

SEC Issues Final Rules Implementing Dodd-Frank Amendments to the Investment Advisers Act of 1940

On June 22, 2011, the SEC issued final rules and rule amendments implementing certain provisions of Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “**Dodd-Frank Act**”) that amend the Investment Advisers Act of 1940 (the “**Advisers Act**”). The final rules were described in two extensive adopting releases issued by the SEC on the same day. One of the two releases (the “**Exemptions Release**”) sets forth final rules implementing certain new exemptions from the registration requirements of the Advisers Act created by the Dodd-Frank Act. Effective July 21, 2011, the rules contained in the Exemptions Release, among other things:

- define “venture capital fund” for the purposes of the new Advisers Act exemption for advisers to venture capital funds;
- exempt from registration certain private fund advisers with less than \$150 million in assets under management in the United States; and
- clarify the meaning of certain terms used in the new exemption for foreign private advisers.

In the companion release issued on the same day (the “**Registration Release**”), the SEC issued final rules that implement certain other amendments to the Advisers Act effected by the Dodd-Frank Act, including:

- the increased statutory threshold for adviser registration with the SEC, which will generally be \$100 million for most U.S. advisers;
- the reporting requirements for certain advisers exempt from registration (“exempt reporting advisers”);
- conforming and other changes to Form ADV; and
- certain rule amendments, including amendments to the SEC’s “pay-to-play” rule, which reflect changes made by the Dodd-Frank Act.

In addition, the SEC extended until March 30, 2012: (i) the date by which investment advisers currently relying on the private adviser exemption must register and come into compliance with the obligations of a registered adviser and (ii) the requirement of every registered investment adviser to file a one-time Form ADV amendment to report its eligibility for registration with the SEC. The SEC had previously suggested in a letter that these extensions would be granted, as reported in the [April 15, 2011 Investment Management Regulatory Update](#). An SEC-registered mid-sized adviser that does not meet the new eligibility criteria rules for registration with the SEC must withdraw its SEC registration and become registered in one or more states no later than June 28, 2012.

Finally, on the same date, the SEC issued a final rule implementing the definition of “family office” as required by Title IV of the Dodd-Frank Act. Pursuant to Section 409 of the Dodd-Frank Act, a company that is a family office is excluded from the definition of an investment adviser under the Advisers Act and thus would generally not be subject to any provisions of the Advisers Act. The SEC proposed its rule defining “family office” on October 12, 2010, as reported in the [November 12, 2010 Investment Management Regulatory Update](#).

The issuance of these final rules marks the end of a long implementation period where many of the open questions from the proposed rules were answered, though many other issues will need to be clarified by

the SEC in future guidance. The final rules in the Exemptions Release and Registration Release were originally proposed on November 19, 2010. Davis Polk issued two Client Memoranda summarizing those proposed rules: *SEC Proposes Rules Implementing New Exemptions from Advisers Act Registration Under the Dodd-Frank Act* and *SEC Issues Proposal Implementing Advisers Act Registration and Reporting Amendments Under the Dodd-Frank Act*. In the final rules, the SEC adopted many of the rules substantially as proposed but also made several modifications to some of the proposed rules. This Client Memorandum summarizes the details of the final rules and certain notable interpretive guidance provided by the SEC in the adopting releases.

Exemptions Release

Venture Capital Fund Advisers

New section 203(l) of the Advisers Act provides that an adviser that solely advises venture capital funds is exempt from registration under the Advisers Act and directs the SEC to define “venture capital fund.” The SEC adopted new rule 203(l)-1 under the Advisers Act that defines “venture capital fund.” The exemption, like the other new exemptions for private fund advisers with less than \$150 million in assets under management in the United States and foreign private advisers, is not mandatory, and an adviser that qualifies under this exemption could still choose to register with the SEC if it has sufficient assets under management.

As in the proposing release, the SEC reiterated that Congress intended to distinguish advisers to “venture capital funds” from advisers to “private equity funds,” for which Congress did not provide an exemption. In contrast to private equity funds, according to the SEC, venture capital funds typically make long-term investments in smaller companies or early-stage companies that are held privately with the goal of eventually selling the companies or taking them public. Venture capital funds, the SEC stated, generally are not leveraged, contribute capital to companies that are not leveraged and are less connected to the public markets, and thus present less potential systemic risk.

Definition of Venture Capital Fund

The final rule defines a “venture capital fund” generally as a fund that:

- immediately after the acquisition of any asset, other than qualifying investments or short-term holdings, holds no more than 20 percent of the amount of the fund’s aggregate capital commitments in “non-qualifying investments” (other than short-term holdings) (the “**non-qualifying basket**”);
- does not borrow or otherwise incur leverage apart from a limited amount of short-term borrowing (excluding certain guarantees by the fund of qualifying portfolio company obligations);
- except in extraordinary circumstances, does not offer investors redemption or other liquidity rights;
- represents itself as pursuing a venture capital strategy to investors; and
- is a private fund.

The final definition removes the requirement in the proposed definition that the venture capital fund either be involved in the management of, or otherwise control, the qualifying portfolio company.

Non-qualifying Investments. The most important change to the definition of venture capital fund is the inclusion of the 20 percent non-qualifying basket. A non-qualifying investment is any investment that is not a “qualifying investment” (or short-term holding). Thus, under the final definition, a fund may invest up to 20 percent of its aggregate capital commitments (calculated immediately after the acquisition of the non-qualifying investment) in investments that would not meet the criteria of “qualifying investments,”

such as non-convertible debt, publicly traded securities or shares of other private funds. The SEC agreed with many commenters, including Davis Polk, on the need for flexibility in venture capital fund investments, but stated that a limit of 20 percent would balance the competing concerns of flexibility and the risk of allowing private equity funds to be included in the definition. The SEC arrived at the 20 percent threshold by analogy to rule 35d-1 (the “**names rule**”) under the Investment Company Act of 1940 (the “**Investment Company Act**”).

Qualifying Investments. Apart from the non-qualifying basket, a venture capital fund must generally hold only qualifying investments (or short-term holdings). Under the final rule, qualifying investments are:

- equity securities issued by a qualifying portfolio company that are directly acquired by the fund from the company (“**directly acquired equity**”);
- equity securities issued by a qualifying portfolio company in exchange for directly acquired equity issued by the same qualifying portfolio company; or
- equity securities issued by a company of which a qualifying portfolio company is a majority-owned subsidiary, or a predecessor, and that are acquired by the fund in exchange for directly acquired equity issued by such qualifying portfolio company.

A security received as a dividend by virtue of the fund’s holding of a qualifying investment would also be a qualifying investment.

The SEC states that these restrictions are for the purpose of ensuring that the fund’s capital is being used to finance the business operations of the qualifying portfolio company as opposed to trading in secondary markets. According to the SEC, the definition of qualifying investments continues to exclude investments in equity securities acquired in secondary market transactions in order to maintain the distinction between venture capital and private equity funds. The SEC notes, however, that an eligible venture capital fund would be allowed to purchase secondary market equity subject to the cap of its non-qualifying basket.

The definition includes as qualifying investments “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 would allow a venture capital fund to participate in the reorganization of the capital structure of a portfolio company. Following the suggestion of commenters, including Davis Polk, the definition also includes as a qualifying investment “any equity security issued by a company of which a qualifying portfolio company is a majority-owned subsidiary, or a predecessor, and that is acquired by the fund in exchange for directly acquired equity.” Under this provision, in connection with an acquisition (or merger) of a qualifying portfolio company by (or with) another company, an eligible venture capital fund could acquire equity securities (including publicly traded equity) of the other company in exchange for directly acquired equities of a qualifying portfolio company.

Equity Securities of Portfolio Companies. Consistent with the proposed rule, the final rule defines “equity security” by reference to the definition of “equity security” in section 3(a)(11) of the Securities Exchange Act of 1934 (the “**Exchange Act**”) and rule 3a11-1 thereunder, and would include common stock, preferred stock, warrants, other securities convertible into equity and limited partnership interests.

Operation of the 20 Percent Limit. Non-qualifying investments (other than short-term holdings) can account for no more than 20 percent of the fund’s capital commitments immediately after the acquisition of the non-qualifying investment. Accordingly, a venture capital fund would need only to calculate the 20 percent limit when the fund acquires a non-qualifying investment, and the fund may use either a historical cost or fair value methodology in its calculation, as long as the same method is applied consistently during the term of the fund. The SEC emphasized that only *bona fide* capital commitments may be used in the calculation, in order to prevent funds from inflating their amount of non-qualifying investments.

Short-Term Holdings. Short-term holdings, which are not included in the calculation of non-qualifying investments, are cash and cash equivalents (as defined in rule 2a51-1(b)(7)(i) under the Investment

Company Act), U.S. Treasuries with a remaining maturity of 60 days or less and, as added by the SEC in the final rule, shares of registered money market funds.

Qualifying Portfolio Company. The final rule defines a “qualifying portfolio company,” substantially as proposed, to be any company that:

- is not a “reporting or foreign traded” company and does not have a control relationship with a reporting or foreign traded company at the time of the investment;
- does not incur leverage in connection with the investment by the venture capital fund and distribute the proceeds of any such borrowing to the private fund in exchange for the private fund investment; and
- is not itself a fund (*i.e.*, is an operating company).

Not a Reporting or Foreign Traded Company. A qualifying portfolio company must not be a reporting or foreign traded company at the time of investment by an eligible venture capital fund. “Reporting or foreign traded” means, with respect to a company, being subject to reporting requirements under sections 13 or 15(d) of the Exchange Act, or having a security listed or traded on any exchange or organized market operating outside the United States. Thus, an eligible venture capital fund is not limited to investing in U.S. companies. Instead, qualifying portfolio companies include non-U.S. companies.

The SEC emphasizes that a qualifying portfolio company need only not be a reporting or foreign traded company (or in a control relationship with one) *at the time of each investment* by a venture capital fund; the venture capital fund could continue to hold the securities of a portfolio company that goes public after its investment.

Portfolio Company Leverage. The final rule excludes companies that *both* incur leverage in connection with the investment by the venture capital fund *and* distribute the proceeds of any such borrowing (or debt issuance) to the venture capital fund *in exchange for* the fund investment. Subsequent distributions of financing proceeds to the venture capital fund solely because it is an existing investor would not, according to the SEC, fall within the prohibition. Following the approach suggested by commenters, including Davis Polk, the final rule eliminates the blanket prohibition in the proposed rule on qualified portfolio companies borrowing in connection with a venture capital investment. The SEC notes that this approach would not exclude companies that borrow in the ordinary course of business or prevent an eligible venture capital fund from providing financing or loans to a portfolio company (provided the financing meets the definition of equity security or is made subject to the 20% limit for non-qualifying investments). The SEC states that this provision would more specifically exclude leveraged transactions that finance buyouts (*i.e.*, private equity transactions) from transactions that provide capital for the operation and business of portfolio companies.

Not a Fund. Private funds, investment companies, asset-backed issuers relying on the rule 3a-7 exemption under the Investment Company Act and commodity pools are excluded from the definition of qualifying portfolio companies. The SEC agreed with certain commenters (including Davis Polk), however, that an eligible venture capital fund may utilize a wholly owned intermediate company formed solely for tax, legal or regulatory reasons to hold the fund’s investment in the qualifying portfolio company. Also, an eligible venture capital fund could use its non-qualifying basket to invest a limited portion of its assets in other funds.

Limitation of Leverage. Consistent with the proposed rule, an eligible venture capital fund cannot borrow funds, issue debt obligations, provide guarantees or otherwise incur leverage in excess of 15 percent of the fund’s contributed capital and uncalled capital commitments. Further, any permitted borrowing must be for a non-renewable term of no longer than 120 calendar days. However, the final rule adds an exception to the 120-day term limit for any guarantee of qualifying portfolio company obligations by the venture capital fund, up to the value of the fund’s investment in the qualifying portfolio company.

No Redemption Rights. An eligible venture capital fund may only provide investors with redemption rights in exceptional circumstances (e.g., a material change in the tax law after an investor invests in the fund, or the enactment of laws prohibiting an investor's participation in the fund's investments in particular countries or industries). Investors, however, could receive *pro rata* distributions from time to time. The SEC clarified that advisers relying on the venture capital fund exemption would not be allowed to create *de facto* periodic redemption or transfer rights, for example, by regularly identifying potential investors on behalf of fund investors seeking to transfer or redeem interests.

Represents Itself as Pursuing a Venture Capital Strategy. The proposed rule required an eligible venture capital fund to represent itself to investors as a venture capital fund. The final rule modifies the proposed rule by focusing on the investment strategy presented to investors and requires only that the fund represent itself to investors as pursuing a venture capital strategy.

Is a Private Fund. An eligible venture capital fund must be a private fund as defined in the Advisers Act (i.e., a 3(c)(1) or 3(c)(7) fund) that is not registered under the Investment Company Act. Registered investment companies ("RICs") and funds regulated as business development companies ("BDCs") under the Investment Company Act are explicitly excluded from the definition of venture capital fund.

Application to Non-U.S. Advisers. A non-U.S. adviser may rely on the venture capital exemption if all of its clients, whether U.S. or non-U.S., are eligible venture capital funds. As discussed above, an eligible venture capital fund must be a private fund. In the case of non-U.S. funds that are technically not 3(c)(1) or 3(c)(7) funds because they have not conducted a private offering in the United States, the rule specifically indicates that an adviser may treat as an eligible venture capital fund any non-U.S. fund that would be a private fund if the fund were to conduct a private offering in the United States (and would otherwise meet the definition of a venture capital fund).

Grandfathering Provision. The final definition of "venture capital fund" includes any private fund that:

- represented to its investors and potential investors at the time it offered its securities that it pursues a venture capital strategy;
- sold securities to one or more investors prior to December 31, 2010; and
- does not sell any securities to, or accept additional capital commitments from, any person after July 21, 2011.

Private Fund Adviser Exemption

The Dodd-Frank Act, through new Section 203(m) of the Advisers Act, directs the SEC to provide an exemption from registration for any investment adviser that:

- acts solely as an adviser to private funds (i.e., an issuer that relies on Section 3(c)(1) or 3(c)(7) of the Investment Company Act);
- has assets under management in the United States of less than \$150 million.

The Dodd-Frank Act requires, however, that such advisers maintain such records and provide to the SEC such annual or other reports as the SEC determines necessary or appropriate in the public interest or for the protection of investors.

Private Fund Adviser Exemption

As set forth in the Exemptions Release, final new rule 203(m)-1 (the "**private fund adviser exemption**") implements the congressional directive in Section 203(m) of the Advisers Act. The requirements of the exemption depend on whether an adviser has its "principal office and place of business" in the United States (a "**U.S. adviser**") or outside the United States (a "**non-U.S. adviser**"). The principal office and

place of business of an adviser is the executive office from which the activities of the adviser are directed, controlled and coordinated. The adopting release notes that this would be the location where the adviser controls or has ultimate responsibility for the management of private fund assets, even though day-to-day management of certain assets may take place at other offices.

Exemption for U.S. Advisers. The private fund adviser exemption provides an exemption from registration under the Advisers Act for any U.S. adviser that (i) acts solely as an adviser to “qualifying private funds” and (ii) has private fund assets under management in the United States of less than \$150 million. All of the U.S. adviser’s private fund assets would be considered to be “in the United States” for purposes of the proposed rule if its principal office and place of business is in the United States, even if the adviser has offices outside the United States.

Qualifying Private Fund. “Qualifying private fund” means any private fund that is not registered under section 8 of the Investment Company Act and has not elected to be treated as a business development company pursuant to section 54 of the Investment Company Act. In comparison to the proposed rule, the SEC expanded the definition of “qualifying private fund” for purposes of rule 203(m)-1 to include funds that qualify for any exclusion from the definition of an “investment company” under section 3 of the Investment Company Act in addition to the exclusions in section 3(c)(1) or 3(c)(7) (e.g., real estate funds that qualify under Section 3(c)(5)(C)), *provided* that the adviser treats the fund in question as a private fund for all purposes of the Advisers Act. The SEC stated that this provision is intended to prevent an adviser to private funds from losing the benefit of this exemption if one of its funds happened to qualify for another exclusion from the definition of investment company under the Investment Company Act. The release indicates that this provision may also apply to a non-U.S. fund seeking to comply with Section 7(d) of the Investment Company Act in connection with its private offering in the United States. The SEC also notes that a “private fund” would include a private fund that invests in other funds. Consistent with its view in the venture capital fund exemption context (discussed above), the SEC stated that an adviser could treat as a private fund for purposes of rule 203(m)-1 a non-U.S. fund that has not made an offering to U.S. persons.

Application to Non-U.S. Advisers. For a non-U.S. adviser, the private fund adviser exemption would be available so long as:

- the adviser has no client that is a U.S. person (generally as defined in Regulation S) except for qualifying private funds; and
- all assets managed by the adviser at a “place of business” in the United States are solely attributable to private fund assets, the value of which is less than \$150 million.

The adopting release clarifies that a non-U.S. adviser may utilize the private fund adviser exemption “without regard to the type or number of its non-U.S. clients or the amount of assets it manages outside the United States.” In support of this interpretation, the SEC cited to its long-held belief that non-U.S. activities of non-U.S. advisers do not substantially implicate U.S. regulatory interests and notes that these limitations on the extraterritorial application of the Advisers Act are consistent with general principles of international comity. Non-U.S. advisers relying on this exemption, according to the SEC, would still be subject to the antifraud provisions of the Advisers Act (and reporting obligations of exempt reporting advisers).

For a discretionary or other fiduciary account maintained outside the United States for the benefit of a U.S. person, an adviser must treat such an account as a U.S. person if the account is held by a non-U.S. fiduciary who is a related person of the adviser. Consistent with the foreign private adviser exemption (discussed below), the rule additionally clarifies that a client would not be considered a U.S. person if the client was not a U.S. person at the time of becoming a client of the adviser.

Place of Business. Under the private fund adviser exemption, “place of business” means “(i) an office at which the investment adviser regularly provides investment advisory services, solicits, meets with, or

otherwise communicates with clients; and (ii) any other location that is held out to the general public as a location at which the investment adviser provides investment advisory services, solicits, meets with, or otherwise communicates with clients.”

Assets Under Management. An adviser relying on the private fund adviser exemption must file *annually* a Form ADV update amendment to report its amount of private fund assets under management. This marks a change from the proposed rule, which would have required an adviser to calculate on a quarterly basis its assets under management for purposes of determining its eligibility for the exemption. The SEC indicates that the reason for the change was to reduce the reporting burden of such advisers and avoid the impact of any short-term market fluctuation on assets under management. An adviser would be required to calculate its assets under management within the 90 days preceding the filing of its annual updating amendment.

The amount of assets under management must be calculated in the same manner as they are calculated for Form ADV reporting purposes, which method the SEC adopted in the companion release. Consistent with the proposed rule, the adopted method requires advisers to calculate their “regulatory assets under management” based on the fair value of the assets and include the value of proprietary assets, assets managed without compensation and, in the case of private funds, uncalled capital commitments. Advisers could use GAAP or another international accounting standard to calculate fair value. Advisers may also utilize other fair valuation standards provided that they do so consistently and in good faith. In addition, regulatory assets under management must be determined on a gross basis (*i.e.*, without deducting liabilities such as accrued fees and expenses or the amount of any borrowing). The SEC notes that the reporting of gross assets on Form ADV would not preclude an adviser from representing to its clients its assets under management on a net basis.

The SEC notes that, depending on the facts and circumstances, it may view two or more separately formed advisory entities, each of which has less than \$150 million in private fund assets under management, as a single adviser for purposes of assessing the availability of exemptions from registration. In addition, whether an adviser to a single-investor fund could rely on the exemption would depend on the particular facts and circumstances. The SEC notes that, while there are circumstances in which a single-investor fund may be treated as a private fund for these purposes (*e.g.*, funds that are meant for multiple investors but for a period of time have only one investor), advisers could not convert managed accounts to single-investor funds in order to qualify for the exemption. Similarly, an adviser that provides individualized investment advice directly to investors in a private fund would be required to count them as clients for purposes of the exemption.

The SEC indicates that whether an adviser manages assets at a place of business in the United States is a factual determination that depends on whether the adviser provides “continuous and regular supervisory or management services” at that location. The SEC further states that it would not view providing research or conducting due diligence to fall within that criterion if a person outside of the United States ultimately makes and implements independent investment decisions.

Transition Period. An adviser that becomes ineligible to continue relying on the private fund adviser exemption because the value of its private fund assets under management has exceeded \$150 million would have a 90-day transition period from the filing of its annual updating amendment to Form ADV to register with the SEC. The SEC notes that the transition safe harbor would only be available to an adviser that has complied with the applicable reporting requirements of the exemption. In contrast, an adviser would no longer qualify for the private fund adviser exemption immediately upon accepting a client that is not a private fund.

Foreign Private Advisers

The Dodd-Frank Act eliminated (effective July 21, 2011) the “private investment adviser” exemption contained in section 203(b)(3) of the Advisers Act, which, in the case of foreign advisers, provided an exemption from registration for foreign investment advisers that, among other things, have had fewer than 15 U.S. clients over the preceding 12 months and do not hold themselves out generally to the U.S. public as investment advisers. The Dodd-Frank Act, however, provides a narrow registration exemption for any “foreign private adviser,” which under the Dodd-Frank Act is defined as any investment adviser who:

- has no “place of business” in the United States;
- has, in total, fewer than 15 “clients and investors” in the United States in private funds advised by the adviser;
- has aggregate assets under management 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, or such higher amount as the SEC may, by rule, deem appropriate in accordance with the purposes of the Advisers Act; and
- does not:
 - hold itself out generally to the U.S. public as an investment adviser;
 - act as an investment adviser to any RIC; or
 - act as a BDC.

The Dodd-Frank Act defines the term “private fund” to mean an issuer that relies on Section 3(c)(1) or 3(c)(7) of the Investment Company Act.

Foreign Private Adviser Exemption

As set forth in the Exemptions Release, new rule 202(a)(30)-1 (the “**foreign private adviser exemption**”) implements the foreign private adviser exemption and defines certain undefined terms used in the definition.

Place of Business. “Place of business,” under the foreign private adviser exemption, has the same meaning as in the private fund adviser exemption, as described above. The SEC stated that any office from which an adviser regularly communicates with clients, whether U.S. or non-U.S., would be a place of business, as would be any location where an adviser regularly conducts research or other activities intrinsic to the provision of investment advisory services. An office where solely administrative services and back-office activities are performed would not be included, the SEC notes, if they are not activities intrinsic to providing investment advisory services and do not involve communicating with clients. The SEC clarified that a non-U.S. adviser would not be presumed to have a place of business in the United States solely because it is affiliated with a U.S. adviser, but a non-U.S. adviser might be deemed to have a place of business in the United States if its personnel regularly conduct activities at an affiliate’s place of business in the United States. A temporary location of an adviser, the SEC notes, could also be a place of business depending on whether the adviser has let it generally be known that it will conduct advisory business at the location.

“Clients and Investors.” Eligibility for the new foreign private adviser exemption is determined in part by the number of clients of an adviser. The foreign private adviser exemption would incorporate the safe harbor rules and many of the client counting rules of rule 203(b)(3)-1 currently in effect for the private adviser exemption. (Rule 203(b)(3)-1 is being rescinded by the SEC in conjunction with the elimination of the private adviser exemption.)

Definition of Clients. Under the final rule, an adviser would be allowed to treat the following as a single client:

- A natural person and:
 - that person's minor children;
 - any relative, spouse, or relative of the spouse of that person who has the same principal residence as such person;
 - all accounts of which that person and/or the person's minor child or relative, spouse, or relative of the spouse who has the same principal residence as such person are the only primary beneficiaries; and
 - all trusts of which that person and/or the person's minor child or relative, spouse, or relative of the spouse who has the same principal residence as such person are the only primary beneficiaries;
 - For purposes of the foregoing, spouse includes spousal equivalent.
- A corporation, general partnership, limited partnership, limited liability company, trust, or other legal organization to which the adviser provides investment advice based on the organization's investment objectives; and
- Two or more legal organizations that have identical shareholders, partners, limited partners, members, or beneficiaries.

The definition of client incorporates certain "special" client counting rules under rescinded rule 203(b)(3)-1, such as counting investors in a fund if the adviser provides advisory services to the investors separate and apart from the fund. However, the foreign private adviser exemption requires an adviser to count those for whom the adviser does not receive compensation for advisory services. The final rule avoids double-counting of clients and investors by providing that an adviser need not count a private fund as a client if the adviser counts any investor in that private fund for purposes of the foreign private adviser exemption. Conversely, an adviser need not count a person as an investor in a private fund if the adviser counts such person as a client of the adviser.

Definition of Investors. Under the final rule, the definition of "investor" incorporates the counting methods required by sections 3(c)(1) and 3(c)(7) of the Investment Company Act. As such, any person who would be included in the number of beneficial owners of a 3(c)(1) fund, or included in the determination of whether all of a 3(c)(7) fund's investors were qualified purchasers, would be deemed an investor. Thus, the definition of "investors" for purposes of the foreign private adviser exemption generally incorporates the look-through rules applicable to counting investors in 3(c)(1) and 3(c)(7) funds. The SEC indicates that the look-through analysis generally depends on the facts and circumstances. As examples of persons that would be included as investors in an adviser's private fund on a look-through basis, the SEC cited the following examples: (i) holders of the securities of a feeder fund formed or operated for the purpose of investing in such private fund and (ii) owners of total return swaps on such private fund. To avoid double-counting, an adviser would be able to treat as a single investor any person who is an investor in two or more private funds advised by the adviser.

The rule also counts beneficial owners of "short-term paper" (as defined in section 2(a)(38) of the Investment Company Act) issued by a private fund as investors (even though they are generally excluded from the 3(c)(1) calculation). Unlike in the proposed rule, however, knowledgeable employees (and certain related persons) as described in rule 3c-5 under the Investment Company Act would not count as investors under the rule.

In the United States. In general, the foreign private adviser exemption defines "in the United States" by reference to the definitions of "U.S. person" and "United States" in Regulation S under the Securities Act,

except that, similar to the private fund adviser exemption, it would treat a discretionary account owned by a U.S. person but managed by a non-U.S. affiliate of the adviser as a person “in the United States,” even though such person would not be considered a “U.S. person” under Regulation S. For determining whether an investor or client was “in the United States,” an adviser is generally only required to look to the point in time when the person either became a client or an investor. Clients or investors that were not “in the United States” at the time of becoming a client or an investor, but later became a person “in the United States,” would generally *not* need to be treated as being “in the United States.”

Assets Under Management. For purposes of the foreign private adviser exemption, as with the exemption of private fund advisers rule discussed above, foreign advisers would be required to calculate their regulatory assets under management as they are calculated for Form ADV reporting purposes.

Subadvisers and Advisory Affiliates

In general, subadvisers are permitted to rely on each of the new exemptions provided they satisfy the requirements of such exemptions. In determining its eligibility under the new exemptions that require an adviser solely to advise venture capital funds or private funds, a subadviser may generally disregard the primary adviser as a client and consider only the funds to which the subadviser provides services.

The adopting release notes that interpretive questions exist as to whether an adviser with advisory affiliates would be able to rely on these new exemptions without taking into account the activities of its affiliates. According to the SEC, whether an adviser would need to take into account the activities of an affiliate generally depends on the degree of separateness between the adviser and the affiliate, which is a question of facts and circumstances. Citing the *Richard Ellis* no-action letter, the SEC stated in the release that affiliated advisers that are separately organized but operationally integrated would be treated as a single adviser, which could result in the requirement for one or both to register. The adopting release also addressed the open question of the continuing viability of the *Unibanco* line of letters. As described by the release, under the *Unibanco* letters, a non-U.S. advisory affiliate of a registered adviser that shared personnel with, and provided certain services through, a registered adviser affiliate, subject to certain conditions, would not have been required to register under the repealed private adviser exemption. The SEC stated in this release that, while it is not withdrawing any statement expressed in the *Unibanco* letters, it expects the staff to provide guidance, “as appropriate,” on the application of those letters in the context of the new foreign private adviser exemption and the private fund adviser exemption.

Effective Dates

The rules adopted by the SEC contained in the Exemptions Release, including rule 203(l)-1 (the venture capital fund definition), rule 203(m)-1 (the private fund adviser exemption) and rule 202(a)(30)-1 (the foreign private adviser exemption), will be effective July 21, 2011.

- ▶ [See the Exemptions Release containing the full text of the final rules](#)
- ▶ [See the press release and fact sheet issued by the SEC](#)

Registration Release

Increased Threshold for Adviser Registration with the SEC

Under the Dodd-Frank Act, Congress transferred most of the regulatory burden of monitoring many smaller advisers to the states by increasing the threshold for SEC registration to \$100 million in assets

under management for most U.S. investment advisers. The apparent purpose of this reallocation was to allow the SEC to focus its examination resources on larger investment advisers.

Effective July 21, 2011, the minimum assets under management threshold for SEC registration for most U.S. investment advisers (that do not manage registered investment companies or business development companies) will be:

- \$100 million in general, but
- \$25 million for advisers that would either (i) not be subject to registration and examination in the state in which they maintain their respective principal offices and places of business or (ii) otherwise be required to register with 15 or more states.

Advisers with more than \$100 million in assets will generally not be affected by this reallocation of federal and state authority. However, this new standard will require a significant number (approximately 3,200, according to the SEC) of so-called “mid-sized advisers” (those that have between \$25 and \$100 million of assets under management) to withdraw their SEC registrations and instead register with the state securities authorities of their home states (and potentially other states in which they have clients).

The final rules provide the SEC with the means to implement this new regulatory shift. Under new rule 203A-5, every adviser that is registered with the SEC will be required to file an amendment to its Form ADV by March 30, 2012 and to report the market value of its assets under management, as determined within 90 days of such one-time filing, to determine whether the adviser meets the revised eligibility rules for registration with the SEC. An adviser that does not meet the revised criteria will be required to withdraw its SEC registration by filing Form ADV-W no later than June 28, 2012. Under new rule 203A-5(a), mid-sized advisers registered with the SEC as of July 21, 2011 must remain registered with the SEC (unless exempted from registration) until January 1, 2012.

Replacement of the \$5 million buffer with buffer for advisers close to \$100 million in assets under management. According to the SEC, final rule 203A-1 is designed to prevent an adviser from having to switch frequently between state and SEC registration as a result of changes in the value of its assets under management or the departure of one or more clients. In particular, while amended rule 203A-1 eliminates the current buffer for advisers that have assets under management between \$25 million and \$30 million that permits these advisers either to remain regulated by the states or the SEC, it replaces it with a similar buffer for mid-sized advisers. Specifically, amended rule 203A-1(a) implements a \$10 million buffer by providing that an adviser otherwise subject to the \$100 million threshold may, but is not required to, register with the SEC instead of the states if it has between \$100 million and \$110 million in assets under management. Similarly, once registered with the SEC, an adviser need not withdraw its registration until it has less than \$90 million of assets under management. Advisers with \$110 million or more in assets under management are required to register with the SEC (unless otherwise exempt).

Mid-sized advisers subject to a rule 203A-2 exemption from the prohibition on SEC registration (discussed below) and advisers to a registered investment company or business development company under the Investment Company Act will not be able to rely on the buffer because they are required to register with the SEC regardless of whether they have \$100 million of assets under management. In addition, advisers that rely on amended rule 203A-2(c) to register with the SEC (because they expect to be eligible for registration within 120 days) cannot rely on the buffer and must have \$100 million of assets under management within 120 days to remain registered with the SEC.

Certain Amendments to Item 2 of Form ADV. The SEC has adopted the revisions to Item 2 of Part 1A of Form ADV substantially as proposed. Item 2 requires an adviser to indicate its basis for SEC registration, to account for the new statutory thresholds and proposed implementing rules. Under the amended Item 2, an adviser is required to indicate its eligibility to register with the SEC as one of the following seven types of SEC-eligible advisers:

- large advisers (more than \$100 million, or \$90 million if relying on the buffer, in regulatory assets under management, as further explained below);
- mid-sized advisers that do not meet the criteria for state registration or examination;
- foreign advisers or advisers with their principal place of business in the State of Wyoming;
- advisers that meet certain exemptive requirements under rule 203A-2 (e.g., pension consultants, multi-state advisers);
- advisers (or sub-advisers) to registered investment companies;
- advisers to business development companies with at least \$25 million in regulatory assets under management; and
- advisers that received an order permitting such adviser to register with the SEC.

Advisers Exempted from the Prohibition on SEC Registration. The SEC adopted amendments as proposed that eliminate and amend certain exemptions from the prohibition on SEC registration for advisers that do not meet the assets under management threshold, such as those contained in rule 203A-2. The SEC also clarified certain terms used in the Dodd-Frank Act regarding the registration requirements of mid-sized advisers.

- **NRSROs.** The SEC eliminated the exemption from the prohibition on SEC registration for nationally recognized statistical rating organizations with less than \$100 million in assets under management.
- **Pension consultants.** Pension consultants, which typically do not have “assets under management,” are nonetheless currently eligible to register as investment advisers with the SEC, if they advise plans with at least \$50 million in assets. The final rule increases this plan asset eligibility requirement to \$200 million in order to maintain the same two-to-one proportion between required plan assets and the assets under management threshold.
- **Multi-state advisers.** To conform to changes created by the Dodd-Frank Act, the final rule, as proposed, modifies the exemption from the prohibition of registering with the SEC for advisers that are required to register in 30 or more states under rule 203A-2(e) to permit investment advisers required to be registered with 15 or more states to register with the SEC.
- **Rule 203A-4 Safe Harbor.** The adopting release rescinds, as proposed, rule 203A-4, which provided a safe harbor from SEC registration for an investment adviser registered with the state in which it has its principal office based on a reasonable belief that it lacks sufficient assets under management to register with the SEC.
- **Mid-sized Advisers.** As described above, effective July 21, 2011, an adviser with \$25 million to \$100 million in assets under management is prohibited from registering with the SEC *if* such adviser is “required to be registered” as an investment adviser, and is “subject to examination” in its home state. Under the adopted rule, a mid-sized adviser that relies on an exemption from registration with its home state would not be considered to be “required to be registered” with its home state and thus would be required to register with the SEC. After corresponding with each state’s investment adviser regulator, the SEC has determined that advisers will not be “subject to examination” in the states of Wyoming (which has no investment adviser statute), New York and Minnesota. Hence, mid-sized advisers with their principal place of business in these states will be required to register with the SEC.

New Calculation of Assets Under Management. Under Section 203 of the Advisers Act, “assets under management” is defined as the “securities portfolios” with respect to which an investment adviser provides “continuous and regular supervisory or management services.” Currently, the Instructions to

Form ADV provide guidance on the calculation of assets under management by allowing (but not requiring) advisers to include certain types of assets in the calculation, namely, proprietary assets, assets an adviser manages without receiving compensation, and assets of foreign clients. The final rules, which were adopted as proposed, create a new defined term “regulatory assets under management” and require advisers to include the foregoing categories in their calculation of regulatory assets under management. Moreover, an adviser must calculate its regulatory assets under management on a gross basis, without deducting outstanding indebtedness and other accrued but unpaid liabilities that are in client accounts. The SEC indicates that whether a client (e.g., a fund) uses investor capital or borrowed funds to purchase managed assets is not relevant to its determination of the size and significance of the adviser’s activities.

The SEC also provides guidance on how private fund advisers must calculate the value of their regulatory assets under management. In calculating its regulatory assets under management with respect to its private funds, an adviser is now required to:

- include the value of any private fund over which it exercises “continuous and regular supervisory or management services,” regardless of the nature of the assets of the fund;
- include any uncalled capital commitments made to the fund; and
- value the private funds using a fair value methodology (even for illiquid or other securities that are not readily marketable). If the governing documents of a fund provide for a specific process for calculating fair value (e.g., providing the General Partner discretion over the determination of fair value), then the adviser could rely on such process for calculating its regulatory assets under management, provided it is done so consistently and in good faith. If, however, an adviser uses GAAP or another basis of accounting to calculate fair value for financial reporting purposes, the SEC expects such adviser to use the same basis for determining regulatory assets under management.

Subadvisers to private funds must also include the value of the portion of the portfolio for which they provide continuous and regular supervisory or management services.

This new method of calculating assets under management applies uniformly for purposes of determining eligibility for SEC registration, reporting regulatory assets under management on Form ADV, and the new exemptions from registration under the Advisers Act created by the Dodd-Frank Act.

Exempt Reporting Advisers

The Dodd-Frank Act created two new exemptions from Advisers Act registration for advisers that solely advise (i) venture capital funds or (ii) private funds and have assets under management in the United States of less than \$150 million. For each of these exemptions, the Dodd-Frank Act directs the SEC to require these advisers to maintain such records and submit such reports as the SEC determines necessary or appropriate in the public interest or for the protection of investors. To implement this reporting requirement, the SEC has adopted, as proposed, new rule 204-4 requiring such advisers (“**exempt reporting advisers**”) to file certain reports with the SEC using Form ADV within 60 days of relying on the exemption. The SEC stated that recordkeeping requirements for exempt reporting advisers would be addressed in a future release.

Scope of Reporting. Exempt reporting advisers are not subject to the full panoply of reporting required for registered investment advisers, but need only to report a narrower subset of such information. Under the adopted rule, exempt reporting advisers are required to complete the following items in Part 1A of Form ADV and corresponding sections of Schedules A, B, C and D:

- Item 1 – Identifying information;

- Item 2.B. – SEC Reporting by Exempt Reporting Advisers;
- Item 3 – Form of Organization;
- Item 6 – Other Business Activities;
- Item 7 – Financial Industry Affiliations and Private Fund Reporting (revisions to Item 7 are discussed below);
- Item 10 – Control Persons (including disclosure of the owners of the adviser); and
- Item 11 – Disclosure Information (including the disciplinary history for the adviser and its employees).

For now, such advisers are not required to complete the remaining items of Part 1A or prepare a brochure on Form ADV Part 2. However, the SEC states in the adopting release that it will continue to monitor whether exempt reporting advisers should also be required to complete other items of Form ADV.

Public Availability of Reports. The SEC indicates that exempt reporting adviser reports will be made publicly available.

Updating Requirements. An exempt reporting adviser must file an update to its Form ADV filing, as is currently the case for registered advisers, on an annual basis within 90 days of the end of the adviser's fiscal year (or more frequently if specifically required by the instructions to Form ADV).

Final Reports. Pursuant to final rule 204-4, when an adviser ceases to be an exempt reporting adviser, it is required to file an amendment to its Form ADV to indicate that it is filing a final report. An exempt reporting adviser wishing to register with the SEC can file a single amendment to its Form ADV that will serve both as a final "report" and as an application for registration under the Advisers Act. In the final rule release, the SEC added that, while such application is pending, an adviser may continue to operate as an exempt reporting adviser in accordance with the terms of the relevant exemption.

Transition Safe Harbor for Private Fund Advisers. Amended General Instruction 15 to Form ADV provides a safe harbor for certain exempt reporting advisers relying on the "private fund adviser" exemption under rule 203(m)-1. Such an adviser that has complied with all of its reporting obligations as an exempt reporting adviser may continue advising private fund clients for up to 90 days after filing an annual updating amendment indicating that it has private fund assets of \$150 million or more before filing its final report and application for registration. This transition period is not available to advisers relying on the "venture capital adviser" exemption in Section 203(l).

Initial Filing Date. Each exempt reporting adviser will be required to file its initial report on Form ADV by March 30, 2012.

Subject to Examination. In the adopting release, the SEC indicates that it does not anticipate that the staff will conduct compliance examinations of exempt reporting advisers on a regular basis. Nonetheless, the SEC notes that exempt reporting advisers, which are exempt from registration pursuant to Sections 203(l) and (m) of the Advisers Act, are not "specifically exempt" from registration under Section 203(b), and thus it has the authority under Section 204(a) of the Advisers Act to examine records of exempt reporting advisers and would do so if it receives indications of wrongdoing.

Changes to Form ADV Disclosure

The SEC has adopted changes to Form ADV that are designed to enhance its oversight of investment advisers. The rules as adopted require advisers to provide the SEC with additional information primarily about three areas of their business: (i) information regarding the private funds they advise; (ii) more information in general about their advisory business, including the types of clients they advise, their employees and advisory activities and business practices that may present conflicts of interest, such as

the use of affiliated brokers, soft dollar arrangements and payments for client referrals; and (iii) additional information about certain non-advisory activities and their financial industry affiliations. The SEC anticipates that the increased knowledge it will glean from the revised Forms ADV will enable it to better understand advisers' operations and business focus, and will thereby facilitate its assessment of risks and conflicts and aid in its identification of firms for examination.

Private Fund Reporting

Scope of Private Fund Reporting. The rules modify Form ADV to require an adviser, in response to Item 7.B and Schedule D, to provide information about all of the adviser's private funds regardless of their forms of organization. Form ADV no longer requires reporting of funds advised by the adviser's affiliates, and sub-advisers are permitted to exclude private funds that are included on another adviser's Schedule D. In addition, an adviser that sponsors funds in a master-feeder structure is generally permitted to submit one Schedule D for all funds in such structure. Non-U.S. advisers are permitted to forego reporting on private funds they advise that are both organized outside the U.S. and not offered in the U.S. and not beneficially owned by any U.S. person.

Information Required To Be Disclosed About Private Funds. The adopted rules create a new Section 7.B.1 of Schedule D that expands the data advisers are required to disclose about their private funds. Among other items, the Schedule D submitted for each fund needs to disclose certain information about the fund, including:

- (i) the name of the private fund; (ii) its jurisdiction of organization; (iii) its general partner, directors, trustees or persons occupying similar positions; (iv) the Investment Company Act exclusion on which the fund relies; (v) the names and jurisdictions of each foreign financial regulatory authority with which the fund is registered; and (vi) whether the fund is in a master-feeder arrangement;
- whether the fund is a fund of funds (for these purposes, the Form ADV instructions specify that the fund should be considered a "fund of funds" if it invests 10% or more of its total assets in other pooled investment vehicles, whether or not they are also private funds);
- the fund's investment strategy (by checking the box corresponding to one of seven categories – hedge fund, liquidity fund, private equity fund, real estate fund, securitized asset fund, venture capital fund or other private fund);
- the fund's gross asset value, the minimum investment commitment required of an investor in the fund and the approximate number of beneficial owners of the fund;
- the approximate percentage of the fund beneficially owned by (i) the adviser and its related persons, (ii) funds of funds and (iii) non-U.S. persons; and
- whether clients of the adviser are solicited to invest in the fund, and the percentage of the adviser's clients that has invested in the fund.

The SEC chose not to adopt three private fund disclosure items because it concluded that the benefit of public disclosure would not outweigh the potential competitive harm. Specifically, the SEC is not adopting the proposed requirements that an adviser:

- disclose each private fund's net assets;
- report private fund assets and liabilities by class and categorization in the fair value hierarchy established under GAAP; and
- specify the percentage of each fund owned by particular types of beneficial owners.

In lieu of reporting a fund's name on its Schedule D, the new rules allow advisers to use an identification code, thereby preserving the anonymity of the name of the fund.

Information Required To Be Disclosed About Private Funds' Service Providers. Under the new rules, a reporting adviser is also required to identify its funds' auditors, prime brokers, custodians, administrators and marketers, and disclose their locations and whether such service providers are related persons of the adviser. These new provisions were adopted substantially as proposed, with minor modifications. For each service provider, the SEC requires that an adviser clarify the nature of the services it provides and disclose certain other information, such as:

- with respect to an auditor, whether it is independent, registered with and subject to inspection by the PCAOB, and whether audited financial statements are distributed to investors;
- with respect to a prime broker, whether it is SEC-registered and acts as a fund's custodian;
- with respect to a custodian, whether it is a related person of the adviser;
- with respect to an administrator, whether it prepares and sends account statements to investors and the percentage of the fund's assets for which it provides valuation services; and
- with respect to each marketer, whether it is a related person of the adviser, its SEC file number and the URL for any website used to market the fund.

Because the above information will be public, the SEC expects that it would supplement investors' due diligence efforts and allow service providers to identify the funds claiming to rely on their services.

Additional Disclosure About the Adviser and its Advisory Business

Information About the Adviser's Employees. Item 5.B of Part 1A of Form ADV requires advisers to report the number of employees who are registered representatives of a broker-dealer. This Item has been expanded also to require the reporting of the number of the adviser's employees who are registered as investment adviser representatives or insurance agents. In addition, the revised Form ADV requires advisers to report the specific number of such employees rather than checking a box that corresponds to a range of the number of employees.

Information About the Adviser's Clients. An adviser is required to (i) provide an approximate number of clients it has over 100; (ii) report the approximate percentage of its clients that are not U.S. persons; and (iii) specify the types of clients that it advises (adding categories for business development companies, other investment advisers, and insurance companies) and the percentage that each client type represents of its total number of clients.

Information About Assets Under Management. Advisers are now required to report percentages of assets under management by client type.

Information About the Adviser's Advisory Services. The rules expand the list of advisory activities reportable by an adviser. Such list now includes: (i) portfolio management for pooled investment vehicles other than registered investment companies and (ii) educational seminars or workshops (which do not include periodic meetings at which advisers educate existing clients about issues related to the ongoing management of their accounts).

Additional Disclosure About Participation in Client Transactions. Advisers that have discretionary authority to determine the brokers or dealers used for client transactions, or that recommend brokers or dealers to clients, are required to report whether any such brokers or dealers are related persons. An adviser also must disclose whether any soft dollar benefits received qualify for the safe harbor under Section 28(e) of the Securities Exchange Act of 1934 (the "**Exchange Act**"), and whether it or any related person receives compensation, directly or indirectly, for client referrals.

Custodian Arrangements: Advisers must indicate the total number of persons that act as qualified custodians for the adviser's clients in connection with advisory services the adviser provides to its clients. The SEC clarified that advisers need not comply with the custody rule with respect to the account of a

registered investment company. The SEC also amended Schedule D to include a check box to indicate that the reporting adviser has not yet received a report prepared by an independent accountant that audited a pooled investment vehicle or that examined internal controls. Advisers must report in this section of Schedule D whether any such report contained an unqualified opinion. The adviser would be required to file promptly an amendment to update its response when the accountant's report is available.

To correct a drafting error, the SEC amended the notes within Item 9.A. to require an adviser to exclude from Item 9.A. (which requires the adviser to disclose the approximate amount of client funds and securities for which it has custody) and to report *only* in Item 9.B. (which requires the adviser to disclose the approximate amount of client funds and securities for which a related person has custody) client assets for which custody is attributed to the adviser as a result of related person custody. The SEC stated in the adopting release that Item 9.A. was intended to be limited to assets of which the adviser has custody other than through a related person, but that it originally inadvertently required the adviser to include assets attributable to it in certain circumstances where a related person had custody of the assets. The SEC also clarified that adviser responses to Items 9.B. and 9.C. must include funds and securities of which a related person has custody "in connection with advisory services the adviser provides to clients."

Advisers With \$1 Billion in Assets. The revised Form ADV also requires an adviser to indicate whether the adviser itself had total assets (rather than assets under management) of \$1 billion or more as of its most recent fiscal year. According to the adopting release, it intends to use this information to identify firms that would be subject to future rules or guidelines called for by Section 956 of the Dodd-Frank Act that will address certain incentive-based compensation arrangements. On March 30, 2011, the SEC and other federal regulators jointly proposed a rule under this section of the Dodd-Frank Act that would subject certain financial institutions to requirements relating to incentive-based compensation arrangements, as detailed in the Davis Polk Client Memorandum [*Federal Agencies Finalize Proposed Interagency Rule on Incentive-Based Compensation for Financial Institutions*](#).

Additional Disclosure About the Adviser's Non-Advisory Activities and Affiliations

Information About the Adviser's Non-Advisory Activities. The final rules augment the check-the-box categories of financial services activities on Form ADV and, in addition to the existing categories, require registered advisers and exempt reporting advisers to report if they or any related person are engaged in business as a registered municipal advisor, registered security-based swap dealer, major security-based swap participant (all of which are new types of SEC registrants under the Dodd-Frank Act), or as a trust company. In addition, the new Form ADV requires advisers to disclose if they are engaged in the business of providing professional accounting or legal services. Finally, the amendments require an adviser to report whether a related person is a sponsor, general partner or managing member of a pooled investment vehicle. The instructions clarify that advisers' responses must include related persons that are foreign affiliates, regardless of whether the affiliates are registered with the SEC.

Information About the Adviser's Related Persons. For each related person included in the financial services categories above, an adviser must disclose: (i) its legal and business names (which requirement previously applied only with respect to related persons that are investment advisers or broker-dealers); (ii) the relationship between the adviser and the related person; (iii) the name and jurisdiction of any foreign financial regulatory authority with which the related person is registered; (iv) whether the adviser and the related person share employees or the same physical location; and (v) whether the related person is exempt from registration. However, the final rules added an exception providing that the adviser is not required to disclose this information for any related person if: (i) the adviser has no business dealings with the related person in connection with its advisory services; (ii) the adviser does not conduct shared operations with the related person; (iii) the adviser does not refer clients or business to the related person; (iv) the adviser does not share supervised persons or premises with the related person; and (v) the adviser has no reason to believe that its relationship with the related person otherwise creates a conflict of interest with its clients. An affiliated adviser that shares information technology infrastructure with the

adviser would be considered to share operations with the adviser and may not be omitted from such disclosure.

Information About Other Business Names. The new Form ADV requires an adviser engaged in business under a different name to list such other name(s) and identify the line(s) of business in which the adviser is engaged using such name(s).

Other Form ADV Amendments

Form ADV Amendments Unrelated to Dodd-Frank. The final rules include amendments to Form ADV that are unrelated to Dodd-Frank, including new requirements to report (i) contact information for an adviser's chief compliance officer, rather than the person designated to handle Form ADV inquiries (this information will not be publicly available); (ii) whether the adviser or any of its control persons is a public reporting company under the Exchange Act; and (iii) its "legal entity identifier," if it has one (*i.e.*, a unique identifying number required for reporting purposes by the U.S. Department of the Treasury's Office of Financial Research or a financial regulator).

Technical Amendments to Form ADV. The final rules make the following technical amendments to Form ADV relating to the reporting of disciplinary events: (i) there is now a checkbox for the adviser to indicate whether the disciplinary information reported relates to the adviser or any of its supervised persons; (ii) advisers are now permitted to remove disclosure reporting pages that were filed in error; and (iii) the new form clarifies that disclosure is required in the brochure supplement of any hearing or formal adjudication in which a professional attainment, designation or license of a supervised person was revoked or suspended because of a violation of rules relating to professional conduct.

Effective Dates

Form ADV Amendments. The adopting release indicates that the Form ADV amendments will be effective 60 days after publication in the *Federal Register*. As of the date of this *Client Memorandum*, publication in the *Federal Register* is expected to occur soon.

Private Adviser Registration. As described above, the SEC is extending until March 30, 2012 the date by which advisers currently relying on the private adviser exemption must register and come into compliance with the obligations of a registered adviser, pursuant to its authority in Section 206A of the Advisers Act. The adopting release notes that, because initial applications for registration can take up to 45 days to be approved by the SEC, these advisers should file applications by February 14, 2012.

Amendments to the "Pay-to-Play" Rule

The SEC's "pay-to-play" rule, rule 206(4)-5 under the Advisers Act (the "**Pay-to-Play Rule**"), generally prohibits registered and certain unregistered advisers from engaging in certain "pay-to-play" practices. The final rules amend the Pay-to-Play Rule in response to certain changes made to the Advisers Act by the Dodd-Frank Act.

Application to Newly Created Exemptions. Rule 206(4)-5 previously applied to advisers that were either registered with the SEC or unregistered in reliance on the private adviser exemption under Section 203(b)(3) of the Advisers Act. The final rules extend the Pay-to-Play Rule to apply to exempt reporting advisers. In addition, the Registration Release confirms that the Pay-to-Play Rule applies to advisers relying on the foreign private adviser exemption from registration that was added to Section 203(b)(3) of the Advisers Act by the Dodd-Frank Act.

Registered Municipal Advisors. The final rules amend the provision of the Pay-to-Play Rule that prohibits advisers from paying third-party solicitors and placement agents to solicit governmental entities unless such persons are "regulated persons" (*i.e.*, registered investment advisers or broker-dealers that are members of the Financial Industry Regulatory Authority ("**FINRA**")) subject to similar pay-to-play

restrictions. Specifically, the SEC has amended the rule by adding municipal advisors to the definition of “regulated persons,” thus permitting an adviser also to pay a “municipal advisor” to solicit governmental entities on its behalf. A “municipal advisor” is defined as a municipal advisor that:

- is registered under section 15B of the Exchange Act; and
- is subject to pay-to-play rules adopted by the Municipal Securities Rulemaking Board (“MSRB”) determined by the SEC to be (i) substantially equivalent to or more stringent than the Pay-to-Play Rule imposed on investment advisers and (ii) consistent with the objectives of the Pay-to-Play Rule.

Compliance Date Extended. The final rules extend the compliance date with respect to the Pay-to-Play Rule’s restrictions on payments to third-party solicitors from September 13, 2011 to June 13, 2012 in order to provide time for the MSRB and FINRA to adopt pay-to-play rules and to give third-party solicitors and placement agents additional time to come into compliance with the Pay-to-Play Rule.

- ▶ [See the Registration Release containing the full text of the final rules](#)
- ▶ [See the press release and fact sheet issued by the SEC](#)

Family Offices

SEC Adopts Rule Defining “Family Offices” under the Dodd-Frank Act

On June 22, 2011, the SEC adopted rule 202(a)(11)(G)-1 (the “**Family Office Rule**”) under the Advisers Act to define “family offices” as required by Title IV of the Dodd-Frank Act. Pursuant to Section 409 of the Dodd-Frank Act, a company that is a family office is excluded from the definition of an investment adviser under the Advisers Act and thus would generally not be subject to any provisions of the Advisers Act. The SEC proposed its rule defining “family office” on October 12, 2010, which was summarized in the [November 12, 2010 Investment Management Regulatory Update](#).

“Family offices” are typically established by wealthy families to manage the assets of, and provide other services to, its family members. Sometimes, families join together to established multi-family offices. The SEC estimates that there are 2,500 to 3,000 single family offices, generally servicing families with at least \$100 million of investable assets. Services provided by family offices typically include portfolio management, financial, tax, accounting, trust administration and estate planning advice for family members.

Family offices generally meet the definition of an “investment adviser” under Section 202(a) of the Advisers Act because family offices are in the business of providing advice about securities for compensation. Although some family offices have been excepted from the definition of investment adviser by exemptive order, many family offices have relied on the exemption from registration under Section 203(b)(3) of the Advisers Act, which is the “private investment adviser” exemption from registration for an adviser that had fewer than 15 clients during the course of the preceding 12 months and does not hold itself out to the public as an investment adviser. The Dodd-Frank Act will repeal the “private investment adviser” exemption, effective July 21, 2011.

Section 409 of the Dodd-Frank Act, however, creates an exclusion from the definition of an investment adviser for any family office (as defined by the SEC), thus placing such entities generally outside the scope of the Advisers Act. Section 409 of the Dodd-Frank Act directs the SEC to define the term “family office” consistently with previous exemptive policy of the SEC and in a manner that recognizes “the range of organizational, management, and employment structures and arrangements employed by family offices.” The Family Office Rule is designed to codify exemptive orders that were previously issued by

the SEC to family offices and reflects the SEC's current exemptive policy regarding family offices, as well as the SEC's responses to certain comments it received on the proposed rule. The main policy behind the previously issued SEC exemptive orders is that the Advisers Act was not designed to regulate families in the management of their own assets.

The Family Office Rule would define a "family office" as any firm that (i) has no clients other than family clients, (ii) is wholly owned by family clients and is exclusively controlled (directly or indirectly) by one or more family members and/or family entities, and (iii) does not hold itself out to the public as an investment adviser.

Family Clients

The Family Office Rule provides that excluded family offices would not be permitted to have any investment advisory clients other than "family clients." Family clients include (i) current and former family members, (ii) key employees of the family office (and, under certain circumstances, former key employees), (iii) non-profit organizations, charitable foundations and other charitable organizations funded exclusively by family clients, (iv) estates of current and former family members or key employees, (v) trusts existing for the sole current benefit of family clients or, if both family clients and charitable and non-profit organizations are the sole current beneficiaries, trusts funded solely by family clients, (vi) revocable trusts funded solely by family clients, (vii) certain key employee trusts and (viii) companies wholly owned (directly or indirectly) exclusively by, and operated for the sole benefit of, one or more family clients (with certain exceptions).

Family Member. The term "family member" includes all lineal descendants (including by adoption, stepchildren, foster children, and individuals who were a minor when another family member became a legal guardian of that individual) of a common ancestor (who may be living or deceased), and such lineal descendants' spouses or spousal equivalents; *provided* that the common ancestor is no more than 10 generations removed from the youngest generation of family members. This definition is intended to allow a family member to choose a common living or deceased relative and define family members by reference to the degree of lineal kinship to such designated relative. The family office may re-designate the common ancestor over time and thus serve the shifting family office clientele over time. The Family Office Rule expands the proposed rule's definition of "family member" to include foster children and persons who were minors when another family member became their legal guardian.

The Family Office Rule does not extend to family offices that provide advisory services to multiple families.

Former Family Member. In contrast to the proposed rule, the Family Office Rule treats "former family members" (*i.e.*, former spouses, spousal equivalents and stepchildren) as family clients in the same manner as family members for purposes of the Family Office Rule. The proposed rule would have permitted former family members to retain investments that were held through the family office at the time they became a former family member, but would have prohibited such former family members from making new investments through the family office. The Family Office Rule no longer makes such a distinction.

Involuntary Transfers. In cases where assets under the management of a family office are transferred involuntarily to a person or entity that does not qualify as a family client, the Family Office Rule would allow the family office to continue to advise such a client without violating the terms of the exclusion for one year following the completion of the transfer of legal title to the assets resulting from the involuntary event. In response to commenters, including Davis Polk, the SEC modified the transition period to one year instead of the four months originally proposed. Within that one-year period, the family office would have to transfer the assets, obtain an exemptive ruling or otherwise restructure to comply with the Advisers Act.

Family Trusts and Estates. Under the proposed rule, trusts or estates qualifying as family clients were limited to those existing for the *sole* benefit of one or more family clients. To accommodate common

estate planning and charitable giving plans, the Family Office Rule expands qualifying trusts or estates also to include: (i) any irrevocable trust (a) in which one or more family clients are the only *current* beneficiaries or (b) funded exclusively by one or more other family clients in which other family clients and non-profit organizations, charitable foundations, charitable trusts or other charitable organizations are the only *current* beneficiaries, (ii) any revocable trust of which one or more family clients are the sole grantors (regardless of whether the beneficiaries of such revocable trusts are family members), (iii) any estate of a family member, former family member, key employee or certain former key employees and (iv) in an attempt to provide additional estate planning flexibility for key employees whose own relatives may not be permissible family clients, any trust of which each (a) trustee is a key employee and (b) settlor is a key employee or the key employee's current and/or former spouse or spousal equivalent who, at the time of the contribution, holds a joint, community property interest with the key employee (a "**Key Employee Controlled Trust**").

Non-profit and Charitable Organizations. The Family Office Rule treats as a family client any non-profit organization, charitable foundation, charitable trust (including charitable lead trusts and charitable remainder trusts whose only current beneficiaries are other family clients and charitable or non-profit organizations) or other charitable organization, in each case funded exclusively by one or more family clients. In comparison to the proposed rule, the Family Office Rule expands the types of charitable organizations qualifying as family clients by (i) including non-profit organizations, (ii) permitting non-profit and charitable organizations to be funded by "family clients" rather than "family members" and (iii) removing from consideration whether family members established any such organization. The SEC has provided a transition period of until December 31, 2013 for any company that would be a family office except for its having as a client one or more non-profit or charitable organizations that have accepted non-family-client funding, in order to give such current family offices sufficient time to transition these advisory arrangements or restructure the charitable or non-profit organization(s) to comply with the Family Office Rule. In order for a family office to rely on this transition period, the non-profit or charitable organization advised by such family office cannot accept additional funding from any non-family clients after August 31, 2011, except for any funding received prior to December 31, 2013 pursuant to a pledge made prior to August 31, 2011.

Other Family Entities. Under the Family Office Rule, any company, including any pooled investment vehicle exempt from registration as an investment company under the Investment Company Act, that is wholly owned (directly or indirectly) exclusively by, and operated for the sole benefit of, one or more family clients would generally be treated as a family client. In contrast to the proposed rule, the Family Office Rule does not require such a company to be wholly controlled by family clients in order to be treated as a family client.

Key Employees. Key employees are "family clients" and would be able to participate in the investment opportunities provided by the family office and receive investment advice from the family office. A key employee is defined as any natural person (including any key employee's spouse or spousal equivalent who holds a joint, community property interest with that key employee) who is (i) an executive officer, director, trustee, general partner or a person who serves in a similar capacity of the family office or its affiliated family office or (ii) any other employee of the family office or its affiliated family office who participates in the investment activities of the family office or affiliated family office in connection with that employee's regular duties (other than performing solely clerical or similar duties) and has been performing such duties for the family office or affiliated family office (or substantially similar duties for another company) for at least 12 months. In response to commenters, including Davis Polk, the SEC has expanded the definition of "key employee" from the proposed rule to include key employees of an "affiliated family office," *i.e.*, a family office wholly owned by family clients of another family office and that is controlled by one or more family members of such other family office and/or family entities associated with such other family office and has no clients other than family clients of such other family office. The Family Office Rule also provides a definition of "executive officer" (*i.e.*, the president, any vice president in charge of a principal business unit, division or function, any other officer who performs a policy-making

function, or any other person who performs similar policy-making functions, for the family office) which is nearly identical to that of rule 205-3(d)(4) under the Advisers Act and rule 3c-5(a)(3) under the Investment Company Act.

Former Key Employees. Similar to the proposed rule, the Family Office Rule prohibits key employees (including their trusts and controlled entities) from making additional investments through the family office upon the end of employment, but would not require former key employees to transfer or liquidate the investments that such key employees held through the family office at the time their employment ends. For a family office to continue to be exempt from registration under the Family Office Rule, however, a Key Employee Controlled Trust and certain other entities may be required to transfer or liquidate investments at the time the key employee's employment ends, subject to the one-year involuntary transfer rule mentioned above.

Ownership and Control

The Family Office Rule requires the family office to be wholly owned by family clients and exclusively controlled (directly or indirectly) by one or more family members or family entities (*i.e.*, any family trust or estate, non-profit or charitable organization or other family entity qualifying as a family client under the Family Office Rule, other than key employees and their trusts). The Family Office Rule expands who can own the family office from "family members" specified in the proposed rule to "family clients." In making this change, the SEC agreed with commenters, including Davis Polk, that permitting employees to own equity interests in family offices is an important incentive to attract and retain talented employees.

Grandfathering

Similar to the proposed rule, the Family Office Rule contains a grandfathering provision that includes in the definition of a family office persons not registered or required to be registered under the Advisers Act on January 1, 2010 that would meet all of the required conditions under the Family Office Rule but for the provision of investment advice to certain clients, including, for example, (i) natural persons who, at the time of their investment, are officers, directors or employees of the family office who have invested with the family office before January 1, 2010 and are accredited investors or (ii) any company owned exclusively and controlled by one or more family members.

The SEC reiterated in its adopting release that it is not rescinding exemptive orders previously issued to family offices, which, according to the SEC, may be slightly broader in some areas than the Family Office Rule, while narrower in other areas. Family offices currently operating under the exemptive orders could continue to rely on such orders, or, if they meet the conditions of the Family Office Rule, they could rely on the Family Office Rule.

Transition Period and Effective Dates

The Family Office Rule will become effective on August 29, 2011.

The SEC has provided a transition period ending March 30, 2012 for family offices currently exempt from registration under the Advisers Act in reliance on the private adviser exemption (which will be repealed on July 21, 2011) in order to allow such family offices time to determine whether they meet the conditions of the Family Office Rule or to restructure or register under the Advisers Act if they do not.

- ▶ [See the adopting release containing the full text of the Family Office Rule](#)
- ▶ [See the press release and fact sheet issued by the SEC](#)

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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