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Dodd-Frank Act Rulemaking: SEC Proposes New Exemptions and Disclosure Requirements for Investment Advisers

Introduction

Five months after President Obama signed into law the sweeping Dodd-Frank Wall Street Reform and Consumer Protection Act, the US Securities and Exchange Commission has proposed rules to add definition around the Dodd-Frank Act's limited new exemptions under the US Investment Advisers Act of 1940. The SEC's proposals also would (i) expand the reporting regimen applicable to SEC-registered investment advisers generally, (ii) establish a wholly new category of "exempt reporting adviser" to be subject to unexpectedly broad – and public – disclosure requirements, and (iii) add further color to the Dodd-Frank Act's expanded role for the US states in investment adviser supervision and regulation. The agency's proposals are set out in what the SEC refers to as the Exemptions Release[1] and the Implementing Release[2] and in those releases' accompanying appendices[3] – a collection of paperwork that weighs in at more than 400 pages.

This rulemaking process is among the most significant for investment advisers in decades and requires attention from all manner of firms, whether or not currently registered with the SEC and be they US or non-US. SEC Chairman Mary L. Schapiro has stated that "[a]t least some part of [these] proposals will touch virtually every investment adviser."[4]

In this alert we cover the following developments:

Of Special Interest to Firms Currently Exempt from SEC Registration

- Repeal of the "counting clients" exemption and addition of the following new exemptions:
    - Foreign private adviser (see p. 4)
    - Private fund adviser ($150 million threshold) (p. 5)

1 Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers, Investment Advisers Act Release No. 3111 (Nov. 19, 2010), *available at* http://sec.gov/rules/proposed/2010/ia-3111.pdf.

2 Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Act Release No. 3110 (Nov. 19, 2010), *available at* http://sec.gov/rules/proposed/2010/ia-3110.pdf.

3 *See*, *e.g.*, Appendix A: Form ADV: General Instructions, *available at* http://sec.gov/rules/proposed/2010/ia-3110-appa.pdf; Appendix B: Form ADV: Instructions for Part 1A, *available at* http://sec.gov/rules/proposed/2010/ia-3110-appb.pdf; Appendix C: Form ADV: Glossary of Terms, *available at* http://sec.gov/rules/proposed/2010/ia-3110-appc.pdf; Appendix D: Form ADV, Part 1A, *available at* http://sec.gov/rules/proposed/2010/ia-3110-appd.pdf (each, Nov. 19, 2010).

    - Venture capital fund adviser (p. 6)

- Possible SEC examination programs for firms relying on the $150 million threshold and venture capital fund exemptions (p. 9)
- Interpretive issues relating to how the activities of a firm's affiliates may affect its registration status and reliance on registration exemptions (p. 9)
- Possible books and records rules for newly registering advisers (p. 9)

Of Interest to All Advisers, Whether Currently Registered or Considering Registration

- Timing of all changes under consideration (see p. 2)
- Proposed new rules governing which firms will be registered and supervised by US states vs. the SEC (p. 10)
- Proposed new rules for calculation of a firm's assets under management (p. 10)
- Proposed new rules for defining who is or is not a "US Person" under the Advisers Act (p. 11)
- Proposed new fund-by-fund reporting, on Form ADV, for all registered advisers *and* for firms relying on the $150 million threshold and venture capital fund exemptions (p. 12)
- Other proposed new Form ADV changes (p. 13)

Before continuing, however, it is critical to note that a regulatory proposal is just that. It remains a proposal and subject to change until finalized. Interested parties have the opportunity to react to and influence the process by submitting written comments to the SEC or through meetings with SEC officials. Given the breadth of the proposals, a robust (and at times no doubt critical) comment process is inevitable. These comments must be submitted to the SEC by mid-January 2011, although the exact due date has not yet been announced.

It also should be noted that one closely watched aspect of the Dodd-Frank Act's treatment of investment advisers – systemic risk-related reporting around such topics as the firm's leverage, trading practices, counterparties, etc. – remains unaddressed. With that, plus ongoing Congressionally mandated studies (e.g., on the merits of a self-regulatory organization for investment advisers and on investment adviser and broker-dealer duties owed to clients), further investment adviser-related rulemaking is to be expected in the months to come.

Timing

To allow for proper consideration of the raft of comments that will come in only at or just before the January comments due date, final rules cannot be expected from the SEC much before mid-February or early March 2011. For currently unregistered firms that are not yet sure whether they will be required to register, this is unfortunate timing given the need to complete the registration (assuming one will be required) by July 21, 2011.

Moreover, the registration schedule is in reality more compressed than even that July deadline would suggest. As the SEC is entitled to a 45-day period to review an adviser's registration filing before acting on it, we expect it will be prudent for a firm to submit its filing by June 3, 2011. To be in a position to make a June 3 filing, we further expect the firm will have begun

[4] SEC Chairman Schapiro, Proposals to Implement Investment Adviser Provisions of the Dodd-Frank Act (speech) (Nov. 19, 2010), *available at* http://www.sec.gov/news/speech/2010/spch111910mls-items1-2.htm.

serious work on its registration – the key components of which are the (public) Form ADV and the required compliance infrastructure – at least several months before then.

Other dates of note include the following:

- Every SEC-registered adviser must disclose its assets under management (AUM) to the SEC no later than 30 days after July 21, 2011 to determine whether it meets the new federal registration threshold of $100 million AUM. Any currently SEC-registered adviser that instead will have to transition to state registration and supervision must file a Form ADV-W by October 19, 2011 in order to withdraw its SEC registration, by which time it must, if so required, be registered with any applicable states.
- The SEC has proposed that initial reports by exempt reporting advisers must be submitted no later than August 20, 2011. These reports are discussed below.

The New Exemptions

Unregistered fund managers and other investment advisers have long relied on the so-called "counting clients" or "private adviser" exemption under Section 203(b)(3) of the Advisers Act. Under this exemption, an adviser with 14 or fewer clients that does not hold itself out publicly in the United States as an investment adviser is generally exempt from registration as an investment adviser in the United States.[5] An adviser that is ineligible for the private adviser exemption or another exemption would typically register with the SEC, unless it has less than $25-$30 million in AUM, in which case it would typically register with one or more US states.

With the enactment of the Dodd-Frank Act, however, the current regulatory landscape has been drastically modified, particularly for managers of "private funds."[6] Most notably, effective July 21, 2011, the "private adviser" exemption has been revoked. In its place will be a narrow new "foreign private adviser" exemption and partial exemptions for a new category of investment adviser, which the SEC proposes to call the "exempt reporting adviser."

Exempt reporting advisers are those that (i) manage solely private funds and have less than $150 million in AUM in the United States, or (ii) manage solely venture capital funds. Entities falling under the "exempt reporting adviser" definition avoid certain substantive requirements of the Advisers Act but become subject to many of the public filing obligations of a registered adviser, including significant new reporting obligations concerning each private fund they manage, and are subject to examination by the SEC.[7] Many non-US advisers, and smaller US managers of private funds, will find themselves classed as "exempt reporting advisers."

An investment adviser eligible for either a full or partial SEC registration exemption may nonetheless voluntarily register, presuming the firm meets the requisite $100 million AUM threshold dividing federal from state registrations. (Non-US firms may voluntarily register with the SEC regardless of their AUM level.)

5 In determining whether they were required to register with the SEC, non-US advisers historically have been able to count only their US funds and their accounts with US clients. Many of these non-US advisers who have accepted US investor money into their funds or advisory accounts will now find themselves subject to active SEC obligations.

6 For purposes of this rulemaking, "private funds" are those that would be investment companies as defined in Section 3 of the Investment Company Act of 1940 ("Investment Company Act") but for Sections 3(c)(1) or 3(c)(7) of that Act.

7 Many <u>registered</u> advisers will also be significantly affected by the level of detail to be included in Form ADV filings concerning each private fund they manage, as described later in this alert.

The rulemaking also proposes to modify how AUM is calculated for purposes of these SEC exemptions and eligibility criteria. The SEC's proposals, discussed later in this alert, generally take an expansive view of AUM. This would have the effect of making AUM-based exemptions available to fewer investment advisers than otherwise might be the case.

"Foreign Private Advisers"

The Dodd-Frank Act provides for a narrow new exemption for a "foreign private adviser." To qualify for the foreign private adviser exemption, an investment adviser must satisfy all of the following conditions:

- Have no place of business[8] in the United States[9]
- Have, in total, 14 or fewer clients in the United States and investors in the United States in private funds advised by the investment adviser[10]
- Have aggregate AUM attributable to clients in the United States and investors in the United States in private funds advised by the investment adviser of less than $25 million[11]
- Not hold itself out generally to the public in the United States as an investment adviser
- Not advise a US-registered fund or business development company

For purposes of determining who is a "client" in the United States, the SEC has kept the general client determination framework intact from the repealed private adviser exemption. A corporation, general partnership, limited partnership, limited liability company, trust, or other legal organization each would be considered a single client, rather than "looking through" to count holders of their securities. Multiple legal organizations that have identical shareholders, partners, limited partners, members, or beneficiaries would be considered a single client.

A different and more complicated test applies to determine who is an "investor" in the United States. First, the SEC would look to the definitions of "beneficial owner" from Section 3(c)(1) of the Investment Company Act and "qualified purchaser" from Section 3(c)(7) of that Act as defining who constitutes an "investor." As a result of the "look-through" provisions of those Sections, a foreign private adviser may need to monitor, for example, the US beneficial ownership of any third party fund that holds more than 10% of the foreign private adviser's fund or that invests more than 40% of its assets in the foreign private adviser's fund. The diligence that a foreign private adviser must perform with respect to fund investors may thus become fairly complex. Second, the SEC would count any "knowledgeable employee" of the fund as an investor, meaning that principals or employees who are US persons would generally be counted as US investors. Third, for this purpose, investors include any holders of the fund's short-term paper, which could affect the willingness of a foreign private adviser to cause a fund to borrow from a US lender or even use a US prime broker.

[8] A "place of business" would be defined as 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.

[9] "United States" is defined as the United States of America, its territories and possessions, any state of the United States, and the District of Columbia.

[10] We discuss these terms in a later section of this alert.

[11] The Dodd-Frank Act provided for the SEC to include this $25 million threshold "or such higher amount as the Commission may, by rule, deem appropriate in accordance with the purposes of this title." In neither the discussion at the SEC's November 19th open meeting nor in the written rule proposals did the SEC explain why it did not propose to use this authority to raise this $25 million threshold. Shearman & Sterling LLP commented to the SEC on this point, urging a higher threshold. Shearman & Sterling's comment letter is *available at* http://www.sec.gov/comments/df-title-iv/exemptions/exemptions-29.pdf. The Exemptions Release acknowledges our suggestion but does not further address it.

If an entity satisfies the requirements of the foreign private adviser exemption, it would be free from the registration, reporting and recordkeeping requirements of a registered adviser. As with all investment advisers, registered or not, foreign private advisers would remain subject to the SEC's anti-fraud rules and certain other provisions of the Advisers Act. In addition, foreign private advisers are proposed to be subject to the SEC's rules on US state and local political contributions and use of placement agents to solicit US local and state government plan investments (these are often called "pay-to-play" rules). Due to the severe penalties for non-compliance with those rules, a foreign private adviser that may accept investments from such plans into its funds or accounts will need to formalize its compliance procedures in this area.[12]

Exempt Reporting Advisers – "Private Fund Advisers" and the New "Venture Capital Exemption"

The SEC has proposed two categories of "exempt reporting advisers": (i) "private fund advisers" subject to a $150 million AUM limit and (ii) certain venture capital firms. Advisers that fall under one of these definitions would be exempt from SEC registration but still be subject to public reporting and recordkeeping requirements and examination by the SEC – each of these new requirements is discussed below. While these exempt reporting advisers would be exempt from registering under the Advisers Act, the SEC notes that exempt reporting advisers would still be subject to any applicable US state registration, which can actually be more burdensome than SEC registration in some ways.[13]

"Private Fund Advisers" – $150 Million AUM Solely in Private Funds

The proposed rules provide for a new "private fund adviser" exemption. An adviser would be exempt from registration if it both (i) advises solely private funds and (ii) in the aggregate, manages less than $150 million in AUM in the United States. As proposed, this $150 million threshold would be calculated quarterly and reflects both contributions and redemptions of investor capital, and investment appreciation and depreciation. As discussed below, the private fund adviser exemption will function very differently for US advisers as compared to non-US advisers.

Under the proposed rules, a private fund adviser could manage an unlimited number of private funds. However, if an adviser relying on this exemption acquires just one other type of client – such as a separate account – the adviser would have to register with the SEC unless another exemption is available. This is because accepting any client other than a private fund means the firm no longer advises <u>solely</u> private funds.

Upon becoming ineligible to rely on the private fund adviser exemption due to an increase in AUM above the $150 million threshold on a calendar quarter-end date, an investment adviser would then be permitted one calendar quarter to register with the SEC, resulting in (unless a more generous period is ultimately approved) something of a gallop to complete the firm's registration in time. Even this limited grace period would not be available to any private fund adviser that has not complied with "all applicable Commission reporting requirements."[14] For that reason, a private fund adviser may wish to establish a robust compliance program with respect to its SEC reporting, as any compliance failure may mean that the adviser must register in advance of reaching the $150 million threshold.

[12] Shearman & Sterling's summary of the SEC's rules on US state and local political contributions is *available at* http://www.shearman.com/sec-adopts-rules-targeting-pay-to-play-practices-by-investment-advisers-07-16-2010/.

[13] Burdens of state registration may include, for example, the need to maintain registrations in multiple states and pay corresponding fees, certain state requirements that the adviser file Form ADV Parts 1 and 2 (meaning that certain advisers could find themselves preparing such filings anyway, despite being exempt reporting advisers for SEC purposes), some states' testing requirements for certain personnel, and compliance with any substantive state laws applicable to state-registered investment advisers.

[14] The Exemptions Release does not discuss any materiality threshold (such as for violations that were promptly cured), provide for any "statute of limitations" after which non-compliance sunsets, or make clear whether such "applicable Commission reporting requirements" relate only to the newly established reports to be made by a private fund adviser, or also to other SEC reports such as under Section 13 of the US Securities Exchange Act of 1934.

Again, the terms of this exemption apply quite differently to US versus non-US advisers. A US adviser would count all assets of all private funds it manages, whether those funds are formed within or outside of the United States. By contrast, a non-US adviser – that is, an adviser whose principal office and place of business[15] is outside of the United States – need consider only those private funds it manages from the United States. Therefore, for purposes of both the "solely private funds" test and the AUM test, a non-US adviser may disregard accounts and investment funds managed from outside of the United States, regardless of the extent of investments by US persons in those non-US funds or non-US accounts.

As should be evident, the scope of this exemption as it relates to non-US firms would depend heavily on how the term "managed from the United States" is understood. As proposed, having executive management for a firm's funds business in the United States results in "management from the United States." It is less clear, but portfolio management personnel in the United States presumably also will be a concern, while other functions (e.g., marketing) should present less risk.[16]

"Venture Capital Exemption" – Solely Advising Venture Capital Funds

The other category of exempt reporting adviser is provided for in what the SEC calls the "venture capital exemption." Under this exemption, an investment adviser solely of venture capital funds would not be required to register with the SEC. Unlike the private fund adviser exemption (and in an odd reversal of years of SEC practice), the venture capital exemption would apply its provisions equally to non-US advisers, such that a non-US adviser seeking to rely on this exemption may not advise any non-US fund or account other than a venture capital fund.

Advisory firms that direct most, but not all, of their investment focus on early stage companies and who were holding out hope for the SEC to define "venture capital fund" broadly will be disappointed. The SEC expressly distinguished between typical private equity funds, whose advisers will generally be subject to registration, and venture capital funds, taking the position that "venture capital funds [have] long-term investors in early-stage or small companies that are privately held, as distinguished from other types of private equity funds, which may invest in businesses at various stages of development including mature, publicly held companies."[17] Consistent with that reasoning, this exemption is proposed to be narrowly written.

A "venture capital fund" would be a private fund that satisfies <u>all</u> of the following:

- Holds itself out to investors as being a venture capital fund
- Invests only in equity securities of private operating companies with the purpose of primarily providing operating or business expansion capital (not to buy out other investors)[18]
- Is not leveraged (other than limited short-term borrowing), and its portfolio companies do not borrow in connection with the fund's investment[19]

[15] For purposes of Section 203A of the Advisers Act, "principal office and place of business" has been defined as the executive office of the investment adviser from which its officers, partners, or managers direct, control, and coordinate its activities.

[16] Under the proposed rules, and perhaps unexpectedly, it appears to be irrelevant where a non-US firm's funds are formed or domiciled. The SEC instead seems to be looking only to the location of the fund's management.

[17] Exemptions Release, at text accompanying footnote 40.

[18] Under the proposed rule, at least 80% of the portfolio company securities held by a venture capital fund must be acquired directly from the portfolio company, which in turn cannot redeem or repurchase from existing security holders in connection with such venture capital fund investment.

[19] A venture capital fund would not be permitted to "borrow, issue debt obligations, provide guarantees or otherwise incur leverage, in excess of 15 percent of the private fund's aggregate capital contributions and uncalled committed capital, and any such borrowing, indebtedness, guarantee or leverage is for a non-renewable term of no longer than 120 calendar days."

- Has an arrangement whereby the fund or the investment adviser offers to provide, and if accepted, does so provide, significant guidance and counsel concerning the management, operations or business objectives and policies of the qualifying portfolio company,[20] or controls its portfolio companies
- Does not offer investors redemption or other similar liquidity rights

Although the above criteria provide insight into what types of advisers would qualify for this exemption, the SEC's commentary suggests that the definition is a moving target for now. The SEC invites comment on such central questions as:

- Whether venture capital funds should be defined as investing only in "start-up companies" or "small companies" and, if so, what considerations will go into defining each of these terms (such as net income, revenue or age of the entity)
- Whether non-US advisers should be able to rely on this exemption even if they manage (i) a fund that does not offer to, or have as a beneficial owner, any US person,[21] or (ii) non-US funds that are not "venture capital funds"
- Whether advisers relying on this exemption will be able to continue holding securities in portfolio companies which "go public" post-investment by the venture capital fund
- What the leverage limitations should be for both venture capital funds and their portfolio companies
- What should be the true scope of permissible companies (currently "operating companies") in which the investment adviser can invest and what bright-line criteria should be implemented

The SEC proposes to grandfather any firm that advises solely funds that hold themselves out as "venture capital funds." A topic of discussion at the SEC's November 19th open meeting at which these rules were proposed was the decision not to provide much definition around what it means for a fund to have represented that it is a venture capital fund – this ambiguity appears to have been intentional, but the absence of guidance (if indeed none is forthcoming) presumably will result in variation firm-to-firm when complying with this requirement going forward. Any grandfathered fund must (i) have sold securities to one or more unaffiliated investors prior to December 31, 2010 and (ii) not sell any securities to any person after July 21, 2011.

Whether, for purposes of this grandfathering test, a "sale" occurs after July 21, 2011 as a result of drawdowns of previously committed capital (which certainly would be an odd outcome) appears to be up in the air for the moment. The text of the proposed rule expressly defines a sale to include "accepting any committed capital." However, the Exemptions Release commentary that describes this rule suggests exactly the opposite, leaving the SEC's intent unclear.

Significant New Requirements for Exempt Reporting Advisers

During its November 19th open meeting, the most contentious point seemed to be the extent to which exempt reporting advisers are to make reports to the SEC and be subject to the SEC examination authority. Commissioner Kathleen L. Casey, who cast the lone dissenting vote, expressed her fear that the benefits of being an exempt reporting adviser "are effectively

[20] The SEC has proposed to define a "qualifying portfolio company" as any company that: (i) is not publicly traded; (ii) does not incur leverage in connection with the investment by the private fund; (iii) uses the capital provided by the fund for operating or business expansion purposes rather than to buy out other investors; and (iv) is not itself a fund (i.e., is an operating company).

[21] The Exemptions Release suggests that such a fund would not meet the definition of a "private fund" and thus would not be a "venture capital fund." If the SEC reaches that conclusion in its final rule adoption, non-US venture capital firms will find this exemption extremely narrow.

rendered empty by our parallel proposal imposing reporting requirements on these advisers."[22] Industry comments can be expected to hammer at that theme and may even raise questions about whether this type of reporting was contemplated by Congress.

In particular, it is currently proposed that a manager relying on the "private fund adviser" exemption would be free of certain compliance obligations to which a registered adviser is subject, but would nonetheless be required to file and periodically update reports with the SEC. These exempt reporting advisers would use the same Form ADV registration document as fully registered advisers. Rather than completing all of the items on the form, exempt reporting advisers would fill out a subset of items from Part 1A of Form ADV. In addition to filing information about itself, an exempt reporting adviser would be required to file extensive information relating to each of the private funds that it advises (described below). Surprisingly, given the Dodd-Frank Act's emphasis on confidential reporting mechanics for investment advisers, these filings with the SEC would be publicly available on the agency's website.[23]

Information to be filed about the exempt reporting adviser and its advisory business would include the following:

- Basic identifying information about the adviser
- The identity of its direct and indirect owners and its control persons (for this purpose, directors, certain officers, and similar personnel)
- Financial industry affiliations
- Other business activities in which the adviser and its affiliates engage[24]
- Disciplinary history of the adviser and its employees that may reflect on their integrity

The SEC also proposes to require that an exempt reporting adviser make the same fund-by-fund reporting disclosures as it proposes to require of registered investment advisers (again, this is described below). Both US and non-US advisers would report on all private funds they advise. A non-US adviser, however, would not have to disclose information regarding non-US funds that are not offered to US persons and have no US persons as beneficial owners.

Subject to Exams

As contemplated by the Dodd-Frank Act, exempt reporting advisers would be subject to at least some level of ongoing SEC examination. At the SEC's November 19th meeting, a Commissioner questioned the SEC staff about these examinations, and the SEC staff seemed to downplay the likelihood of including exempt reporting advisers as subjects of routine examinations. Instead, the SEC staff suggested that such advisers may be the focus of targeted exams upon the SEC's being alerted to red flags.

Nevertheless, Commissioner Casey expressed her concern that a proposal "that contemplates exams and active oversight will inevitably require these exempt advisers to absorb the additional costs of robust compliance functions and associated compliance personnel." We agree. The reality is that SEC examiners reviewing the operations of an exempt reporting adviser are likely to view those operations through just the same lens as they would a fully registered adviser. It will then be

[22] SEC Commissioner Casey, Rules Implementing Amendments to the Investment Advisers Act of 1940; Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers (speech) (Nov. 19, 2010), *available at* http://sec.gov/news/speech/2010/spch111910klc-items1-2.htm.

[23] The SEC further suggests that it is open to considering comments that it should require exempt reporting advisers to prepare and file all other items of Form ADV, including the narrative Form ADV Part 2.

[24] The SEC indicates that it intends to review this information to monitor conflicts of interest that may suggest significant risk to the adviser's clients.

up to the unfortunate adviser, in the heat of the moment, to convince the SEC staff that its compliance arrangements were appropriate under the circumstances.

Interpretive Issues Relating to Affiliates

In this rulemaking, the SEC has not addressed a number of interpretive issues relating to, for example, how an adviser uses affiliated sub-advisers or affiliated personnel. Notwithstanding that this can be among the more complex areas of the law, the SEC simply remarks in the Exemptions 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." With reference to the question of so-called "participating affiliates" in particular (e.g., under the *Unibanco* and related no-action letters[25]), the Exemptions Release encourages commenters "to submit comment letters addressing with particularity and specificity interpretative issues that may not be addressed in our proposed rules." This is, in short, a topic to monitor closely during the course of the rulemaking, especially for firms with an interest in leveraging affiliate arrangements.

Books and Records Rules for Newly Registering Advisers

Upon the elimination of the "private adviser" exemption on July 21, 2011, certain previously exempt advisers will become subject to the recordkeeping requirements of the Advisers Act, including requirements to keep records relating to past performance. The SEC, however, is proposing that those advisers that did not previously register while they were eligible for the "private adviser" exemption would not be required to keep certain performance-related records. Nevertheless, to the extent that such records were kept, even though they were not required to be maintained, such advisers would be required to preserve those records. As noted above, the SEC has reserved discretion to adopt recordkeeping rules for exempt reporting advisers.

State-Federal Threshold – "Mid-Sized" Advisers; Multi-State Registration

Once an investment adviser is subject to registration, the question is whether the adviser is to register with the SEC or, instead, a US state. That is where the new "mid-sized adviser" exemption comes in.

Historically, an investment adviser with more than $25 million in AUM would register with the SEC, with a buffer (between $25 million and $30 million AUM) within which an adviser may be registered with one or more states. The proposed rules differentiate among three categories: small, mid-sized and large advisers. The Exemptions Release describes these categories as follows (although, as noted above, non-US firms always have the option of registering with the SEC):

Small adviser – less than $25 million in AUM	Generally prohibited from registering with the SEC
Mid-sized adviser – between $25 million and $100 million in AUM	Generally prohibited from registering with the SEC, so long as required to register in the state of principal office and place of business and subject to examination as an investment adviser by state securities authorities
Large adviser – at least $100 million in AUM	Generally must register with the SEC (unless an exemption is available); if so, would not be subject to state registration but may be subject to notice filings in certain states in which it has clients

[25] *Uniao de Banco de Brasileiros S.A.*, SEC Staff No-Action Letter (July 28, 1992); *Mercury Asset Management plc*, SEC Staff No-Action Letter (April 16, 1993); *The National Mutual Group*, SEC Staff No-Action Letter (March 8, 1993); *Murray Johnstone Holdings Ltd.*, SEC Staff No-Action Letter (October 7, 1994); *Royal Bank of Canada*, SEC Staff No-Action Letter (June 3, 1998).

Each SEC-registered investment adviser will be required to calculate its AUM and report it to the SEC during the 30-day period following July 21, 2011. This report is intended to alert the SEC (and the adviser) whether the adviser is eligible to be register0.ed with the SEC. Any adviser determined to be ineligible for SEC registration will have another 60 days in which to withdraw its SEC registration and register with each applicable state, including to take and pass any state-required examination.[26]

Going forward, any adviser that is required to register in 15 or more states will be eligible to register with the SEC instead. The threshold had previously been 25-30 states, depending on the circumstances.[27]

Regulatory Assets Under Management

Uniform Calculation Methodology

Currently, registered advisers have a certain amount of discretion with respect to how they calculate their AUM. The SEC is moving to a uniform approach for calculating AUM that can be used for (i) determining whether an adviser is eligible to register with the SEC, (ii) disclosing the value of AUM on Part 1 of Form ADV, and (iii) determining whether an adviser qualifies for the available exemptions from registration. The resulting AUM will be an adviser's "regulatory assets under management." This figure may be different than the figure used by the adviser in Part 2 of its Form ADV that the adviser delivers to clients or in other materials prepared by the adviser.

With respect to the new "regulatory assets under management" determination, the SEC proposes that an adviser:

- Will no longer be able to choose to exclude proprietary assets, assets managed without receiving remuneration and assets of non-US clients
- May not deduct any outstanding indebtedness and other accrued, but unpaid liabilities
- Must include the AUM for any private fund client in its total AUM calculation, regardless of the type of assets held by the fund (as discussed in further detail below)
- If acting as a sub-adviser to a private fund, may include only the portion of the value of AUM over which it provides advisory services
- Include any uncalled capital commitments in the calculation of its regulatory assets under management
- Value private fund assets at fair value

The requirement for private funds to value assets at fair value may present difficulties for certain funds. For example, the assets of private equity or venture capital funds typically are illiquid, not fair valued for other purposes, and not easily fair valued. The SEC, however, has expressed its view that this approach is necessary in order to implement a more consistent methodology for calculating and reporting AUM.

[26] The SEC has asked for public comment on whether it should allow for a different period, such as the 180-day period currently in place with respect to transitions from SEC to state registration.

[27] As a related matter, a pension consultant under current law is generally subject to SEC (as opposed to state) registration if it advises plan assets of $50 million or more. The SEC proposes to raise this threshold to $200 million (that is, four times the previous threshold, as is being done in raising the state-federal threshold for other types of firms from $25 million to $100 million). Below $200 million, a pension consultant may be subject to state registration requirements. A "pension consultant" for this purpose means an investment adviser that provides investment advice to (i) any employee benefit plan described in Section 3(3) of the US Employee Retirement Income Security Act of 1974 ("ERISA"); (ii) any governmental plan described in Section 3(32) of ERISA; or (iii) any church plan described in Section 3(33) of ERISA.

Change to the Definition of Securities Portfolios

The SEC has made a significant change to the definition of "securities portfolios." A securities portfolio has long meant a fund or account with at least 50% of its total value consisting of securities. Under both current law and the proposed rules, the SEC excludes "collectibles, commodities, real estate" and other non-securities from that 50% figure. An adviser of such non-securities funds or accounts may historically have had very low or zero AUM for purposes of the SEC's AUM calculation.

As alluded to above, however, under the proposal, any "private fund" – and presumably all of its assets of whatever character – is counted as a "securities portfolio." For that reason, managers of real estate funds, commodity funds, or other funds that mainly hold assets that are not considered securities under the Advisers Act may have a new incentive to analyze whether their funds would be investment companies as defined in Section 3 of the Investment Company Act but for Sections 3(c)(1) or 3(c)(7) of that Act (that is, whether those funds fall within the definition of "private funds").

"US Persons"

Under the above exemptions, to determine which of a foreign private adviser's clients are US clients or investors in the United States in private funds, and to determine whether a client is a US person, the SEC proposed to look to the definition of "US person" in Regulation S under the US Securities Act of 1933 ("Securities Act"), with one exception noted by footnote below. The following is a non-exhaustive summary of who would generally be a "US" client, investor or person:

Is a "US" Client, Investor or Person

- Any natural person resident in the United States
- Any partnership or corporation organized or incorporated under the laws of the United States
- Any estate of which any executor or administrator is a US person
- Any trust of which any trustee is a US person
- Any agency or branch of a foreign entity located in the United States
- Any partnership or corporation if (i) organized or incorporated under the laws of any foreign jurisdiction, and (ii) formed by a US person principally for the purpose of investing in securities not registered under the Securities Act, unless it is organized or incorporated, and owned, by accredited investors who are not natural persons, estates or trusts
- Any non-discretionary account or similar account (other than an estate or trust) held by a dealer or other fiduciary for the benefit or account of a US person
- Any discretionary account or similar account (other than an estate or trust) held by a dealer or other fiduciary organized, incorporated or (if an individual) resident in the United States
- Any discretionary account or similar account (other than an estate or trust) held by a dealer or other fiduciary organized, incorporated or (if an individual) resident outside of the United States <u>if</u> the account is held for the benefit of a US person by a non-US fiduciary who is a related person of the adviser[28]

[28] This is the sole deviation from the definition of "US Person" in Regulation S.

Is Not a "US" Client, Investor or Person

- Any estate of which any professional fiduciary acting as executor or administrator is not a US person if (i) an executor or administrator of the estate who is not a US person has sole or shared investment discretion with respect to the assets of the estate and (ii) the estate is governed by foreign law
- Any trust of which any professional fiduciary acting as trustee is a US person, if a trustee who is not a US person has sole or shared investment discretion with respect to the trust assets
- No beneficiary of the trust (and no settlor if the trust is revocable) is a US person
- Any agency or branch of a US person located outside the United States if (i) the agency or branch operates for valid business reasons or (ii) the agency or branch is engaged in the business of insurance or banking and is subject to substantive insurance or banking regulation, respectively, in the jurisdiction where located
- Any discretionary account or similar account (other than an estate or trust) held for the benefit or account of a non-US person by a dealer or other fiduciary organized, incorporated or (if an individual) resident in the United States

New Fund-by-Fund Public Reporting for All Registered or Exempt Reporting Advisers

We now highlight what is certain to be a controversial reporting regime of concern for hedge fund, private equity and venture capital fund managers alike. As proposed, advisers of private funds – whether registered or exempt reporting advisers – would be subject to reporting that consists of no fewer than 29 items of information, prepared separately for each private fund.[29] This information would be subject to public review on the SEC's website and can be expected to be of interest to the media, a firm's competitors and other market participants, as well as to regulators. The following non-exhaustive list provides a sense of the breadth of the items to be included in Form ADV's new Section 7.B.1 of Schedule D:

- Name and place of formation of the fund
- Name of the directors, general partner, or managing member of the fund
- Details about master funds and feeder funds (whether or not the feeder is affiliated)
- Whether the fund invests more than 10% of its assets in other funds
- Whether the fund invests at all in funds registered under the Investment Company Act
- Type of fund,[30] which the Implementing Release refers to as investment strategy
- Both gross asset value and net asset value (intended to provide a sense of the amount of leverage the fund employs)
- Current value of the fund's Level 1, 2 and 3 assets and liabilities (determined under US generally accepted accounting principles)
- Number of beneficial owners, percentage of fund owned per category of investor,[31] and percentage of fund owned by non-US persons

[29] An investment adviser having its principal office and place of business outside of the United States would not be required to report with respect to a private fund that is not organized in the United States and that is not offered to, or owned by, US persons.

[30] The adviser would indicate whether the fund is a hedge fund, liquidity fund, private equity fund, real estate fund, securitized asset fund, venture capital fund, or "other" (with a description of such "other" type of fund).

- Identities of any other investment advisers or sub-advisers to the fund
- Fund's Form D file number for any fund relying on Regulation D under the Securities Act
- Auditor information, and whether the fund's financial statements are audited
- Identifying information about the fund's prime broker, custodian and administrator
- Identifying information about each marketer of the fund (other than the adviser or its employees), including whether a website is used[32]

It goes without saying that much of the above information is sensitive, and a registered or exempt reporting adviser may face significant confidentiality or similar issues when making these reports. For example, a private fund could have a confidentiality obligation with respect to identifying its directors or certain service providers publicly. In addition, certain information needed to satisfy these disclosure obligations, such as information about type of investor, may not be readily accessible by the adviser. But all practical issues aside, the simple fact is that this private fund reporting will be a "culture shock" among fund managers long accustomed to operating (and indeed as formerly required by statute) out of the public eye.

Other Changes to Form ADV for All Registered or Exempt Reporting Advisers

The Implementing Release outlines a number of proposed changes to be made to Part 1 of Form ADV.[33] In each case, generally, the information is being made more precise. For example, the number of employees will be disclosed as an exact number rather than as a range. Broader disclosure about affiliates will be required. New information about the percentage of clients that are non-US persons will be disclosed. Additional information about the types of investments on which the adviser advises, and additional detail on types of institutional clients, will be provided. For an adviser to investment companies registered under the Investment Company Act, the "Edgar" (or identifying SEC) filing numbers of each fund would be included. An adviser will indicate whether it does business as a trust company, or is a registered municipal advisor, a registered security-based swap dealer, or a major security-based swap participant. Additional information on non-advisory business ventures will be disclosed. Further, advisers will indicate whether they have assets (not AUM, but rather assets on their balance sheet) of greater than $1 billion in order to identify those advisers subject to Section 956 of the Dodd-Frank Act, under which rules may be adopted relating to excessive incentive-based compensation arrangements.

Conclusion

The importance of preparing for registration and reporting in the coming months cannot be underestimated. Firms that are considering their registration options are running out of time to analyze which entities will have to register, whether to restructure affiliates' operations to better fit in the new regulatory framework, or determine whether new service arrangements will be necessary upon commencement as a registered adviser.

31 The ten categories include individuals, private funds, various types of institutional investor, and "other."

32 The Implementing Release notes that the service provider information may be used to identify candidates for an SEC examination.

33 The SEC also recently adopted amendments to Part 2 of Form ADV. Shearman & Sterling's summary of those amendments is *avaiable at* http://www.shearman.com/sec-finalizes-ten-year-effort-to-overhaul-form-adv-for-investment-advisers-08-05-2010/.

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Many advisers will find it prudent to take at least preliminary steps towards registration even before a full understanding of the final rules is available.[34]

Firms that are currently SEC-registered, and expect to remain so, also have much to do. The scope of new reporting planned for fund managers generally – especially the detailed and public fund-by-fund reports that the SEC has proposed – comes as a surprise. Moreover, those proposals may presage even more detailed reporting in later rounds of rulemaking.

Finally, as always, firms may find it appropriate to participate in the public comment process. The necessarily brief timeframe for the SEC's adoption of final rules suggests that views expressed earlier in the comment period could carry more weight than the same viewws expressed among the heavy rush of comments expected shortly after the winter holidays.

This publication is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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[34] In addition, we have previously written about what regulatory compliance means for an SEC-registered adviser, and those writings demonstrate that compliance involves far more than simply registering. For a series of papers on registered investment adviser compliance programs, *see* "Compliance Programs of Investment Companies and Investment Advisers", *available at* http://www.shearman.com/am_0304/, "Implementing and Reviewing SEC-Mandated Compliance Programs", *available at* http://www.shearman.com/am_0305/, and "Compliance Program Annual Reviews – The Second Season", *available at* http://www.shearman.com/am_022007/.