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Dodd-Frank Act Rulemaking: SEC Finalizes Exemptions and Disclosure Requirements for Investment Advisers and Sets Compliance for Early 2012

Introduction

On June 22, 2011, eleven months after President Obama signed into law the sweeping Dodd-Frank Wall Street Reform and Consumer Protection Act, a divided US Securities and Exchange Commission finalized key rules to effect the Dodd-Frank Act's overhaul of certain exemptions available under the US Investment Advisers Act of 1940 (the "Advisers Act"). Soon to expire is the widely relied-upon "counting clients" or "private adviser" exemption from SEC registration. In its place will be a suite of more limited exemptions, including a pair of "quasi-exemptions" that avoid registration but – controversially – carry real and ongoing compliance burdens. The SEC at the same time extended the registration deadline for firms that presently rely on the counting clients exemption to March 30, 2012 (in lieu of what would have been a looming July 21, 2011 deadline). Finally, the SEC adopted new fund-by-fund reporting requirements under Form ADV.

Collectively, the rules – which are set out in what the SEC refers to as the Exemptions Release[1] and the Implementing Release[2] and in various accompanying appendices,[3] as well as in a separate release relating to family offices[4] – represent some of the most significant legal developments for investment advisers in decades. They will require attention from all types of firms, whether or not currently registered with the SEC and whether or not domiciled in the United States.

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. IA-3222 (June 22, 2011) (the "Exemptions Release"), *available at* http://www.sec.gov/rules/final/2011/ia-3222.pdf.

2 Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Act Release No. IA-3221 (June 22, 2011) (the "Implementing Release"), *available at* http://www.sec.gov/rules/final/2011/ia-3221.pdf.

3 *See, e.g.*, Appendix A: Form ADV: General Instructions, *available at* http://www.sec.gov/rules/final/2011/ia-3221-appa.pdf; Appendix B: Form ADV: Instructions for Part 1A, *available at* http://www.sec.gov/rules/final/2011/ia-3221-appb.pdf; Appendix C: Form ADV: Glossary of Terms, *available at* http://www.sec.gov/rules/final/2011/ia-3221-appc.pdf; Appendix D: Form ADV, Part 1A, *available at* http://www.sec.gov/rules/final/2011/ia-3221-appd.pdf (each, June 22, 2011).

4 Family Offices, Investment Advisers Act Release No. IA-3220 (June 22, 2011), *available at* http://www.sec.gov/rules/final/2011/ia-3220.pdf.

The SEC received over 200 comment letters in response to the proposals that preceded this rulemaking.[5] While these comments led to a number of important clarifications and improvements, many aspects of the final rules were adopted substantially as proposed. There also remain a number of areas open to further rulemaking. These include new recordkeeping rules (not yet proposed, but alluded to), systemic-risk-related reporting (proposed) that would cover such topics as a firm's leverage, trading practices and counterparties,[6] and rules that could follow recently concluded studies addressing, first, the merits of a self-regulatory organization for investment advisers[7] and, second, the duties owed by investment advisers and broker-dealers to their clients.[8]

In this alert we cover the following developments:

Of Special Interest to Firms Currently Exempt from SEC Registration

- Repeal of the "counting clients" exemption (i.e., Section 203(b)(3)-1) and addition of the following new exemptions/exclusions:
  - Foreign private adviser (see p. 4)
  - Family offices (see p. 6)
  - Private fund adviser ($150 million threshold) (p. 7)
  - Venture capital fund adviser (p. 9)
- SEC examination programs and required reporting for firms relying on the $150 million threshold and venture capital fund exemptions (p. 11)
- Books and records rules for newly registering advisers (p. 12)
- Interpretive issues relating to how the activities of a firm's affiliates may affect its registration status and reliance on registration exemptions (p. 18)

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

- Timing of all changes under consideration (see p. 3)
- Final rules governing which firms will be registered and supervised by US states versus the SEC (p. 13)
- Final rules for calculation of a firm's regulatory assets under management[9] (p. 13)
- Final rules for defining which clients or fund investors are or are not "US Persons" (p. 15)

5 Shearman & Sterling provided comments to the SEC in advance of the proposed rulemaking, *see* http://www.sec.gov/comments/df-title-iv/exemptions/exemptions-29.pdf, and in response to the proposed rulemakings, *see* http://www.sec.gov/comments/s7-37-10/s73710-79.pdf and http://www.sec.gov/comments/s7-25-10/s72510-92.pdf (the Exemptions and Implementing Releases) and *see* http://www.sec.gov/comments/s7-25-10/s72510-85.pdf (the family office rule). Our comment letters were cited frequently by the SEC staff in these releases and we appreciate the careful consideration given to our suggestions and concerns.

6 For more information, you may wish to refer to Shearman & Sterling's publication on proposed Form PF, *available at* http://www.shearman.com/under-rubric-of-systemic-risk-joint-sec-cftc-proposal-would-dramatically-expand-reporting-by-private-fund-managers-04-28-2011/.

7 *See* SEC study *available at* http://www.sec.gov/news/studies/2011/914studyfinal.pdf.

8 *See* SEC study, *available at* http://www.sec.gov/news/press/2011/2011-20.htm.

9 The regulatory assets under management calculation will be used to determine such items as whether an investment adviser meets the $100 million threshold for SEC-registration and the $150 million threshold for relying upon the "private fund adviser" exemption.

- Final 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. 16)
- Other new Form ADV changes (p. 17)

Timing

The final rules provide that any adviser operating in reliance on the counting clients exemption may delay registering with the SEC until March 30, 2012.[10] However, because the SEC is entitled to a 45-day period to review an adviser's registration filing before acting on it, firms registering with March 30 in mind effectively will need to submit their filings by February 14, 2012.

Other dates of note include the following:

- Every SEC-registered adviser must file an amended Form ADV in order to disclose its assets under management ("AUM") to the SEC no later than March 30, 2012, to determine whether it meets the new federal registration threshold of $100 million AUM. The filing must be a full Form ADV update. Advisers with fiscal year-ends other than December 31 may have to make two full updates in 2012 (i.e., one in the first quarter to determine whether they still qualify to be registered with the SEC and the second later in the year to satisfy the annual reporting requirement).
- Any SEC-registered adviser that, based on the AUM reported in the filing just described, will have to transition to state registration and supervision must file a Form ADV-W by June 28, 2012 in order to withdraw its SEC registration, by which time it must, if so required, be registered with any applicable states.
- Initial reports by exempt reporting advisers (discussed below) must be submitted between January 1, 2012 and March 30, 2012. For these firms, the 45-day SEC review period required for a full registration is irrelevant and can be ignored.
- Venture capital funds intending to be grandfathered into venture capital treatment (discussed below) must cease offering by July 21, 2011.

The New Exemptions

Under the now-expiring counting clients exemption, an adviser that has had 14 or fewer clients during the preceding 12 months and that does not hold itself out publicly in the United States as an investment adviser generally has been exempt from SEC registration as an investment adviser.[11] The more limited exemptions that will replace this exemption are as follows:

- A narrow new "foreign private adviser" exemption.
- Partial exemptions for a new category of investment adviser, which the SEC calls the "exempt reporting adviser".

[10] The reprieve represented by this March 2012 date was not a surprise. It had been signaled for some time. *See*, e.g., letter from SEC official, *available at* http://www.sec.gov/rules/proposed/2010/ia-3110-letter-to-nasaa.pdf. For a public policy rationale for the extension, you may wish to refer to Shearman & Sterling's letter to the SEC on the topic, *available at* http://www.sec.gov/comments/s7-25-10/s72510-92.pdf.

[11] Many advisers that are currently relying on the counting clients exemption will be required to register with the SEC, provided no exemption from registration is available. However, in a sign that the SEC may be open to expanding on the limited scope of the new exemptions, the SEC has indicated in a no-action letter addressed to Zenkoryen Asset Management of America Inc., dated June 30, 2011, that the SEC will not take enforcement action against wholly owned subsidiaries of financial institutions that manage investments exclusively on behalf of their parent companies and that do not register as investment advisers. *See* http://sec.gov/divisions/investment/noaction/2011/zenkoryen063011.pdf.

- A complete exclusion from the definition of an "investment adviser" under the Advisers Act for "family offices", which are entities established by individual families to provide wealth management and other services to the family.

"Exempt reporting advisers" are those that (i) manage solely private funds[12] and have less than $150 million in private fund assets under management in the United States, or (ii) manage solely venture capital funds. An entity falling under the exempt reporting adviser definition avoids most substantive requirements of the Advisers Act,[13] but becomes subject to many of the public filing obligations of a registered adviser, including significant new reporting obligations concerning each private fund it manages, and is potentially subject to examination by the SEC. 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 with the SEC, assuming the firm meets the requisite AUM threshold (generally $100 million) dividing US federal from state registrations. As some states have not confirmed to the SEC that their state securities authorities implement examination programs (a prerequisite for the SEC to relinquish jurisdiction), an adviser with its principal place of business in New York or Wyoming (and not otherwise required to be registered with any of the 48 other states) remains subject to SEC registration at AUM levels of $25 million and above.[14] Non-US firms may voluntarily register with the SEC regardless of their AUM level.

The rulemaking also modifies how AUM is calculated for purposes of these SEC exemptions and eligibility criteria and does so by generally taking a more expansive view of AUM than in the past. This will have the effect of making AUM-based exemptions available to fewer investment advisers than would otherwise be the case.

"Foreign Private Advisers"

A firm able to fit within the narrow confines of the new exemption for "foreign private advisers" will be free from the registration, reporting and recordkeeping requirements of a registered adviser. But as with all investment advisers, registered or not, foreign private advisers remain subject to the SEC's antifraud rules and certain other provisions of the Advisers Act.

To qualify for this exemption, an investment adviser must satisfy *all* of the following conditions (which remain virtually unchanged since the SEC's initial draft proposals under the Dodd-Frank Act):

[12] For purposes of this rule, "private funds" are those that would be investment companies as defined in Section 3 of the Investment Company Act of 1940 (the "Investment Company Act") but for Section 3(c)(1) or 3(c)(7) of that Act. The SEC further clarified that an adviser to a fund that is exempt from registration as an investment company pursuant to Section 3(c)(1) or 3(c)(7) of the Investment Company Act would not lose the right to rely on the private fund adviser exemption just because the fund also qualifies for another exclusion from investment company registration. For example, a fund that as a precaution relies on Sections 3(c)(1) or 3(c)(7), but in fact also qualifies as an exempt real estate fund under Section 3(c)(5)(C) of the Investment Company Act, could still be a "private fund" for purposes of the private adviser exemption. The adviser must, however, treat the fund as a private fund for all purposes, including Form ADV reporting. What are and are not private funds is further discussed below.

[13] Those investment advisers relying upon an exemption from registration under the Advisers Act are nevertheless subject to the antifraud provisions under Section 206 of the Advisers Act.

[14] This list of states for which the $25 million threshold remains relevant because the state does not maintain an investment adviser examination program can be expected to change from time to time. Oddly, for example, the Implementing Release lists Minnesota as such a state, while a subsequent SEC Q&A does not. *See* "Division of Investment Management: Frequently Asked Questions Regarding Mid-Sized Advisers" *available at* http://www.sec.gov/divisions/investment/midsizedadviserinfo.htm.

- Have no "place of business" in the United States[15]
- 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
- 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[16]
- 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 counting clients exemption.[17] A corporation, general partnership, limited partnership, limited liability company, trust, or other legal organization that receives advice based on its investment objectives (rather than the individual investment objectives of its investors) would be considered a single client, rather than "looking through" to count holders of their securities. Moreover, the SEC generally takes the view that multiple legal organizations that have identical shareholders, partners, limited partners, members, or beneficiaries would be considered a single client. The SEC also clarified that the term "client" includes clients from which an adviser receives no compensation. This is in line with the adopted uniform method for calculating AUM (described below) that requires an adviser to include assets managed without compensation.

A different and more complicated test, however, applies to determine who is an "investor" in the United States:

- First, the SEC would look to the definitions of "beneficial ownership" from Section 3(c)(1) of the Investment Company Act and "qualified purchaser" for purposes of Section 3(c)(7) of that Act as defining who constitutes an "investor". As a result of the "look-through" provisions of those sections and related SEC staff interpretive provisions, a foreign private adviser may need to monitor at the time of investment, 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. In addition, the SEC takes the position that an adviser would need to count an owner of a total return swap on the private fund as an investor, given that arrangement effectively replicates the risks and rewards of investing in the private fund to the swap owner.
- Second, to avoid double-counting, the adviser need not count a private fund as a client if the adviser counted all investors in that private fund as investors for purposes of determining the availability of the foreign private adviser exemption. Likewise, a person does not need to be counted as an investor if it is counted as a client of the adviser.

15 A "place of business" is 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. For example, any office from which an adviser regularly communicates with its clients, whether in the United States or abroad, would be a place of business. In addition, an office or other location where an adviser regularly conducts research would be a place of business because the SEC considers research to be intrinsic to the provision of investment advisory services. A place of business generally would not include an office where an adviser solely performs administrative and back-office activities.

16 The Dodd-Frank Act provided that the SEC could include either this $25 million threshold "or such higher amount as the Commission may, by rule, deem appropriate." The SEC acknowledged that authority, but offered no basis for its decision not to consider an alternative threshold. Moreover, the rules provide for no buffer or cure period, so that if, for example, a $20 million investment with a firm that is attributable to a US person were to grow to more than $25 million as a result of capital appreciation, currency exchange rate fluctuations or other reasons, the firm could – quite suddenly – lose its eligibility to remain exempt as a foreign private adviser.

17 For purposes of determining whether a client or an investor is a US person, the SEC will utilize the definition of "US person" in Regulation S of the US Securities Act of 1933 (the "Securities Act"). This topic is further discussed on p. 15.

- Third, various judgment calls will be required in respect of US investors that may have "slipped in" to a firm's advised private funds without being solicited to invest or as a result of a change in the person's status over time. As a starting point, the SEC says that if an adviser reasonably believes that an investor is not "in the United States" as of the time of such investor's investment, the adviser may disregard that investor for purposes of these counts. Illustrating the principle, the SEC specifically permits disregarding a person that was not in the United States at the time of becoming a client or investor but subsequently moves to the United States. This presumably means that a person's status generally would have to be assessed each time a fund investor acquires securities issued by the fund, but not each time a separate account client makes a follow-on investment.
- Fourth, advisers generally must include any holders of the fund's debt, including "short-term paper".[18] The SEC clarified, however, that unless the extension of credit by a fund's broker-dealer or custodian bank results in the issuance of a security by the fund to its creditor, the creditor would not be considered an investor for purposes of the foreign private adviser exemption. For the same reason, the SEC suggests that certain commercial lenders should not count as investors for purposes of the foreign private adviser exemption.
- Finally, in modification to the initial proposal, the definition of "investor" does not include an investor's beneficial owners who are so-called "knowledgeable employees".

Given the variety of attribution rules outlined above, the diligence that a foreign private adviser must perform with respect to fund investors quickly becomes onerous.

"Family Office"

Recognizing that they are quintessentially private enterprises, the Dodd-Frank Act directed the SEC to fully exclude family investment offices from the Advisers Act. The new family office rule does that, but the SEC's definition of a family office will not capture all types of family offices, so that some will find they must restructure to fit the new definition or register as investment advisers (absent another applicable exemption). (Another alternative for a family office organization that falls outside the new rule would be to apply for a tailored exemptive order.)

Under the family office rule, the following criteria for exclusion from the Advisers Act must be satisfied:

- The family office must have no clients other than "family clients" (as defined below)
- The family office must be wholly owned by family clients and be exclusively controlled (directly or indirectly) by one or more family members and/or family entities – all from a single family
- The family office cannot hold itself out to the public as an investment adviser

"Family clients" include, among others: current and former family members, certain employees of the family office, charities funded exclusively by family clients, trusts existing for the sole current benefit of family clients, revocable trusts funded solely by family clients, certain key employee trusts, and, with certain exceptions, companies wholly owned exclusively by, and operated for the sole benefit of, family clients.

Under the family office rule, a family may define itself by reference to a common ancestor (who need not be living) and then define "family members" based on the degree of lineal kinship to the common ancestor. While the rule does place a limit of ten generations between the referenced ancestor and the youngest generation, the referenced ancestor can be changed over

[18] "Short-term paper" is defined by referencing Section 2(a)(38) of the Investment Company Act, which defines it as "any note, draft, bill of exchange, or banker's acceptance payable on demand or having a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof payable on demand or having a maturity likewise limited".

time so as to include additional lineal descendants (although this could reduce the extended members of the family that will satisfy the definition of "family member").

Finally, the family office rule liberalizes the restrictive original proposal regarding who may own and control the family office, but only to a degree. While persons other than family may have an ownership stake in the enterprise, assuming those non-family owners qualify as "family clients" (as key employees would), exclusive control must rest with family members. This is intended to create flexibility in structuring the ownership of family offices. However, so as to preserve exclusive family control, the incentive structures available to key employees of family offices, at least with respect to equity incentives, are effectively limited to having key employees own no more than a minority interest in the family office.

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

The SEC had proposed – and has now established – 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 will be exempt from SEC registration, but will still be subject to the antifraud provisions of the Advisers Act, certain public reporting and recordkeeping requirements as well as examination by the SEC.

Resulting in a split 3:2 vote, both Republican-appointed SEC Commissioners refused to support this aspect of the rulemaking after expressing real concern about the burdens that attach to being an exempt reporting adviser. SEC Commissioner Troy Paredes put his dismay this way:

> [The rule] goes too far towards collapsing the distinction between what it means to be unregistered versus registered. I am troubled that [it] charts an increasingly regulatory course forward such that the Advisers Act regime that applies to exempt advisers will end up closely resembling the regime that regulates registered advisers; that as their reporting and recordkeeping obligations mount, exempt advisers will find themselves subject to what in substance is registration.[19]

Commissioner Kathleen L. Casey added that the final rules provide "no meaningful relief" for exempt advisers and argued that "it can only be assumed that the ultimate goal is to promote registration ... by nullifying any benefit of exemption."[20] Chairman Mary Schapiro seemed unfazed, however, and – implicitly agreeing with Commissioner Paredes' prophesies for the future – hinted that the obligations of exempt reporting advisers may be increased over time.

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

A "private fund adviser" will be exempt from registration if it both (i) advises solely private funds and (ii) in the aggregate, manages less than $150 million of private fund assets in the United States. As discussed below, the private fund adviser exemption functions very differently for US advisers as compared to non-US advisers.

Under the final rules, a private fund adviser may manage an unlimited number of private funds. However, if an adviser relying on this exemption advises just one other type of client – such as a separately managed account with a client other

[19] Remarks of SEC Commissioner Troy A. Paredes, "Statement at SEC Open Meeting: Rules Implementing Amendments to the Investment Advisers Act of 1940 and Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers" (June 22, 2011), *available at* http://www.sec.gov/news/speech/2011/spch062211tap-items-1-2.htm.

[20] Remarks of SEC Commissioner Kathleen L. Casey, "Statement at SEC Open Meeting: Rules Implementing Amendments to the Investment Advisers Act of 1940 and Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers" (June 22, 2011), *available at* http://www.sec.gov/news/speech/2011/spch062211klc-items1-2.htm.

than a private fund – 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 solely private funds.

The SEC interprets the "solely" private funds requirements strictly and clarifies that an adviser cannot combine other exemptions. For example, an adviser could not advise venture capital funds with AUM in excess of $150 million in addition to other types of private funds with less than $150 million in AUM.

In determining what is a private fund and what is a separate account, the SEC appears reluctant to qualify a fund with a single investor as a "private fund" for purposes of the exemption. The SEC is concerned that an adviser simply could convert client managed accounts to single-investor funds in order to avoid registration under the Advisers Act. That said, the SEC acknowledges that there may be a variety of reasons why a fund has only a single investor and suggests that it would recharacterize a single-investor fund (commonly called a fund of one) as a managed account only in certain situations, such as where the fund was purposefully structured to avoid registration obligations. It is also clear that any vehicle treated as a "private fund" for purposes of fitting into the private fund adviser exemption likewise should be treated as a private fund for Form ADV reporting purposes. The inverse situation, however, remains unclear. Specifically, if a vehicle is to be treated as a managed account such that the adviser is unable to rely upon the exemption, it is not certain whether that managed account can be disregarded as a private fund for Form ADV purposes.

The final rules provide that an adviser relying on the private adviser exemption must make a determination annually, rather than quarterly as initially proposed, to assess whether it satisfies the $150 million AUM threshold. Upon becoming ineligible to rely on the private fund adviser exemption due to an increase in AUM above the $150 million threshold, the adviser generally would be required to register with the SEC within 90 days after submitting its annual exempt reporting adviser Form ADV filing, and may continue to act as a private fund adviser during this transition period.[21] As the amendment to Form ADV must be filed within 90 days after the adviser's fiscal year-end, the adviser in effect has 180 days after such fiscal year-end to register with the SEC. This grace period is, however, not available to advisers that fail to comply with each of the SEC reporting requirements applicable to an exempt reporting adviser as such, or that have accepted a client that is not a private fund;[22] such advisers would have to plan to register with the SEC prior to losing their ineligibility for the exemption. 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 precipitate a rush to register.

Treatment of Non-US Entities Under the Exemption for "Private Fund Advisers"

The terms of this exemption apply quite differently to US advisers versus advisers whose principal place of business is outside the United States. [23]

- First, a non-US adviser may have clients outside of the United States that are not private funds. A non-US adviser may advise, for example, a managed account (or even thousands of managed accounts) without losing its eligibility for the exemption as long as the beneficial owner of such account is not a US person and the management of the account is at a place of business outside the United States.

[21] Form ADV instructions leave the adviser a range of dates on which it may calculate its private fund assets, addressing concerns raised by commentators about short-term fluctuations in AUM. Form ADV must be filed within 90 days after the end of the adviser's fiscal year, but the calculation can be made as of any date within 90 days prior to the date of the filing.

[22] The Exemptions Release does not discuss any materiality threshold (such as for violations that were promptly cured). The SEC has clarified, however, that the provision does not pertain to all SEC rules or filing violations, but rather only to those specifically required of "exempt reporting advisers as such".

[23] The "principal place of business" means the executive office of the investment adviser from which the officers, partners, or managers of the adviser direct, control, and coordinate the activities of the adviser, even if day-to-day management of "client accounts" may take place at another location.

- Second, a non-US adviser need consider only those private funds it manages at a place of business in the United States. [24] By contrast, a US adviser must count all assets of all private funds it manages, whether those funds are formed within or outside of the United States.

Having a place of business in the United States in and of itself would not be of concern. Rather, the determining factor is whether the investment adviser "manages" assets, or has "assets under management", at the US place of business. For this purpose, "assets under management" are based on the securities portfolios for which an adviser provides "continuous and regular supervisory or management services". Generally, providing research or conducting due diligence should not be "continuous and regular supervisory or management services" at a US place of business if a person outside the United States makes independent investment decisions based on such research or due diligence and implements those investment decisions. This means that US-based research or diligence teams typically would not be a concern, while US-based portfolio managers could present issues.

The SEC believes that these principles recognize that non-US activities of non-US advisers are less likely to implicate US regulatory interests and is in keeping with general principles of "international comity" (referring to mutual respect between nations). The rule also is designed to encourage the participation of non-US advisers in the US market by applying the US securities laws in a manner that does not impose US regulatory and operational requirements on a non-US adviser's non-US advisory business. Non-US advisers relying on the private fund advisers exemption will remain subject to the Advisers Act antifraud provisions and will become subject to the reporting requirements applicable to exempt reporting advisers described below.

"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 a significant reversal of years of SEC practice in similar contexts), the provisions of the venture capital exemption would apply 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.

As with family offices, many venture capital firms also could find themselves outside of the definition of a term they have long used to describe their business. Under the final rules, a "venture capital fund" would be (i) a "private fund" (the definition of which is discussed above), or (ii) a non-US fund that has not offered or sold its securities in the United States through the use of US jurisdictional means or to a U.S. person (as defined in Regulation S under the Securities Act) outside the United States, but that would be a private fund if the issuer were to engage in any such activity, and that further satisfies all of the following:

- Holds no more than 20% of the fund's capital commitments in "non-qualifying investments" (other than short-term holdings), with "qualifying investments" generally consisting of equity securities of "qualifying portfolio companies"[25] that are generally *directly* acquired by the fund (and not on the secondary market)[26]

[24] To be clear, a non-US adviser may accept an unlimited amount of fund investments from an unlimited number of US persons, even if invested in a US fund (i.e., a fund organized under the laws of any state of the United States), so long as the asset management is performed at a place of business outside the United States.

[25] A "qualifying portfolio company" is defined as any company that (i) is not a reporting or foreign traded company and does not have a control relationship with a reporting or foreign traded company, (ii) does not incur leverage in connection with the investment by the private fund investment, and (iii) is an operating company (and not itself a fund). The terms reporting and foreign traded companies are defined in the rule and are intended to refer to public companies, thereby focusing the exemption on investors in private companies.

[26] The SEC revised the definition of qualifying investments to also include equity securities issued by the qualifying portfolio company that are received in exchange for directly acquired equities issued by the same qualifying portfolio company. This revision enables qualifying funds to

- Is generally not leveraged (other than limited short-term borrowing), excluding certain guarantees of qualifying portfolio company obligations by the fund[27]
- Does not offer investors redemption or other similar liquidity rights except in extraordinary circumstances
- Represents to its investors and prospective investors that it carries out a venture capital strategy[28]
- Is not registered under the Investment Company Act and has not elected to be treated as a business development company

The SEC had considered defining a qualifying fund as a fund that invests in "small" companies, but it did not do so in the final rule, noting the lack of consensus for defining such a term. The SEC also decided not to adopt a managerial assistance element as part of the venture capital fund definition, recognizing the difficulties of applying such criterion, especially in a syndicated transaction involving multiple funds.

The SEC also was sensitive to concerns raised by commentators that the definition of venture capital fund should not operate to foreclose investment funds from investment opportunities that would benefit investors but not change the basic character of the venture capital fund. At the same time, the SEC was troubled that various modifications to its proposed investment limitations could, especially if applied as a group, permit reliance on the exemption by advisers to other types of funds than those the SEC believed Congress intended for this exemption. To balance these competing considerations, the SEC now allows a venture capital fund to invest up to 20% of its capital in investments that would not otherwise satisfy the elements of the rule (the "non-qualifying basket"). The non-qualifying basket may be used, for example, to acquire equity securities on the secondary market, longer-term or higher yielding debt securities or the like. The 20% non-qualifying basket is thus a significant concession to market realities. Use of the basket is not, however, entirely at the discretion of the fund, since the fund – taken as a whole – remains at all times subject to the larger requirement that it should represent itself as following a venture capital strategy.

The SEC also decided to exempt any firm that advises solely funds that meet the following "grandfathering" test. A grandfathered fund should hold itself out as pursuing a venture capital strategy, have sold securities to one or more investors prior to December 31, 2010, and not sell any securities to (including accepting any capital commitments from) any person after July 21, 2011. The SEC clarified that a grandfathered fund would include any fund that has accepted all capital commitments by July 21, 2011 (including capital commitments from existing and new investors) even if none of the capital commitments has been called by such date. Calling capital after July 21 would only be consistent with the grandfathering provision, if the investor was already obligated by that date to make the contribution (if called).

participate in the reorganization of the capital structure of the portfolio company. The final rules similarly treat as a qualifying investment an equity security issued by another company in exchange for directly acquired equities of a qualifying company, provided that the qualifying company becomes a majority-owned subsidiary of the other company or is a predecessor company. This provision enables a qualifying fund to acquire securities in connection with the acquisition (or merger) of a qualifying portfolio company by another company. As a result of this modification, a venture capital fund could hold equity securities of a company subject to reporting under the US Securities Exchange Act of 1934, as amended (the "Exchange Act").

[27] 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."

[28] Under this revised "holding out" criterion, it is not necessary for a fund to use "venture capital" or like terms in its name. The key is how the fund describes the totality of its investment strategy to investors and prospective investors. That said, the SEC repeatedly suggests that "multi-strategy" funds will be ineligible. The SEC will also look at factors external to the offering documents, such as the context created by listing a fund in a database of funds that are primarily venture capital funds versus databases of other types of funds.

Significant New Requirements for Exempt Reporting Advisers – Filings and SEC Oversight

Two of the more contentious points arising during the rulemaking process were the new disclosure obligations placed on exempt reporting advisers and the fact they would be subject to the SEC's examination authority. As already described, the requirements are sufficiently controversial that two Commissioners spoke out strongly against them before withholding their votes on these aspects of the rules.

With respect to the reporting requirements, an exempt reporting adviser is required to file and periodically update reports with the SEC using the same Form ADV registration document as fully registered advisers. Unlike registered advisers, rather than completing the entire Form ADV, exempt reporting advisers will have to fill out a subset of items from Part 1 (and none of the narrative Part 2). The filings will be publicly available on the SEC website. In the Implementing Release, the SEC indicated that making disclosures publicly available will create the requisite transparency to identify those practices that may be harmful to investors, allow investors to conduct thorough due diligence and deter potential fraudulent activity. To alleviate confusion, the SEC intends to clearly indicate online whether a particular Form ADV has been filed by a registered or unregistered adviser.

After the initial filing date of March 30, 2012 passes, entities that become exempt reporting advisers must submit their initial Form ADV within 60 days after first relying upon either the "private fund adviser" or "venture capital" exemption. Thereafter, exempt reporting advisers must update their Form ADV filing at least annually, within 90 days after the adviser's fiscal year end. There are certain changes, however, that require more frequent amendments; for instance, those relating to the adviser's identifying information and disciplinary history.

Information to be filed about the exempt reporting adviser and its advisory business will include the following (as examples):

- Basic identifying information about the adviser, including whether it has at least $1 billion in assets on its balance sheet (as opposed to "client" assets under management)
- The exemption upon which the adviser is relying that allows it to be eligible to be an exempt reporting adviser (private fund adviser or venture capital)
- 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[29]
- Disciplinary history of the adviser (including its officers, partners, directors or employees) that may reflect on its integrity

Additionally, under the final rules, the SEC requires that an exempt reporting adviser make the same fund-by-fund reporting disclosures as it requires of registered investment advisers (again, this is described below). Both US and non-US advisers would report on all "private funds" they advise: for non-US advisers, as described above, this refers only to US funds, (they would not have to disclose information regarding non-US funds that are not offered or sold within the United States or to US persons).

Additionally, the SEC retained jurisdiction to subject exempt reporting advisers to at least some level of ongoing SEC "examination".[30] Yet at the SEC's open meeting on June 22, 2011, Chairman Schapiro stated that the SEC does "not intend to conduct routine examinations of exempt reporting advisers."[31] She went on to say that, "[a]s many observers know, the Commission has scarce resources and it is important therefore that we target those resources toward the advisers that are actually registered with us, where the investing public expects us to be focused."

The SEC staff nonetheless suggested that exempt reporting advisers may be the focus of targeted, or "for-cause", examination if the SEC is alerted to red flags. Based on this authority, it would be prudent for exempt reporting advisers to consider implementing compliance programs intended to address the main areas on which the SEC examination staff typically focuses.

Books and Records Rules for Newly Registering Advisers

As previously exempt advisers register with the SEC and become subject to the recordkeeping requirements of the Advisers Act, including requirements to keep records relating to past performance, they will face the issue of how they address their past recordkeeping practices, which are often more fragmentary. Under the final rules, those advisers that were previously relying upon the counting clients exemption are not obligated to maintain any performance-related information for periods during which they were not SEC-registered. However, to the extent performance-related information was maintained during such periods, the previously exempt advisers are required to preserve those records for the requisite amount of time as required by Rule 204-2 under the Advisers Act.[32]

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

Once it has been determined that an investment adviser is subject to registration, the next question is whether the adviser is to register with the SEC or, instead, a US state. That is where the new "mid-sized adviser" rule comes in.

Historically, an investment adviser with more than $30 million in AUM has been required to register with the SEC (absent an applicable exemption), with a buffer (between $25 million and $30 million AUM) within which most advisers could elect to register with the SEC rather than potentially needing to be registered with one or more states in addition to its SEC registration. An investment adviser with less than $25 million in assets under management generally has been prohibited from registering with the SEC. The final rules similarly differentiate among three categories of investment advisers: small, mid-sized and large advisers. The Implementing Release describes these categories as follows (although, as noted above, non-US firms always have the option of registering with the SEC):

[29] The SEC has indicated that it intends to review this information to monitor conflicts of interest that may suggest significant risk to the exempt reporting adviser's clients.

[30] The term "examination" refers to the periodic books and records reviews, often performed onsite at an adviser's offices, that the SEC performs as part of its core industry monitoring and oversight efforts.

[31] Remarks of SEC Chairman Mary L. Schapiro, "Statement at SEC Open Meeting: Rules Implementing Amendments to the Investment Advisers Act of 1940 and Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers" (June 22, 2011), *available at* http://www.sec.gov/news/speech/2011/spch062211mls-items-1-2.htm.

[32] Five years is the general amount of time that books and records must be maintained by those advisers subject to Section 204 of the Advisers Act and the rules thereunder, though investment performance-related records also must be kept from throughout the period of the performance shown (assuming any advertising of that performance).

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 (i) required to register with the securities commissioner of the state in which it maintains its principal office and place of business and (ii) subject to examination as an investment adviser by state securities authorities. Currently, all states except New York and Wyoming have indicated to the SEC that advisers with principal places of business in those states are subject to examination 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 registered, would not be subject to state registration but may be subject to notice filings in certain states in which it has clients or offices.

Each SEC-registered investment adviser will be required to file an amendment to its Form ADV no later than March 30, 2012. In addition to responding to the new items contained in Form ADV (discussed below), this will identify those mid-sized advisers that do not meet the necessary AUM threshold (i.e., with less than $100 million in AUM). Such mid-sized advisers will have to withdraw from the SEC's regulatory purview by filing Form ADV-W no later than June 28, 2012, and will also have to register with each applicable state (which may include, among other things, passing state examinations or submitting investment management agreements for review and comment) by that deadline. The SEC did, however, recognize the potential regulatory burden that would be placed on those advisers that become subject to regulation by numerous states. To this end, the final rules provide that 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.[33]

Mid-sized advisers that are registered with the SEC as of July 21, 2011 will be required to remain so registered until January 1, 2012.[34]

Switching From SEC to State Regulation – The Buffer

The final rules have adopted a buffer in order to provide some leeway to registered mid-size advisers that will allow them to determine whether they should switch between state and SEC registration. Specifically, under the final rules, the threshold above which a mid-sized investment adviser must register with the SEC has been raised to $110 million. Once registered, a large adviser need not withdraw its registration until its regulatory assets under management fall below $90 million.

Regulatory Assets Under Management

Uniform Calculation Methodology

Registered advisers will lose certain discretion that they currently have when calculating their AUM, at least for regulatory purposes with the SEC. The new approach for calculating AUM applies when (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

[33] As a related matter, a pension consultant under current law is generally eligible to register with the SEC if it provides investment advice with respect to pension plan assets of $50 million or more regardless of whether such assets (or any other assets on which it advises) technically qualify as the consultant's assets under management (which, often, they do not due to its limited advisory role). The SEC has raised this threshold to $200 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.

[34] This process allows more flexibility for advisers in terms of timing than the SEC's initial proposal under which an SEC-registered adviser would have had to calculate its AUM and report it to the SEC during the 30-day period following July 21, 2011. Also under the previous proposal, any adviser determined to be ineligible for SEC registration would have only had another 60 days in which to withdraw its SEC registration and register with each applicable state.

qualifies for the available exemptions from registration. The resulting AUM will be an adviser's "regulatory assets under management". This figure may be different from the figure used by the adviser in Part 2 of its Form ADV, which the adviser delivers to clients, or in other materials prepared by the adviser.

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

- Will no longer be able to choose to exclude proprietary assets, assets managed without receiving remuneration or 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)
- May, if acting as a sub-adviser to a private fund, include only the portion of the fund's assets over which it provides advisory services
- Must include any uncalled capital commitments in the calculation of its regulatory assets under management
- Must value assets of private fund clients at market value, or if the market value is unavailable, 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. While this new approach represents a marked departure from current practice, whereby advisers are permitted to calculate their AUM based on the method utilized to report their assets to clients, the SEC believes that the new approach is necessary in order to implement a more consistent methodology for calculating and reporting AUM.

The SEC has acknowledged that the requirement to value private fund assets at fair value may increase compliance costs. In order to mitigate these costs somewhat, the SEC has stated that investment advisers need not employ third-party pricing services or appraisers. Rather, the final rules provide that the fair value of the assets may be determined in accordance with the constitutive documents of the private funds that the investment manager advises. For example, the documents may provide that the fair valuation of the fund's assets is carried out by the general partner.

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 of which at least 50% of the total value consists of securities. Under both current law and the final rules, the SEC excludes "collectibles, commodities, real estate" and other non-securities from that 50% figure. Accordingly, an adviser of 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 final rules, any "private fund" – and presumably all of its assets of whatever character – will be 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 cause to analyze whether their fund clients 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"). Only if managers are certain that they do not advise "private funds" may they exclude the assets held in such funds from their AUM calculation.

"US Persons"

In applying the new exemptions under the Dodd-Frank Act, the SEC will look to the definition of "US person" in Regulation S under the Securities Act (with one exception noted by footnote below) to determine whether a client is a US person and which of a foreign private adviser's clients are US clients or investors in the United States in private funds. The following is a non-exhaustive summary of who would generally be 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 organized or incorporated under the laws of any non-US jurisdiction, if 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[35]

The following is a non-exhaustive summary of who would generally <u>not</u> be a "US" client, investor or person:

- Any estate of which any professional fiduciary acting as executor or administrator is 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 and if 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

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

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

The following section highlights what is certain to be a controversial reporting regime of concern for hedge fund, private equity and venture capital fund managers alike. Under the final rules, advisers of private funds – whether registered or exempt reporting advisers – will be subject to reporting that consists of no fewer than 28 items of information, prepared separately for each private fund managed by the adviser.[36] This information will be publicly available 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
- The exclusion from the Investment Company Act on which the fund relies
- Whether the fund invests at all in funds registered under the Investment Company Act
- Type of fund,[37] which the Implementing Release refers to as "investment strategy"
- The gross asset value
- Minimum subscription amount required for non-affiliated entities
- Number of beneficial owners and the percentage of the fund owned by non-US persons, funds-of-funds, the adviser and its related persons
- Identities of any other investment advisers or sub-advisers to the fund
- The 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 and prepared in accordance with US GAAP
- Identifying information about the fund's prime broker, custodian and administrator, and whether any of these service providers are related to the adviser
- Percentage of the private fund's assets that were valued by a non-affiliate during the last fiscal year[38]

[36] 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 a "US person" (as defined below) and that is not offered to, or beneficially owned by, US persons. Moreover, a non-U.S. fund that has not utilized US jurisdictional means while offering its securities would not be a private fund, at least for these reporting purposes. As such, for purposes of the private fund disclosure requirements, it would seem that a fund that makes a valid offering pursuant to Regulation S of the Securities Act and no corresponding US offering would not be considered a private fund, regardless of whether it comes to have US persons (as defined under Regulation S) as its beneficial owners.

[37] 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).

[38] For purposes of this disclosure requirement, an entity should be viewed as valuing an asset if the valuation procedure was carried out for purposes of subscriptions, redemptions, distributions or fee calculations.

- Identifying information about each marketer of the fund (other than the adviser or its employees), including whether a website is used

The SEC removed several disclosure items from its initial proposal. For example, an adviser will not be required to disclose both net and gross assets of each fund it manages. The initial proposal also called for private funds to categorize their investors and disclose the amount of shares held by each such category of investor. It was argued that this information created the opportunity to reverse engineer the identity of shareholders, which could dissuade certain institutional investors from owning shares of private funds. In removing these items from the revised Form ADV, the SEC stated that the potential competitive harm created by these disclosures outweighed the public benefits created by revealing such information.[39] If a private fund has more than one adviser, only one adviser must report the full scope of information related to that fund. With respect to master-feeder structures, to the extent the disclosures for each individual entity would contain substantially identical information, the adviser need only submit a single report that consolidates the information for each entity in the structure.

Notwithstanding the concessions provided by the SEC in regards to the private fund disclosures (as discussed in the previous paragraph), much of the required information will be sensitive, and a registered or exempt reporting adviser may face significant confidentiality or similar issues when making these reports. For example, pursuant to provisions appearing in constitutive documents, management agreements or agreements with service providers, many private funds have confidentiality obligations with respect to disclosing certain service providers or directors publicly. Moreover, practical issues aside, the reality is that this private fund reporting regime represents a 180-degree shift for fund managers long accustomed to operating outside of the public realm.

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

The Implementing Release outlines a number of changes to be made to Part 1 of Form ADV.[40] In each case, generally, the information is being made more precise and detailed. For example, the number of employees will be disclosed as an exact number rather than as a range. Broader disclosure about affiliates is required. Advisers must provide greater information regarding the number and types of clients they advise. Advisers must report the percentage of their clients that are non-US persons. 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" filing number (SEC identification) of each fund will be included. An adviser will have to 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; this disclosure is intended to identify those advisers subject to Section 956 of the Dodd-Frank Act, for which the SEC has proposed rules relating to incentive-based compensation arrangements.[41]

[39] The SEC has also proposed a new Form PF for purposes of compiling data for systemic risk purposes. The much more data-intensive Form PF reporting will apply to registered advisers, but not to firms that are not registered, such as exempt reporting advisers, foreign private advisers or family offices. *See*, *supra*, note 6 for a link to Shearman & Sterling's Form PF publication.

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

[41] Shearman & Sterling's summary of the proposed rules regarding incentive compensation at covered financial institutions with at least $1 billion in assets is *available at* http://www.shearman.com/financial-regulatory-agencies-issue-joint-proposed-rules-on-compensation-04-06-2011/.

Participation in Client Transactions

In an effort to bring potential conflicts of interest to light, the revised Form ADV will adopt three amendments regarding disclosures in relation to transactions with clients. First, an adviser with the authority to select broker-dealers for client transactions will have to indicate whether any such broker-dealers are affiliated with the adviser. Second, an adviser receiving soft dollars must disclose whether such arrangement falls within the safe harbor provided under section 28(e) of the Exchange Act, for eligible brokerage or research services. Finally, Form ADV will require that advisers indicate whether they receive compensation, directly or indirectly, for referring their clients to broker-dealers.

Custodians

In 2009, Form ADV was amended for purposes of requiring registered advisers to indicate whether the adviser or any of its related persons were acting as qualified custodians. The final rules have expanded somewhat on this requirement, given that registered advisers will also have to disclose the total number of custodians engaged with respect to the adviser's clients, and whether or not these custodians are affiliated with the adviser.

Subadvisers and Affiliates

The application of the new regulatory regime to subadvisers raises a number of complex questions. On the one hand, the SEC recognizes that in many subadvisory relationships a subadviser has contractual privity with a private fund's primary adviser rather than the private fund itself and that the clients of the primary adviser "may" (as opposed to "must") be viewed as a client of the subadviser. On the other hand, it seems that the SEC generally expects a subadviser to take the number, type and amount of managed assets of clients of the primary adviser into account when determining whether the subadviser fits within one of the exemptions under the final rules. In fact, the SEC has expressed the view that it would consider a subadviser to be eligible to rely on the private fund adviser exemption (and thereby be an exempt reporting adviser) only if the subadviser's services to the primary adviser relate "solely" to private funds and the other conditions of the final rules are met (i.e., having less than $150 million in private fund assets under management in the United States).[42]

The SEC further clarified that an adviser would not be permitted to manage, for example, $200 million in private fund assets without registering with the SEC by simply reorganizing as two separate advisers, stating that such approach would violate the prohibition in Section 208(d) of the Advisers Act to not do indirectly what a person could not do directly. The SEC would therefore treat as a single adviser two or more affiliated advisers that are separately organized but operationally integrated, which – subject to certain limitations – could result in a requirement for one or both advisers to register.

At least for affiliated advisers, the SEC added some legal certainty to established business practices of global advisory firms. In reaction to some commentators' requests, the SEC clarified that nothing in the final rules is intended to withdraw any of the guidance provided by its staff in the *Unibanco* letters.[43] Unregistered non-US investment advisers (as what is often termed "participating affiliates") may therefore continue to provide advisory services to US clients through an affiliated SEC-registered adviser, and to share personnel and resources with such registered adviser, as long as the affiliates are separately organized, the registered adviser is staffed with personnel (located in the United States or abroad) capable of providing investment advice, all personnel of the participating affiliate involved in US advisory activities are deemed associated persons of the registered affiliate (subject to, for example, certain code of ethics requirements), and the SEC has adequate access to trading and other records of the participating affiliate and to its personnel to the extent necessary to enable it to

[42] Likewise, a subadviser would be eligible to rely on the venture capital fund exemption only if its services to the primary adviser relate "solely" to venture capital funds and the other requirements of the exemption are met.

[43] The *Unibanco* line of no action letters commenced with *União de Bancos de Brasileiros S.A.*, SEC Staff No-Action Letter (Jul. 28, 1992).

identify conduct that may harm US clients or markets. By explicitly endorsing the *Unibanco* guidance in the Implementing Release, the SEC created a new barrier for its staff (which always technically had the right to do so) to revoke the *Unibanco* guidance.[44] At the same time, however, the SEC reserved the right to adjust its guidance in relation to new issues that may come up in the future by indicating that the staff will provide further guidance, as appropriate, based on facts that may be presented regarding the application of the *Unibanco* letters in the context of the new foreign private advisers exemption and the private fund advisers exemption.

Doing Indirectly What Is Not Permissible to Do Directly

In adopting the final rules, the SEC took an unusually expansive view of the relevance of the prohibition in Section 208(d) of the Advisers Act. That section provides that "[i]t shall be unlawful for any person indirectly, or through or by any other person, to do any act or thing which it would be unlawful for such person to do directly under the provisions of this title or any rule or regulation thereunder." The Exemptions Release notes that "[w]e would view a structure with no purpose other than circumvention of the Advisers Act as inconsistent with section 208(d)." While that position is by no means new, the emphasis throughout the Exemptions Release – which at least ten times either refers to Section 208(d) or cross-references text that refers to that section – suggests that investment advisers should take care as they structure relationships or operations in light of the final rules.

Application of the "Pay-to-Play" Rule

Currently, the "pay-to-play" rule, which governs US state and local political contributions and the use of placement agents to solicit advisory contracts from elected officials, applies to advisers that are either SEC registered or that are not registered in reliance upon the counting clients exemption. To avoid the narrowing of the applicability of the pay-to-play rules that could have arisen from the revocation of that exemption, the SEC amended the pay-to-play rules so that they apply to both exempt reporting advisers and foreign private advisers. 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.[45]

Conclusion

With the final rules, the SEC takes a new approach to regulating the investment advisory industry. Consistent with the requirements of the Dodd-Frank Act, it adopted several exemptions in place of the former counting clients exemption, including the new exempt reporting adviser categories, although the benefits of being an exempt reporting adviser have been seriously questioned, even by some current Commissioners. Given this wholly new regime of quasi-exemptions instead of full exemptions, the coming years can be expected to present exempt reporting advisers with a steady flow of significant new interpretive issues and operational challenges.

Other issues will spring from implementing the foreign private adviser exemption, where the SEC established an expansive set of look-throughs designed to find US "owners" potentially well up the chain from the private funds involved. Still others will derive from the emphasis on holding out in the venture capital fund exemption and the many new Form ADV requirements and definitions (or lack thereof).

[44] The SEC has endorsed *Unibanco* previously, but there was concern among some observers that the Dodd-Frank Act's revision to terms relating to non-US advisory firms could have been claimed at some point as a regulatory basis to limit that relief either by SEC or SEC staff action.

[45] 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/.

Turning to immediate "to-do" obligations, firms that are considering their registration options must be careful not to run out of time to analyze which entities will have to register, whether to restructure affiliate operations to better fit within the new regulatory framework, or determine whether new service arrangements will be necessary upon commencing operations as a registered adviser. Now that the final rules have been approved, unregistered advisers should begin taking concrete measures for registration or reporting, and developing proper compliance procedures, as the first quarter of 2012 approaches.[46] Firms that are currently SEC registered, and expect to remain so, also have much to do, especially in regards to the detailed and public fund-by-fund reports that the SEC has adopted.

[46] 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, you may wish to refer to our publications entitled "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/.

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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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