.

SEC Rule Proposals Implementing Dodd-Frank Changes to the Threshold

The SEC has adopted new rules for the implementation of the Dodd-Frank Act's increased threshold for registration. The adopted rules differ in a number of respects from the proposed rules.

Under the adopted rules, advisers registered with the SEC on January 1, 2012, must file an amendment to Form ADV no later than March 30, 2012. These amendments to Form ADV will be required to respond to new items in Form ADV and identify mid-sized advisers no longer eligible to remain registered with the SEC. Any adviser no longer eligible for SEC registration will have to withdraw its registration no later than June 28, 2012. Mid-sized advisers registered with the SEC as of July 21, 2011, must remain registered with the SEC (unless an exemption is available) until January 1, 2012. Effective July 21, 2011, advisers newly applying for registration with the SEC with between $25 and $100 million in AUM are prohibited from registering with the SEC and must register with the appropriate state securities authority.

The new rules amend Advisers Act Rule 203A-1 to provide newly registering advisers with a choice between state and SEC registration when they have $100 million to $110 million in AUM. Once registered, advisers will not be required to withdraw registration unless they have less than $90 million in AUM. Thus, the SEC has created a buffer range from $90 million to $110 million in AUM to prevent advisers from having to switch between SEC and state registration. However, the final rules also eliminate the current $5 million buffer for small advisers with $25-$30 million in AUM.

Under the new rules, if an adviser is registered with a state security authority, it must apply for registration with the SEC within 90 days of filing an annual Form ADV amendment reporting that it is eligible for SEC registration and not relying on an exemption from registration. If an adviser is registered with the SEC and files an annual Form ADV update reporting that it is not eligible for SEC registration (and is not relying on an exemption), it must withdraw from SEC registration within 180 days of its fiscal year end. During a period where an adviser is registered with both the SEC and one or more state securities authorities, the Advisers Act and applicable state law will apply to such adviser's advisory activities.

A mid-sized adviser not required to register as an investment adviser in the state in which it has its principal office and principal place of business or not subject to examination in such state is eligible (and generally required) to register with the SEC. An adviser would be deemed to not be "required to be registered" with the state securities authority if the adviser is exempt from registration under the law of the state in which it has its principal office and place of business, or is excluded from the definition of investment adviser in that state. To determine whether mid-sized advisers are "subject to examination as an investment adviser" in the state in which they have their principal office and principal place of business, the SEC contacted the state securities authority for each state and identified those states that do not subject advisers registered with them to examination. Based on those responses, all state securities authorities other than Minnesota, New York and Wyoming advised the SEC staff that advisers registered with them are subject to examination. Accordingly, advisers with their principal office and place of business in Minnesota, New York and Wyoming with AUM between $25 million and $100 million must register with the SEC. Such an adviser is required to represent annually that it is not required to register and/or subject to examination as an adviser in the state where it maintains its principal office and place of business.

SEC Registration Prohibition Exemptions

Section 203A(c) of the Advisers Act provides the SEC with the authority to permit investment advisers to register with the SEC even though they would be generally prohibited from registering. The SEC has adopted six exemptions in Rule 203A-2 from the prohibitions on registration, which would apply to mid-sized advisers. The newly adopted rules amend three of the exemptions as follows:

- eliminate the exemption in Rule 203A-2(a) from the prohibition on SEC registration for nationally recognized statistical rating organizations,
- amend the exemption available to pension consultants in Rule 203A-2(b) to increase the minimum value of plan assets from $50 million to $200 million, and
- amend the multi-state adviser exemption in Rule 203A-2(e) to permit all investment advisers required to register as an investment adviser with 15 or more states to register with the SEC (*i.e.*, whether small advisers or mid-sized advisers).

Elimination of Safe Harbor

Rule 203A-4 currently provides a safe harbor for non-registration with the SEC for an investment adviser that is registered with the state securities authority of the state in which it has its principal office and place of business based on a reasonable belief that it is prohibited from registering with the SEC because it does not have sufficient AUM. The SEC eliminated this safe harbor because advisers have generally not asserted it as a defense in the past and the SEC determined that it would be inappropriate to apply it to the new registration threshold.

Identifying Eligibility to Register as an Adviser with the SEC on Form ADV

The new rules modify Item 2 of Part 1A of Form ADV, which requires each investment adviser applying for registration to indicate its basis for registration with the SEC. Under the amended Form ADV, an adviser would be required to identify whether it qualified for registration as an adviser with the SEC as:

- a large adviser (having $100 million or more of regulatory assets under management or having $90 million or more in regulatory assets under management at the time of filing its most recent annual updating amendment and is already registered with the SEC),
- a mid-sized adviser that does not meet the criteria for state registration and examination,
- an adviser with its principal office and place of business in Wyoming or outside the United States,
- an adviser meeting the requirements for one or more of the exemptive rules under Section 203A of the Advisers Act (*e.g.*, pension consultants, multi-state advisers),
- an adviser (or subadviser) to a registered investment company,
- an adviser to a business development company with at least $25 million of regulatory AUM, or
- an adviser with some other basis for registering with the SEC.

The SEC will modify IARD to prevent an applicant from registering and an adviser from continuing to be registered unless it represents upon initially registering and annually that it meets the eligibility criteria set forth in the Advisers Act and applicable rules.

Assets Under Management

A number of determinations relating to adviser registration depend on the amount of assets such adviser has under management. Section 203A(a)(2) of the Advisers Act defines “assets under management” as the “securities portfolios” with respect to which an adviser provides “continuous and regular supervisory or management services.” The recently adopted rules change the instructions to Form ADV to implement a uniform method of calculating AUM. Rule 203A-3 is amended to require that the calculation of “assets under management” for purposes of Section 203A be the calculation of the securities portfolios with respect to which an investment adviser provides continuous and regular supervisory or management services regardless of whether these assets are proprietary assets, assets managed without receiving compensation, or assets of foreign clients. Form ADV generally defines “securities portfolio” to include an account that has at least 50 percent of its total value represented by “securities” with cash and cash equivalents treated as “securities” solely for this purpose.

The new rules and Form ADV eliminate adviser discretion in including (or excluding) these assets from the AUM calculation, which effectively gave certain advisers the ability to opt into or out of state or federal regulation. The new rules would also alter the reference to an adviser's "regulatory assets under management" in Part 1A of Form ADV to differentiate it from the amount of AUM disclosed to clients in Part 2 of Form ADV (which do not necessarily need to meet Section 203A requirements).

Under the final rules, in calculating the assets under management, advisers would generally:

- be required to include the value of any securities portfolio to which an investment adviser provides continuous and regular supervisory or management services, regardless of whether these assets are proprietary assets, assets managed without receiving compensation, or assets of foreign clients;
- not be allowed to subtract outstanding indebtedness and other accrued but unpaid liabilities, which remain in a client's account and are managed by the adviser; and
- use the market value of assets using the same method used to report account values to clients or calculate fees for investment advisory services.

The final rules also provide guidance impacting how an adviser that advises private funds determines the amount of assets it has under management related to such funds. In determining AUM related to private funds, advisers are required to:

- include in AUM 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 (*i.e.*, even if such assets are not "securities") (a sub-adviser would include only that portion for which it provides sub-advisory services);
- not subtract outstanding indebtedness and other accrued but unpaid liabilities of the fund;
- include the amount of any uncalled capital commitments made to the fund; and
- use the market value of private fund assets or the fair value of private fund assets where the market value is unavailable.

Overview of Other Changes to Form ADV

The SEC rules would require advisers to provide additional information on Form ADV about three primary areas: (i) private funds advised by the adviser; (ii) the adviser's employees, clients, and advisory activities; and (iii) other business activities and financial industry affiliations of the adviser.

- *Private Fund Reporting:* The SEC adopted amendments to Item 7.B and Schedule D of Form ADV that expand the information advisers must report about the private funds they advise. Contrary to the proposed Form ADV amendments, the SEC did not include in the final form a requirement that advisers report the current value of the fund's investments broken down by asset and liability class and by Level 1, 2, and 3 US GAAP fair value hierarchy. Other differences between the final and proposed forms are noted below. The information required to be reported about private funds on Form ADV includes items such as:
  - the name and place of formation of the fund;
  - the name of the general partner, manager, trustee, or directors of the fund;
  - information regarding the Investment Company Act exemption relied upon;
  - names of foreign regulatory authorities with which the fund is registered;
  - details about master-feeder arrangements and funds-of-funds (defined as a fund investing 10 percent or more of its assets in other pooled vehicles of any type);
  - whether the fund invests in funds registered under the Investment Company Act;
  - whether the fund is a hedge fund, liquidity fund, private equity fund, real estate fund, securitized asset fund, venture capital fund, or other private fund (these terms are defined in the instructions to Form ADV);
  - the gross asset value of the fund (*but not net asset value as included in the proposed form*);
  - the minimum investment, number of beneficial owners (*but not percentage of fund owned by*

various categories of investors as included in the proposed form), and percentage of fund owned by non-US persons;

- identities of any other advisers or sub-advisers to the fund and whether the advisers clients are solicited to invest in the fund;
- whether the fund relies on Securities Act Regulation D and, if so, the fund's Form D file number;
- whether the fund's financial statements are audited and, if so, various information regarding the fund's auditor;
- identifying information about the fund's prime broker, custodian and administrator; and
- identifying information about each marketer of the fund (other than the adviser or its employees), including whether a website is used.

- *Employees, Clients, and Advisory Activities:* Reported information regarding an adviser's employees, clients, and advisory activities would primarily refine or expand on currently reported information. Form ADV is modified to require an adviser to report in Item 5 information about its transactions, if any, with clients, including whether the adviser or a related person engages in transactions with clients as a principal, sells securities to clients, has discretionary authority over client assets, or whether any of the brokers or dealers are related persons of the adviser. An adviser that indicates that it receives "soft dollar benefits" would also report whether all those benefits qualify for the safe harbor under Section 28(e) of the Securities Exchange Act of 1934 for eligible research or brokerage services. Advisers would also be required to indicate whether it or its related person receives direct or indirect compensation for client referrals to complement the existing question concerning whether the adviser compensates any person for client referrals.
- *Other Business Activities and Financial Industry Affiliations of the Adviser:* Information about an adviser's business activities and affiliations would be used by the SEC to assess conflicts of interest and identify affiliated financial service businesses.

Other amendments to Form ADV include:

- A requirement for each adviser to indicate in Item 1 whether or not the adviser had $1 billion or more in assets (not assets under management) as of the last day of the adviser's most recent fiscal year. The amount of assets would be the adviser's total assets determined in the same manner as the amount of "total assets" is determined on the adviser's balance sheet for its most recent fiscal year end;
- a requirement for advisers to provide contact information for its chief compliance officer and, if the adviser chooses, an additional regulatory contact, neither of which would be made publicly available;
- a requirement to indicate whether any control person of the adviser is a public reporting company;
- inclusion of "Limited Partnership" as an option for organization indication;
- an additional custody question to Item 9 to require advisers to indicate the total number of persons that act as qualified custodians for the adviser's clients in connection with advisory services the adviser provides;
- technical changes with respect to the reporting of disciplinary events; and
- other technical and conforming changes.

Reporting, Recordkeeping, and Exam Requirements for Exempt Reporting Advisers

As described above, the SEC also adopted rules making certain advisers relying on exemptions from registration subject to certain recordkeeping, reporting, and examination requirements under the new rules. These exemptions include those under Advisers Act Section 203(l) for advisers to venture capital funds and Section 203(m) for private fund advisers with AUM in the US of less than $150 million. These "exempt reporting advisers" would only be required to provide the information relating to certain items in Part 1A of the newly adopted Form ADV along with the schedules corresponding to such items. The information required under the new rules includes:

- basic identifying information (Item 1),
- identification exemptions from registration being relied upon (Item 2.B),

- information about form of organization (Item 3),
- information regarding other business activities engaged in by the adviser (Item 6),
- financial industry affiliations and information regarding private funds managed by the adviser (Item 7),
- the adviser's control persons (Item 10), and
- disciplinary history for the adviser and its employees (Item 11).

Exempt reporting advisers would be required to file an initial Form ADV with the SEC within 60 days of relying on the exemption from registration. These advisers would also be required to update information pursuant to the same time frame as advisers registered with the SEC (*i.e.*, update information at least annually within 90 days of the adviser's fiscal year end with interim filing updates in the event of certain changes to their business). Such information would be filed electronically and be publicly available on the SEC's website. When an adviser ceases to be an exempt reporting adviser, the adviser will be required to file an amendment to its Form ADV to indicate that it is filing a final report. An exempt reporting adviser wishing to register with the SEC can file a single amendment to its Form ADV that will serve as its final "report" as an exempt reporting adviser and an application for registration under the Advisers Act. While an application is pending, but before it is approved, an adviser may continue to operate as an exempt reporting adviser in accordance with the terms of the relevant exemption.

The SEC has also explicitly noted that exempt reporting advisers are subject to examination by the SEC and subject to certain recordkeeping requirements. The SEC has indicated that recordkeeping requirements for exempt reporting advisers will be addressed in a future release. No clarification is provided as to what an examination of an exempt reporting adviser could include, but exempt reporting advisers should at least be prepared to produce records and provide documentation backing up their exemption from registration and all information reported to the SEC on Form ADV.

"Pay to Play" Amendments

The recently adopted rules make two amendments to Advisers Act Rule 206(4)-5, which generally prohibits registered and certain unregistered advisers from engaging directly or indirectly in pay to play practices identified in the rule: (i) the scope of the rule is amended to apply to exempt reporting advisers and foreign private advisers; and (ii) amendments add 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. The SEC declined to adopt a proposed rule that would provide a clarification that the definition of a "covered associate" of an investment adviser would include a legal entity, not just a natural person, that is a general partner or managing member of an investment adviser.

What Should I Do Now?

At this point, we suggest that advisers review the rulemaking regarding mid-sized advisers, venture capital fund advisers, foreign private advisers and smaller private fund advisers to determine whether you qualify for SEC or state registration or an exemption from registration. It is important to remember that an adviser that is exempt from SEC registration could still be required to register with one or more states under applicable state investment adviser laws. As a result, advisers relying on an exemption should carefully review applicable state registration requirements. We also suggest that advisers review the revised Form ADV and prepare to respond to new or revised Form ADV items when required. Please feel free to contact us if we can be of assistance in any of these matters.

If you would like to discuss any of the issues discussed in these Client Alerts, please contact any attorney in our Investment Management Group or visit us online at chapman.com.