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SEC Proposes Rules Implementing Amendments to the Investment Advisers Act of 1940

This memorandum provides a general overview of new rules, rule amendments and Form ADV amendments that the Securities and Exchange Commission (the "SEC") is proposing in order to implement certain provisions of the Private Fund Investment Advisers Registration Act of 2010 (the "Registration Act").[1] The Registration Act in part: (1) repeals the private adviser exemption of section 203(b)(3) of the Investment Advisers Act of 1940, as amended (the "Advisers Act"), [2] thus requiring most advisers to hedge funds and other private funds to register with the SEC; (2) introduces several new and more limited exemptions for family office advisers,[3] foreign private advisers, advisers to venture capital funds and advisers to private funds with less than $150 million in assets under management in the United States; (3) generally increases the statutory threshold (from $25 million to $100 million) for registration by investment advisers with the SEC rather than the states; and (4) mandates reporting under the Advisers Act by advisers that act as investment advisers solely to: (a) one or more venture capital funds; or (b) private funds if such investment advisers have assets under management in the United States of less than $150 million (collectively the advisers in clauses (a) and (b) are referred to as "exempt reporting advisers").[4]

The SEC recently has issued a release that proposes: (1) a definition for venture capital funds to be used in the new exemption for advisers to venture capital funds; (2) an exemption for investment advisers to private funds with less than $150 million in assets under management in the United States; (3) definitions to be used in the new exemption for foreign private advisers; and (4) clarification of the treatment of subadvisory relationships and advisory affiliates under the Advisers Act.[5] In a companion release, the SEC proposes changes that would implement the Registration Act.[6] The proposals in the Implementing Release focus on: (1) a new rule and Form ADV amendments facilitating the transition from SEC registration to state registration for advisers with assets under management between $25 million and $100 million ("mid-sized investment advisers"); (2) a new rule describing reporting requirements that will apply to exempt

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1 The Registration Act is comprised of Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (the "Dodd-Frank Act"), which was signed into law by President Barack Obama on July 21, 2010. The Registration Act becomes effective July 21, 2011. Registration Act § 419. For an in depth discussion of the Dodd-Frank Act, including the Registration Act, please refer to "The Dodd-Frank Act: Commentary and Insights."

2 Registration Act § 403. The "Private Adviser Exemption" provides that an investment adviser is exempt from registration if, during the course of the preceding 12 months, it has had fewer than 15 clients and neither holds itself out generally to the public as an investment adviser nor acts as an investment adviser to any registered investment company, or any business development company (a "BDC") that has a currently effective election to be such, under section 54 of the Investment Company Act of 1940, as amended, 15 U.S.C. §§ 80a-1 to 80a-64 (the "Investment Company Act"). *See* 15 U.S.C. § 80b-3(b)(3).

3 For a discussion of the proposed family office adviser exemption please refer to "SEC Proposes Rule Defining 'Family Office' Exclusion from Definition of Investment Adviser."

4 *See* Registration Act §§ 403, 407-10.

5 *See* Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers, Investment Advisers Act Release No. 3111 (Nov. 19, 2010) (to be codified at 17 C.F.R. § 275) (the "Exemptions Release"), *available at* http://sec.gov/rules/proposed/2010/ia-3111.pdf.

6 *See* Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Act Release No. 3110, (Nov. 19, 2010) (to be codified at 17 C.F.R. §§ 275 and 279) (the "Implementing Release"), *available at* http://sec.gov/rules/proposed/2010/ia-3110.pdf; *see also id.* at apps. A-E, proposed Form ADV Uniform Application for Investment Adviser Registration (hereinafter "proposed Form ADV").

reporting advisers; (3) Form ADV amendments primarily designed to give effect to these exemptions and reporting requirements as well as policy considerations underlying the Registration Act; and (4) amendments to the SEC's "pay-to-play" rule.[7] As part of the transitional rules, the SEC is proposing to require **every** investment adviser registered with the SEC on July 21, 2011 to file an amendment to its Form ADV by August 20, 2011 to indicate whether it is still eligible to be registered with the SEC. **Comments on these proposals must be received on or before January 24, 2011**.

I. Exempt Reporting Advisers

Exempt reporting advisers still will be required to file reports with the SEC and will be required to keep such records as the SEC deems necessary to protect investors.[8] As currently proposed, these advisers also will be subject to SEC examinations. Advisers who qualify as exempt reporting advisers or for the exemption for foreign private advisers may still choose to register with the SEC subject to section 203A of the Advisers Act.[9]

Exempt reporting advisers also may still be required to register with one or more state securities authorities. However, the SEC notes that the North American Securities Administrators Association, Inc. ("NASAA") is considering a model rule that would exempt certain exempt reporting advisers from state registration but would require these advisers to file with the states the same reports that they file with the SEC. The SEC invites interested people to submit comments to NASAA for consideration by the state securities authorities.[10]

Two SEC Commissioners voiced concern over elements of the proposed rules relating to exempt reporting advisers and in particular the failure to distinguish sufficiently between registered and exempt advisers. These Commissioners affirmatively invited public comments on specific issues such as the burdensome reporting, recordkeeping and related compliance obligations of exempt reporting advisers, especially the potential adverse impact on venture capital fund advisers.[11]

A. Exemption for Venture Capital Fund Advisers

New section 203(l) of the Advisers Act provides that an investment adviser that solely advises venture capital funds is exempt from registration under the Advisers Act and directs the SEC to define "venture capital fund."[12] This exemption is proposed to be available without regard to the number or size of such venture capital funds.

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7 We have addressed the proposed amendments to the "pay-to-play" rule in a separate memorandum to clients.

8 These recordkeeping requirements are to be addressed in a future SEC release. See Implementing Release at 36 n.115.

9 Section 203A(a)(1) of the Advisers Act generally prohibits an investment adviser regulated by the state in which it maintains its principal office and place of business from registering with the SEC unless it has at least $25 million of assets under management, and preempts certain state laws regulating advisers that are registered with the SEC. 15 U.S.C. §§ 80b-3a(a)(1), (b). Section 410 of the Dodd-Frank Act amended section 203A(a) generally to prohibit an investment adviser that has assets under management between $25 million and $100 million from registering with the SEC if the adviser is required to be registered with, and if registered, would be subject to examination by, the state security authority where it maintains its principal office and place of business.

10 Implementing Release at 38-39 n.127. The email address for NASAA is advcomments@nasaa.org.

11 *See* Kathleen L. Casey, Comm'r, SEC, Statement at SEC Open Meeting — Rules Implementing Amendments to the Investment Advisers Act of 1940; Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less than $150 Million in Assets Under Management, and Foreign Private Advisers (Nov. 19, 2010), http://www.sec.gov/news/speech/2010/spch111910klc-items1-2.htm; Troy A. Paredes, Comm'r, SEC, Statement at Open Meeting to Propose Rules Regarding Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less Than $150 Million in Assets Under Management, and Foreign Private Advisers and Implementing Amendments to the Investment Advisers Act of 1940 (Nov. 19, 2010), http://www.sec.gov/news/speech/2010/spch111910tap-items1-2.htm.

12 Registration Act § 407.

1. Definition of Venture Capital Fund

The proposed definition represents the SEC's effort to reflect Congressional intent to distinguish advisers to "venture capital funds" from the larger category of advisers to "private equity funds" for which Congress considered, but ultimately did not provide, an exemption.[13] The SEC proposes new rule 203(l)-1 which defines a venture capital fund as a fund that:

- invests solely in:
  - "equity securities" of "qualifying portfolio companies" (each defined below) and at least 80 percent of each qualifying portfolio company's securities owned by the fund were acquired directly from the qualifying portfolio company; and
  - "cash and cash equivalents" (as defined in rule 2a51-1(b)(7)(i) under the Investment Company Act[14]) and United States Treasuries with a remaining maturity of 60 days or less;
- directly, or through its investment advisers, offers or provides significant managerial assistance to, or controls, each qualifying portfolio company;
- does not borrow or otherwise incur leverage (other than limited short-term borrowing as described below);
- does not offer its investors redemption or other similar liquidity rights except in extraordinary circumstances;
- represents itself as a venture capital fund to investors; and
- is a private fund.[15]

Qualifying Portfolio Companies. The SEC proposes to define a "qualifying portfolio company" as any company (including any non-United States company) that:

- is not publicly traded at the time of acquisition by the private fund;
- does not incur leverage in connection with the investment by the private fund;
- uses the capital provided by the private fund for operating or business expansion purposes rather than to buy out other investors; and
- is not itself a private fund, investment company or a commodity pool.[16]

Private Companies. The SEC recognizes that a typical and important type of exit strategy to provide liquidity to venture capital investors is through initial public offerings of venture-backed companies.[17] Accordingly, a venture capital fund is proposed to be permitted to continue to hold

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13 Exemptions Release at 10.

14 Cash equivalents include foreign currencies "held for investment purposes" and "(i) [b]ank deposits, certificates of deposit, bankers acceptances and similar bank instruments held for investment purposes; and (ii) [t]he net cash surrender value of an insurance policy." Rule 2a51 under the Investment Company Act, 17 C.F.R. § 270.2a51-1(b)(7) (2010).

15 Section 202(a)(29) of the Advisers Act defines the term "private fund" as an issuer that would be an investment company, as defined in section 3 of the Investment Company Act, 15 U.S.C. § 8a-3, but for section 3(c)(1) or 3(c)(7) of that Act. Registration Act § 402(a). Private funds include hedge funds, private equity funds and other types of pooled investment vehicles. Exemptions Release at 4-5.

16 Exemptions Release at 13-14.

17 *See* Exemptions Release at 20-21.

securities of a portfolio company that subsequently becomes public, but at the time of each investment by the venture capital fund, the portfolio company may not be publicly traded (or in a control relationship with a publicly traded company).[18]

Equity Securities. The SEC proposes to use the definition of equity security in section 3(a)(11) of the Exchange Act and rule 3a11-1 thereunder.[19] The SEC is of the view that this definition is broad and would include various securities in which venture capital funds typically invest and would provide venture capital funds with flexibility to determine which equity securities in the portfolio company capital structure are appropriate for the fund.[20] The SEC's definition does not allow for any investment in debt securities (unless they meet the "equity security" definition), although it does include common stock, preferred stock, warrants and certain convertible securities.

Portfolio Company Leverage. Under the proposed rule, a portfolio company may not incur leverage in connection with the investment by a venture capital fund; however, this definition would not exclude companies that borrow in the ordinary course of their business (*e.g.*, to finance inventory or capital expenditures, manage cash flows and meet payroll).[21] The SEC recognizes that there may not be a bright-line test in determining what constitutes "in connection with" the fund's investment but the SEC would generally view any financing or loan to a portfolio company that was provided by, or was a condition of a contractual obligation with, a fund or its adviser as part of the fund's investment as being a type of financing that is "in connection with" the fund's investment.[22] This aspect of the proposed definition was adopted in reliance on Congressional testimony from venture capitalists that stressed the lack of leverage in venture capital investing and hence the lack of systematic risk presented by these investments.[23] In addition, the SEC views the lack of leverage as a basis to distinguish venture capital funds from leveraged buyout funds.[24]

Capital Used for Operating and Business Purposes. Under the proposed rule, a venture capital fund must acquire 80 percent of its interest in a qualifying portfolio company from the qualified portfolio company itself. [25] According to the SEC and based on Congressional testimony from venture capital investors as well as the SEC's research, this requirement reflects another distinction between venture capital funds and leveraged buyout funds for which Congress did not intend to provide an

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18 Proposed rule 203(l)-1(c)(3) defines a "publicly traded" company as one that is subject to the reporting requirements under section 13 or 15(d) of the Securities Exchange Act of 1934, as amended (the "Exchange Act") or that has a security listed or traded on any exchange or organized market operating in a foreign jurisdiction. Any reference herein to a "proposed rule" is a reference to a rule proposed under the Advisers Act.

19 *See* Section 3(a)(11) under the Exchange Act, 15 U.S.C. § 78c(a)(11) (defining "equity security" as "any stock or similar security; or any security future on any such security; or any security convertible, with or without consideration, into such a security, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right; or any other security which the Commission shall deem to be of similar nature and consider necessary or appropriate, by such rules and regulations as it may prescribe in the public interest or for the protection of investors, to treat as an equity security"); 17 C.F.R. § 240.3a11-1 (2010) (defining "equity security" to include "any stock or similar security, certificate of interest or participation in any profit sharing agreement, preorganization certificate or subscription, transferable share, voting trust certificate or certificate of deposit for an equity security, limited partnership interest, interest in a joint venture, or certificate of interest in a business trust; any security future on any such security; or any security convertible, with or without consideration into such a security, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right; or any put, call, straddle, or other option or privilege of buying such a security from or selling such a security to another without being bound to do so").

20 Exemptions Release at 24.

21 Exemptions Release at 27-28.

22 *See* Exemptions Release at 28.

23 Exemptions Release at 28.

24 Exemptions Release at 27.

25 Exemptions Release at 29.

exemption.[26] A related criterion in the proposed rule also specifies that a qualifying portfolio company must use the capital invested by the venture capital fund for operating and business purposes, not to distribute company assets to other security holders of the company (which could be an indirect buyout).[27] The proposed definition provides limited flexibility to an eligible venture capital fund to acquire up to 20 percent of its interest in a qualified portfolio company from other investors such as a company founder or an "angel" investor seeking liquidity from his or her initial investment.[28]

Operating Companies. The proposed definition of qualifying portfolio company excludes any private fund or other pooled investment vehicle. The SEC is of the view that Congress did not intend the venture capital exemption to apply to funds of funds.[29]

Management Involvement. To qualify as a venture capital fund, the fund or its investment adviser would be required to:

- have an arrangement under which it offers to provide, and if accepted, does provide, significant guidance and counsel concerning the management, operations or business objectives and policies of the qualifying portfolio company; or
- control the qualifying portfolio company.[30]

The SEC borrowed from the provisions relating to BDCs under the Advisers Act and the Investment Company Act for purposes of this element of the proposed definition.[31] Note this requirement is proposed to apply to each and every investment by a venture capital fund, even though the SEC acknowledges that venture capital funds sometimes invest as a group and only one adviser may in fact be expected to provide such assistance.[32]

Managerial assistance generally takes the form of active involvement in the business, operations or management of the portfolio company, or less active forms of control of the portfolio company, such as through board representation or similar voting rights.[33] The SEC acknowledges that the nature of the managerial assistance may change over time, so the proposed rule does not specify a fixed character with respect to managerial assistance.[34]

Limitation on Leverage. In addition to the portfolio company leverage limitation imposed under the proposed definition of "qualifying portfolio companies," an eligible venture capital fund is proposed not to be able to borrow funds, issue debt obligations, provide guarantees or otherwise incur leverage

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26 Exemptions Release at 29.

27 Exemptions Release at 29-30.

28 Exemptions Release at 33.

29 Exemptions Release at 35.

30 Exemptions Release at 36.

31 Exemptions Release at 37-38.

32 Exemptions Release at 39-40. This is in contrast to the exemption for venture capital operating companies under the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), which generally requires investment of at least 50 percent of the assets of a venture capital operating company to be in venture capital investments. Under ERISA a "venture capital investment" is defined as "an investment in [debt or equity securities of] an operating company (other than a venture capital operating company) as to which the investor has or obtains management rights" that are "contractual rights . . . to substantially participate in, or substantially influence the conduct of, the management of the operating company." 29 C.F.R. § 2510.3-101(d)(3) (2010). An "operating company" is defined as "an entity that is primarily engaged, directly or through a majority owned subsidiary or subsidiaries, in the production or sale of a product or service other than the investment of capital" or is an entity that is a "venture capital operating company" or a "real estate operating company." 29 C.F.R. § 2510.3-101(c) (2010).

33 Exemptions Release at 36-37.

34 Exemptions Release at 37.

in excess of 15 percent of the fund's capital contributions and uncalled capital commitments. Also, any permitted fund-level leverage must be for a non-renewable term of no longer than 120 calendar days.[35] The SEC proposes to require that the loans be non-renewable to avoid a fund transforming its short-term debt into long-term debt by continually rolling it over without full repayment to the lender.[36] Like the limitation on leverage for portfolio companies, this element of the definition is intended to respond to Congressional concern about the connection between leverage and systemic risk.[37]

No Redemption Rights. Under the proposed definition, an eligible venture capital fund cannot provide investors with redemption rights except in extraordinary circumstances, but investors of the fund may receive pro rata distributions from time to time as investments mature. Although the SEC has not provided an exhaustive list of what constitutes "extraordinary circumstances," the SEC's general view is that a fund may provide extraordinary rights for an investor to withdraw from the fund under foreseeable but unexpected circumstances that are typically beyond the control of the adviser and fund investor, such as changes in regulatory, tax or other legal requirements.[38]

Representing Itself as a Venture Capital Fund. An eligible venture capital fund must represent itself to investors as a venture capital fund. A private fund could satisfy this proposed requirement by describing its investment strategy as venture capital investing or as a fund that is managed in compliance with the elements of the proposed rule.[39]

Is a Private Fund. An eligible venture capital fund is proposed to be a private fund pursuant to section 3(c)(1) or 3(c)(7) exemption of the Investment Company Act (including offshore funds that rely on section 3(c)(1) or 3(c)(7) with respect to their United States investors), but investment companies registered under the Investment Company Act (each a "Registered Investment Company") and BDCs are explicitly excluded.[40]

2. Application to Non-U.S. Advisers

Although the statutory text of section 203(l) and the legislative reports are silent as to whether Congress intended the venture capital exemption to be applied to non-U.S. advisers, the SEC indicates that 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 venture capital funds as defined in the proposed rule. In so proposing, the SEC recognizes that in other contexts (such as the currently effective client counting rule 203(b)(3)-1(b)(5)[41]), the Advisers Act only looks to non-U.S. advisers' U.S. clients.[42] In addition, the SEC notes that a non-U.S. fund would need to use U.S. jurisdictional means in offering its securities to qualify as a private fund and as a venture capital fund under the proposed rule.[43] Non-U.S. funds that do not make a U.S. offering of securities could not be considered venture capital funds as proposed.[44]

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35 Exemptions Release at 41.

36 Exemptions Release at 42.

37 Exemptions Release at 43-44.

38 Exemptions Release at 47-49.

39 Exemptions Release at 50.

40 Exemptions Release at 51.

41 Rule 203(b)(3)-1(b)(5) under the Advisers Act, 17 C.F.R. § 275.203(b)(3)-1(b)(5) (2010).

42 *See* Exemptions Release at 54.

43 Exemptions Release at 55.

44 *Id*.

3. Grandfather Provision

The SEC proposes to grandfather any existing fund that: (1) represents to investors and potential investors at the time the fund offered its securities that it is a venture capital fund; (2) prior to December 31, 2010, has sold securities to one or more investors that are not related persons of any investment adviser of the venture capital fund; and (3) does not sell any securities to, including accepting any additional capital commitments from, any person after July 21, 2011. The grandfather provision would apply to any fund that has accepted capital commitments by the specified dates even if none of the commitments has been called. The SEC adopted a broad grandfather rule because it believes that existing venture capital funds were unlikely to have been structured to circumvent the exemptions and did not want to burden these funds with revising the fund terms or liquidating non-qualifying investments to satisfy the proposed rule.[45] In proposing this definition and the grandfather provision, the SEC recognizes that existing venture capital funds may have some characteristics that differ from the proposed definition.[46]

B. Exemption for Private Fund Advisers With Less Than $150 Million in Assets Under Management

The Registration Act requires the SEC to provide for an exemption from registration requirements for advisers that act solely as advisers to private funds and have less than $150 million in assets under management in the United States.[47] The SEC's proposed rule 203(m)-1 includes provisions addressing several interpretive questions raised by this exemption, notably the determination of the amount of an adviser's assets under management for purposes of the $150 million threshold and when those assets are deemed to be managed in the United States. The SEC refers to this new exemption as the "Private Fund Adviser Exemption."[48] This should not be mistaken with the existing "Private Adviser Exemption," which has been available to investment advisers who have fewer than 15 clients and satisfy other criteria, and which is being eliminated by the Registration Act.

1. Advises Solely Private Funds

An adviser relying on the Private Fund Adviser Exemption would be limited to advising private funds, but would be permitted to advise an unlimited number of private funds as long as the aggregate value of the private fund assets is less than $150 million.[49] An adviser who advises individuals or manages accounts from the United States would not qualify for this exemption.

The SEC's proposed rule 203(m)-1 differentiates between United States advisers, who are advisers with a principal office and place of business in the United States ("U.S. Advisers"), and non-United States advisers, who are advisers with a principal office or place of business outside the United States ("Non-U.S. Advisers").

The SEC proposes that a Non-U.S. Adviser could take advantage of the exemption if **all** of its clients that are United States persons (as defined below) were qualifying private funds.[50] This means that, for Non-U.S. Advisers only, business activities conducted outside of the United States with clients that are not qualifying private funds would be disregarded for purposes of this exemption. However, the SEC

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45 *See* Exemptions Release at 56-57.

46 Exemptions Release at 100.

47 Registration Act § 408.

48 *See* Exemptions Release at 58-69.

49 Exemptions Release at 59.

50 *Id*.

proposes that a U.S. Adviser would not have the ability to conduct offshore advisory activities with non-qualifying clients if it would like to qualify for the exemption. This proposal reflects the SEC's belief that the non-United States activities of a Non-U.S. Adviser are less likely to implicate United States regulatory interests, and is also consistent with general principles of international comity as well as current client counting rules, which allow Non-U.S. Advisers to count only United States clients.[51]

2. Assets Under Management

In order to determine whether it has less than $150 million in assets under management in the United States, an adviser would have to aggregate the value of all assets of private funds that it manages in the United States. A subadviser only would need to count the portion of the private fund assets for which it has advisory responsibilities.[52]

The SEC proposes to implement a uniform method to calculate assets under management under various provisions of the Dodd-Frank Act. This uniform method, detailed in proposed revised instructions to Form ADV described below, would require advisers to include in their assets under management securities portfolios for which they provide continuous and regular supervisory or management services, regardless of whether these assets are proprietary assets, assets managed without compensation, or assets of foreign clients. The SEC also has proposed to clarify that advisers would include in their assets under management uncalled capital commitments.[53]

An adviser would now be required to calculate the amount of assets under management quarterly on the basis of the fair value of the assets at the end of the quarter so that advisers will value fund assets on a meaningful and consistent basis, even though these values would not be subject to quarterly reporting to the SEC.[54] However, an adviser would not be required to determine fair value in accordance with United States generally accepted accounting principles ("GAAP") or any other body of accounting principles used in preparing financial statements.[55]

3. Assets Managed in the United States

For purposes of the proposed exemption, all of the assets of a U.S. Adviser would be considered to be "assets under management in the United States," even though the adviser has offices outside the United States and the day-to-day management of certain assets takes place in such offshore offices. Non-U.S. Advisers, however, would need only count assets managed from a place of business in the United States toward the $150 million threshold.[56]

The adviser's principal office and place of business is the location where the adviser really controls or has ultimate responsibility for the management of the assets even though day-to-day management of certain assets may take place at another location.[57] The SEC believes its approach encourages the participation of Non-U.S. Advisers in the United States markets by applying the United States securities laws in a manner that does not impose United States regulatory requirements on an adviser's

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51 *Id.* *See also* Rule 203(b)(3)-1(b)(5) under the Advisers Act, 17 C.F.R. § 275.203(b)(3)-1(b)(5) (2010).

52 Exemptions Release at 60-61.

53 *Id.*

54 Exemptions Release at 61-64.

55 *See* Exemptions Release at 63.

56 Exemptions Release at 64-65.

57 Exemptions Release at 65.

non-United States business.[58] The SEC also notes that U.S. Advisers with non-United States subsidiaries managing assets outside the United States generally would not have to count assets managed by non-United States affiliates under the proposed rule.[59]

4. United States Person

Under the rule proposed by the SEC, a Non-U.S. Adviser could not use the Private Fund Adviser Exemption if it provides advice to a client that is a United States person but not a qualifying private fund. The SEC proposes to generally define a "United States person" by reference to Regulation S under the Securities Act of 1933, as amended ("Regulation S"). [60] Under Regulation S, an individual is a United States person if resident in the United States; legal partnerships and corporations are generally treated as United States persons if they are organized or formed in the United States; and trusts are United States persons if the trustee is a United States resident.[61]

The SEC proposes a special rule for discretionary accounts maintained outside of the United States for the benefit of United States persons. Under this rule, a discretionary or fiduciary account must be treated as a United States person if the account is held for the benefit of a United States person by a non-United States fiduciary who is a related person of the adviser. The purpose of this special rule is to prevent advisers from structuring the management of United States clients' accounts in ways that would circumvent the principles of Regulation S.[62]

5. Grace Period

If an adviser can no longer rely on the exemption because the value of its assets under management crosses the $150 million threshold, the SEC proposes a grace period of one calendar quarter to register with the SEC. This three-month grace only would be available to advisers that have otherwise complied with all of the reporting requirements imposed by the SEC.[63]

II. Exemption for Foreign Private Advisers

The Registration Act creates a new exemption for a "foreign private adviser."[64] This new exemption is codified as amended section 203(b)(3) of the Advisers Act. To be eligible for the foreign private adviser exemption, an adviser must: (1) have no place of business in the United States; (2) have, in total, fewer than 15 clients (*e.g.*, managed accounts or pooled investment vehicles) and investors in the United States in private funds advised by the investment adviser; (3) have less than $25 million (or such higher amount as the SEC may deem appropriate) in aggregate assets under management that are attributable to clients in the United States and investors in the United States in private funds advised by the investment adviser; and (4) neither hold itself out generally to the public in the United States as an investment adviser nor act as an investment adviser to any Registered Investment Company.[65] Advisers relying on this new exemption are not subject to reporting or recordkeeping

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58 Exemptions Release at 67.

59 *See* Exemptions Release at 67-68.

60 *See* Exemptions Release at 69.

61 Exemptions Release at 69.

62 *See* Exemptions Release at 70.

63 Exemptions Release at 71.

64 Registration Act § 403.

65 *See* Exemptions Release at 72. The proposed rule clarifies that an adviser is not deemed to be holding itself out to the public solely because it participates in a private placement of securities of a private fund. *See* proposed rule 202(a)(30)-1(d).

provisions under the Advisers Act and are not subject to examination by the SEC. The SEC is proposing a new rule 202(a)(30)-1 that would clarify the meaning of a number of terms included in the definition of "foreign private adviser," specifically: (1) "client;" (2) "investor;" (3) "in the United States;" (4) "place of business;" and (5) "assets under management."[66]

A. Client

The rule proposed by the SEC would include a slightly modified version of the safe harbor for counting clients currently used for purposes of the Private Adviser Exemption that is being eliminated. Specifically, an adviser would be allowed to treat as a single client a natural person and (1) that person's minor children; (2) any spouse, relative or relative of the spouse of the natural person who share the natural person's principal residence; and (3) all accounts and trusts of which the natural person and/or the natural person's minor child, spouse, relative or relative of the spouse which has the same principal residence are the only primary beneficiaries. An adviser also would be permitted to treat as a single client: (1) a corporation, general partnership, limited partnership, limited liability company, trust or other legal entity to which the adviser provides investment advice based on the entity's investment objectives; and (2) two or more legal entities that have identical shareholders, partners, limited partners, members or beneficiaries.[67]

The SEC proposes that an adviser now would need to count a person as a client even though the adviser provides investment advisory services to such person without compensation (consistent with including assets managed without compensation as assets under management for purposes of Form ADV, as described above and below). These clients currently are not counted for purposes of the Private Adviser Exemption that is being eliminated. To avoid double-counting, an adviser would not need to count a private fund as a client if the adviser counted any investor in that private fund as an investor for purposes of determining the availability of the exemption.[68]

B. Investor

The SEC proposes to define "investor" in a private fund as any person who would be considered a beneficial owner of the outstanding securities of a private fund under section 3(c)(1) of the Investment Company Act or who would be included in determining whether the outstanding securities of a private fund are owned exclusively by qualified purchasers under section 3(c)(7) of that Act. An investor investing in two or more private funds advised by the same investment adviser would be treated as a single investor to avoid double-counting.[69]

In defining the term "investor" by reference to sections 3(c)(1) and 3(c)(7) of the Investment Company Act, the SEC notably is seeking to "look-through" nominee arrangements, other types of intermediate accounts or feeder funds to reach the underlying holders of private fund-issued securities.[70] It also forces an adviser to count as an investor the holder of derivative instruments, such as total return swaps, which effectively transfer the economic exposure to private fund securities from the record owner of such securities.[71]

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66 Proposed rule 202(a)(30)-1.

67 Exemptions Release at 73-74.

68 Exemptions Release at 75.

69 Exemptions Release at 76-77.

70 Exemptions Release at 76-79.

71 Exemptions Release at 79.

The SEC also is proposing to treat as investors beneficial owners: (1) who are "knowledgeable employees" with respect to the private fund and certain other persons related to such employees; and (2) of "short-term paper" issued by the private fund, even though these persons would neither be counted as beneficial owners for purposes of section 3(c)(1) nor be required to be qualified purchasers under section 3(c)(7).[72]

C. In the United States

The term "in the United States" is used several times in the definition of "foreign private adviser." The number of clients and investors "in the United States" is limited to fifteen and advisers cannot have a place of business "in the United States" or hold themselves out to the public "in the United States" as an investment adviser if they want to rely on the exemption.

The rule proposed by the SEC defines "in the United States" generally by incorporating the definitions of a "U.S. person" and "United States" under Regulation S. Specifically, "in the United States" would have the following meanings: (1) with respect to any place of business located in the "United States," as that term is defined in Regulation S;[73] (2) with respect to any client or investor in the United States, any person that is a "U.S. person" as defined in Regulation S, except that any discretionary account or similar account held for the benefit of a person "in the United States" by a non-United States professional fiduciary would be a deemed "in the United States" if such professional fiduciary is a related person of the investment adviser relying on the exemption (as described above); and (3) with respect to the public in the "United States," as that term is defined in Regulation S.[74]

For purposes of that definition, the SEC proposes that a person that was not "in the United States" when such person became a client or acquired the securities issued by the fund in the case of an investor would not be treated as being "in the United States" even though such person later moves to the United States.[75]

D. Place of Business

"Place of business" would be defined as: (1) any office where the investment adviser regularly provides advisory services, solicits, meets with, or otherwise communicates with clients; and (2) any location held out to the public as a place where the investment adviser conducts any such activities.[76] This definition is similar to the definition of "place of business" that is contained in the current version of rule 222-1(a) under the Advisers Act.

E. Assets Under Management

As for the new Private Fund Adviser Exemption, the SEC is proposing to follow the uniform method contained in Item 5 of proposed Form ADV to calculate "assets under management." This means that foreign advisers would use the fair value of the assets they manage and would be required to include proprietary assets, assets managed without compensation, assets of non-United States clients as well as uncalled capital commitments for purposes of the calculation of their "assets under management." The SEC believes that requiring all advisers to determine if they are required to register or if they are

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72 Exemptions Release at 80-81.

73 Regulation S defines "United States" as "the United States of America, its territories and possessions, any State of the United States, and the District of Columbia." 17 C.F.R. § 230.902(1) (2010).

74 Exemptions Release at 82.

75 Exemptions Release at 82-83.

76 Exemptions Release at 84-85.

eligible for an exemption by the same method for calculating assets under management will result in a coherent application of the Advisers Act.[77]

III. Subadvisers and Advisory Affiliates

Subadvisers are treated like advisers and, therefore, are permitted to take advantage of each of the new exemptions, provided they satisfy the respective conditions of such exemption. The SEC recognizes that a subadviser may only have contractual privity with the fund's primary adviser rather than the private fund, but proposes that a subadviser could still rely on section 203(m) if its services relate solely to private funds and the other conditions are met.[78] Similarly, a subadviser may rely on section 203(l) if its services relate solely to venture capital funds and the other conditions of the rule are met.[79] The SEC expects advisers with advisory affiliates to have interpretative questions as to whether they are allowed to disregard the activities of their affiliates for purposes of determining if they can rely on any of the new exemptions. On this topic, the SEC references its longstanding position that the determination of whether the advisory businesses of an adviser and its affiliate may be required to be integrated depends on the degree of separateness between them and is a question of facts and circumstances.[80] However, the SEC does not state that this approach will be dispositive in the future.[81] Additionally, the SEC appears to have not squarely addressed the continued viability of certain staff positions set forth in the *Unibanco*[82] and similar SEC staff no-action letters that have led to the development of certain operating structures for registered investment advisers with foreign advisory affiliates.[83]

IV. Eligibility for SEC Registration

A. Treatment of Mid-Sized Investment Advisers

Currently, section 203A of the Advisers Act generally prohibits SEC registration by an investment adviser if the adviser is regulated or required to be regulated as an investment adviser in the state in which it maintains its principal office and place of business, unless the investment adviser: (1) has at least $25 million of assets under management; or (2) advises a Registered Investment Company.[84] Section 410 of the Registration Act now adds to this prohibition from SEC registration any investment adviser that: (1) is "required to be registered"[85] as an investment adviser with a state securities

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77 Exemptions Release at 86.

78 Exemptions Release at 87.

79 *Id*.

80 Richard Ellis, Inc., SEC Staff No-Action Letter, 1981 WL 25241, at *1 (Sept. 17, 1981).

81 Exemptions Release at 87-88.

82 Uniao de Bancos de Brasileiros S.A., SEC No-Action Letter, 1992 WL 183054 (July 28, 1992) ("*Unibanco*").

83 Exemptions Release at 88 n.271. In particular, these operating structures include so-called "participating affiliate" arrangements and the so-called "Advisers Act Lite" regulatory regime for offshore advisers who register under the Advisers Act. The SEC acknowledged receipt of a number of letters requesting clarification regarding these positions, stated that advisers should consider whether they can avail themselves of any of the newly proposed Advisers Act exemptions and encouraged advisers "to submit comment letters addressing with particularity and specificity interpretive issues that may not be addressed in our proposed rules."

84 15 U.S.C. § 80b-3a(a)(1).

85 The SEC states that a mid-sized investment adviser that relies on a state law exempting that adviser from state registration is "not required to be registered" with the state and thus would be required to register with the SEC unless an exemption from SEC registration is otherwise available. *See* Implementing Release at 33. *See also* proposed Form ADV: Instructions for Part 1A, instr. 2b, which proposed instructions are set forth in Appendix B to the Implementing Release, *available at* http://sec.gov/rules/proposed/2010/ia3110-appb.pdf.

authority in the state in which it maintains its principal office and place of business and, if registered, would be "subject to examination"[86] by such state securities authority; and (2) is a "mid-sized investment adviser" with assets under management between $25 million and $100 million. Section 410 generally prohibits a mid-sized investment adviser from registering with the SEC, but exempts a mid-sized investment adviser from this prohibition if: (1) it would be required to register in 15 or more states; or (2) it advises a Registered Investment Company or a BDC.

B. Transition to State Registration

In order to facilitate the withdrawal of an estimated 4,100 SEC registered investment advisers who will now be required to register with a state securities authority, the SEC proposes new rule 203A-5 under the Advisers Act. If adopted, this rule would require **each** investment adviser that is registered with the SEC on July 21, 2011 to: (1) file an amendment to its Form ADV by August 20, 2011 specifying whether it meets the new eligibility criteria for SEC registration; (2) report the market value of its assets under management determined within 30 days of the filing; and (3) if the investment adviser would no longer be eligible for SEC registration, file a Form ADV-W by October 19, 2011. Consequently, this new rule contemplates only a 90-day transition period for investment advisers switching from SEC to state registration due to the implementation of the Registration Act. This transition period is proposed to be shorter than the traditional 180-day transition period afforded investment advisers switching from SEC to state registration in order to promptly implement the Congressional Dodd-Frank Act mandates.[87] The SEC expects to cancel the registration of any adviser who does not file its amendment or withdraw its registration in accordance with the proposed rule.[88]

Exception During Transition Period. The SEC recognizes that certain existing state-registered advisers and advisers registering for the first time that attain the $25 million asset threshold would be required to register with the SEC under current section 203A(a) of the Advisers Act, only to be required to withdraw such registration when the $100 million threshold of the Registration Act is implemented. Accordingly, in order to ease the regulatory burden on these investment advisers, the SEC will not object if any such investment adviser does not register with the SEC during the period beginning January 1, 2011 until the end of the transition period (October 19, 2011 under the proposed rules), provided that the investment adviser: (1) reports on its Form ADV that it has between $30 million and $100 million of assets under management; (2) is registered as an investment adviser in the state in which it maintains its principal office and place of business; and (3) reasonably believes that it is required to be registered with, and is subject to examination as an investment adviser by, that state.[89] Instead, such existing investment advisers should remain registered with, and such newly registering investment advisers should apply for registration with, the applicable state securities authorities.

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86 The SEC has indicated that it intends to correspond with each state securities authority to determine whether an investment adviser registered in that state would be subject to examination as an investment adviser and then incorporate that information into the Investment Adviser Registration Depository (also known as "IARD"). *See* Implementing Release at 34-35. *See also* proposed Form ADV: Instructions for Part 1A, instr. 2.b, *available at* http://sec.gov/rules/proposed/2010/ia3110-appb.pdf.

87 The SEC notes that its ability to effect the timely transition to state regulation is dependent on reprogramming the IARD system and recognizes the possibility of the programming not being complete within the proposed time, in which case the SEC would further delay implementation of the new thresholds. Implementing Release at 12.

88 Implementing Release at 10.

89 Implementing Release at 13.

C. Amendments to Form ADV

Item 2 of Part 1A of Form ADV currently requires an investment adviser to indicate its basis for registration with the SEC and to report annually its eligibility to remain registered. The SEC's proposed amendments to Item 2 are designed to achieve these same goals, but reflect the new categories of eligibility for registration established pursuant to the Registration Act.[90]

D. Regulatory Assets Under Management[91]

In order to effect a more coherent application of the Registration Act's regulatory requirements and more consistent reporting on Form ADV, the SEC is proposing a uniform method of calculating assets under management for the following purposes: (1) determining eligibility for SEC registration; (2) reporting assets under management on Form ADV; and (3) applying the new exemptions from registration under the Advisers Act (as described above in relation to the exemptions for (a) advisers to private funds with less than $150 million in assets under management in the U.S. and (b) foreign private advisers. The SEC is proposing to amend rule 203A-3 to add a definition that would continue to require that "assets under management" for purposes of section 203A will be the assets under management reported in the investment adviser's Form ADV.[92] The SEC is proposing amendments to the Form ADV instructions to guide investment advisers in their calculation of assets under management for the above-described purposes.[93] Currently Item 5.F. of Form ADV permits an investment adviser some limited discretion in choosing which assets to include in this calculation. Proposed amendments to Form ADV and its instructions, however, would remove this discretion and create a uniform method of calculating assets under management by specifying that assets in a securities portfolio for which an investment adviser provides continuous and regular supervisory or management services must include proprietary assets, assets managed without receiving compensation and assets of non-United States clients, all of which may (but are not required) to be included on the current Form ADV. The SEC proposes to clarify that the assets should be calculated without deducting outstanding indebtedness and other accrued but unpaid liabilities, such as accrued fees, expenses or the amount of any borrowing.[94]

The SEC proposes to provide guidance regarding how an investment adviser to private funds calculates assets under management because the current Form ADV provides no instructions for this situation.[95] The SEC would now require an investment adviser 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 held by the private fund. In other words, there is no requirement that the private

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90 Specifically, each investment adviser completing the form would be required to indicate whether it is eligible to register with the SEC because it: (1) is a large investment adviser (having $100 million or more of regulatory assets under management); (2) is a mid-sized investment adviser that does not meet the criteria for state registration and examination; (3) has its principal office and place of business in Wyoming (which does not regulate advisers); (4) has its principal office and place of business outside the United States; (5) is an investment adviser (or sub-adviser) to a Registered Investment Company; (6) is an investment adviser to a BDC and has at least $25 million of regulatory assets under management; (7) is a multi-state adviser that is required to register in 15 or more states; or (8) has some other basis for registering with the SEC. *See* proposed Form ADV, Part 1A, Items 2.A.(1) – (6) and (10), respectively, and all other sub-items of Item 2.A. Proposed Part 1A of Form ADV is set forth in Appendix D to the Implementing Release, *available at* http://sec/gov/rules/proposed/2010/ia-3110-appd.pdf.

91 The SEC proposes to refer to "regulatory assets under management" in Part 1A of Form ADV to distinguish from the "assets under management" disclosure to clients in Part 2, which may be different. Implementing Release at 17.

92 Implementing Release at 16.

93 *See* proposed Form ADV: Instructions for Part 1A, instr.5.b.

94 Implementing Release at 17.

95 *See* Implementing Release at 18.

fund assets consist of "securities."[96] As described above (1) sub-advisers to a private fund would only include the portion of the portfolio over which they provide advisory services and (2) uncalled capital commitments to private funds would be required to be included in assets under management under the proposed rule.

The proposed instructions also require that for this calculation an investment adviser determine the "fair value" of the private fund assets to ensure a more meaningful and consistent valuation of the private funds.[97] As noted above, the "fair value" requirement as proposed does not require a particular determination in accordance with GAAP or other international accounting standards.

E. Switching Between State and SEC Registration

The SEC proposes to amend rule 203A-1 under the Advisers Act to eliminate the $5 million buffer permitting investment advisers with between $25 and $30 million in assets under management to remain registered with state securities authorities rather than requiring such advisers to register with the SEC. The SEC believes this buffer is unnecessary in light of the Congressional determination to require most advisers with assets under management of between $30 million and $100 million to be registered with the states. The SEC's view is that the retention of an investment adviser's ability to rely on its assets under management as reported annually on Form ADV (as opposed to more frequently) will be sufficient protection against an investment adviser having to change registration status frequently as a result of fluctuations in the value of its assets under management. Investment advisers no longer eligible for registration with the SEC would still have the benefit of the current 180-day grace period to switch to state registration.[98]

F. Elimination of Safe Harbor

The SEC is proposing to repeal the safe harbor in rule 203A-4 that protects investment advisers that are not registered with the SEC, but that are registered with the state securities authorities in the state in which they have their principal office and place of business, so long as such investment advisers reasonably believe that they are prohibited from registering with the SEC because they do not have at least $30 million of assets under management. The SEC concludes that investment advisers have not relied on this defense, which only protects against enforcement actions, not private actions.[99]

G. Repeal of Certain Exemptions from Prohibition on Registration

The Advisers Act authorizes the SEC to permit the registration of an investment adviser who would otherwise be prohibited from registering with the SEC, if such prohibition would be "unfair, a burden on interstate commerce, or otherwise inconsistent" with the purposes of section 203A of the Advisers Act.[100] Over the years, the SEC has used this authority to permit certain classes of investment advisers to register with the SEC even though they otherwise would be prohibited from registering.[101]

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96 Proposed Form ADV: Instructions for Form ADV, Part 1A.instr. 5.b.(1).

97 Proposed Form ADV: Instructions for Part 1A, instr. 5.b.(4).

98 Implementing Release at 23-24.

99 The SEC views the safe harbor as no longer applicable since it was adopted for smaller investment advisers with less than $30 million in assets under management who may not have been able to calculate their assets. The SEC believes that investment advisers with more than $100 million in assets under management would be aware of their assets under management. Implementing Release at 30-31.

100 15 U.S.C. § 80b-3a(c).

101 Rule 203A-2 under the Advisers Act, 17 C.F.R. § 275.203A-2 (2010).

In light of recent developments since the adoption of certain of these exemptions, the SEC is proposing to: (1) eliminate the exemption that permits nationally recognized statistical rating organizations ("NRSROs") to register with the SEC;[102] (2) narrow the exemption pertaining to pension consultants by increasing the minimum value of relevant plan assets from $50 million to $200 million (which corresponds to the increase from $25 million to $100 million as the threshold for registration with the SEC under section 410 of the Dodd-Frank Act);[103] and (3) amend the multi-state adviser exemption for small investment advisers to align it with the Registration Act's multi-state adviser exemption for mid-sized investment advisers by permitting SEC registration by all investment advisers otherwise required to register with 15 or more states (rather than the current 30-or-more-states requirement under the multi-state adviser exemption and the current 25-state requirement for SEC registered investment advisers).[104]

V. Reporting by Exempt Reporting Advisers

New Rule 204-4 and Revised Form ADV. While the Registration Act excepts exempt reporting advisers from having to register with the SEC, it also directs the SEC to engage in limited oversight of these advisers. Specifically, the Registration Act mandates that the SEC require exempt reporting advisers to maintain records that the SEC has the authority to examine and submit such reports as the SEC determines necessary or appropriate in the public interest.[105] In exercising this authority, the SEC proposes new rule 204-4 that would require exempt reporting advisers to file reports electronically regarding a limited subset of items on revised Form ADV including: (1) identifying details, such as the exempt reporting adviser's name, address, contact information, form of organization and ownership;[106] (2) the exemption it is relying on to report, rather than register, with the SEC;[107] (3) its, and certain of its affiliates', disciplinary histories, other business activities and financial industry affiliations;[108] and (4) information about any private funds that it advises.[109] In addition, an exempt reporting adviser would be required to file an amendment to its Form ADV when it ceases to be an exempt reporting adviser.[110] The SEC considers that the information so reported would permit it to determine whether these investment advisers or their activities present sufficient concerns as to warrant further attention from the SEC to protect their clients, investors or other market participants.[111] The SEC also notes that exempt reporting advisers that are required to register with a state can use Form ADV to satisfy their state and SEC filing requirements.[112]

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102 *See* Rule 203A-2(a) under the Advisers Act, 17 C.F.R. § 275.203A-2(a) (2010). Since the SEC adopted this exemption, Congress amended the Advisers Act to exclude NRSROs and provided for a separate regulatory regime for them under the Exchange Act. Implementing Release at 26.

103 *See* Rule 203A-2(b) under the Advisers Act, 17 C.F.R. § 275.203A-2(b) (2010); *see also* proposed rule 203A-2(a); Implementing Release at 27.

104 Proposed rule 203A-2(d)(1). In the event that the investment adviser relies on the multi-state adviser exemption, the investment adviser would be required to: (i) indicate on Schedule D of its Form ADV that the investment adviser reviewed applicable state and federal laws in reaching its conclusion that it would otherwise be required to register as an investment adviser in 15 or more states; and (ii) undertake to withdraw from SEC registration if the adviser indicates that the foregoing is no longer the case. Proposed rule 203A-2(d)(2). Implementing Release at 29-30.

105 Registration Act §§ 407, 408.

106 Proposed Form ADV Part 1A, Items 1, 3 and 10.

107 Proposed Form ADV Part 1A, Item 2.C.

108 Proposed Form ADV Part 1A, Items 6, 7A and 11.

109 Proposed Form ADV Part 1A, Items 7.B. Exempt reporting advisers are not proposed to be required to complete or file other items in Part 1A of Form ADV or a client brochure (Part 2 of Form ADV).

110 Proposed rule 204-4(f).

111 Implementing Release at 41.

112 Implementing Release at 38.

Filing of Form ADV. If adopted, this proposed rule and the proposed Form ADV amendments would require a current exempt reporting adviser to file its initial report on Form ADV no later than August 20, 2011.[113] Subsequently, an exempt reporting adviser would be subject to the same timeframe for filing Form ADV updates and amendments as a registered investment adviser, *i.e.*, at a minimum, annual updates within 90 days following the investment adviser's fiscal year end[114] and more frequently, *i.e.* "promptly," as required by the Form ADV instructions with respect to certain specified items of the form. All information reported to the SEC on Form ADV by exempt reporting advisers would be made publicly available on the SEC's website, the Investment Adviser Public Disclosure System ("IAPD").

VI. Amendments to Form ADV

In addition to the Form ADV amendments described in preceding sections of this memorandum, the SEC is proposing other Form ADV amendments that would require a registered investment adviser to provide significantly more disclosure about the private funds it advises, as well as additional disclosure about its advisory business operations, its business practices that may present conflicts of interest, and its non-advisory activities and financial industry affiliations. These disclosure requirements would also apply to exempt reporting advisers. All disclosures made on Form ADV would be publicly available on IAPD.

A. Private Fund Reporting

The proposed Form ADV would now require not only registered investment advisers, but also exempt reporting advisers, to complete newly expanded Item 7.B. of Part 1A. The SEC states the new information will assist it in assessing private fund advisers for purposes of targeting SEC examinations. [115] The expanded information is intended to provide basic organizational, operational and investment characteristics of the fund, the amount of assets, the types of investors in the fund and the fund's service providers.[116] The SEC would require reporting on all private funds, regardless of their form of organization, but would no longer require investment advisers to report on private funds advised by affiliates to avoid duplicative reporting since both registered investment advisers and exempt reporting advisers would be required to complete proposed Section 7.B. of Schedule D.[117] Similarly, the SEC states that the proposed rules would: (1) permit a sub-adviser to exclude from its private fund disclosure those private funds that the primary investment adviser will report in its Schedule D; and (2) permit an investment adviser sponsoring a master-feeder arrangement to submit a single Schedule D for the master fund and all of the feeder funds that would otherwise be submitting substantially identical data.[118] Finally, an investment adviser with a principal office and place of business outside the United States would be able to omit a Schedule D for a private fund that is not organized in the United States and that is not offered to, or owned by, "United States persons."[119]

Private Funds – Section 7.B.1.A. This section would require disclosure of: (1) the state or country where the fund is organized and the name of its directors, trustees or persons occupying similar

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113 Again, the SEC acknowledges that IARD may not be ready to accept amended Form ADV by August 20, 2011, in which case the reporting deadline may be delayed. Implementing Release at 46.

114 Proposed rule 204-1; proposed Form ADV: Instructions for Part 1A, instr. 2.a.

115 Implementing Release at 48.

116 Implementing Release at 51.

117 Implementing Release at 48-49.

118 Proposed Section 7.B.2. of Schedule D; proposed Form ADV: Instructions for Part 1A, instr. 6.

119 *See* proposed Form ADV: Instructions for Part 1A, instr. 6; proposed Form ADV Glossary of Terms, *available at* http://sec.gov/rules/proposed/2010/ia-3110-appc.pdf.

positions; (2) the fund's organization, including whether the fund is part of a master-feeder structure; (3) information about the regulatory status of the private fund and investment adviser, *i.e.*, the exclusion from the Investment Company Act on which the private fund relies, whether the investment adviser is subject to a foreign regulatory authority, and whether the private fund relies on an exemption from registration of its securities under the Securities Act of 1933; (4) the category of fund best describing the private fund's investment strategy, out of seven broad categories; (5) whether the investment adviser is a sub-adviser to the private fund and the name and SEC file number of any other investment advisers to the private fund; (6) the fund's gross and net assets; (7) a description of the fund's assets and liabilities, broken down by class and categorization in the fair value hierarchy established under GAAP; (8) the number and type of investors in the fund; and (9) the minimum amount of investment permitted. The SEC proposes that to preserve a fund's anonymity, the investment adviser could use a code to identify the fund rather than its name.[120] However, all of the other information still would be required to be reported. There are also questions intended to identify conflicts of interest. The SEC says it sought to avoid disclosure of proprietary information about private funds but seeks comment as to whether it succeeded.[121]

Service Providers to Private Funds – Section 7.B.1.B. This section would require investment advisers to report information concerning certain service providers or "gatekeepers" of each private fund advised by the investment adviser; namely, auditors, prime brokers, custodians, administrators and marketers. The investment adviser would need to indicate with respect to each such service provider: (1) whether it is a related person; (2) the services it provides; and (3) identifying information, such as its registration or regulatory status.

B. Advisory Business Information

The SEC also is proposing amendments to Item 5 of Part 1A of Form ADV that would require an investment adviser to provide more precise and detailed information regarding the investment adviser's advisory business. As proposed, Item 5 would require an investment adviser to provide an approximate numerical response to each question about employees, and whether they are registered representatives of broker dealers, registered investment advisers' representatives or insurance agents, rather than the current check-the-box response corresponding to a range of numbers.

As proposed Item 5.C.(2) would: (1) expand the types of clients to be identified; (2) identify clients subject to ERISA and (3) require disclosure regarding the value of regulatory assets under management attributable to each type of client. The Form ADV also would require the investment adviser to disclose the percentage of its clients that are non-United States persons.

The SEC proposes to expand the categories of advisory activities on which an investment adviser must report. The SEC is proposing to add a new Item 5.J. requiring the investment adviser to select from a diverse list of investments, *e.g.*, variable life insurance and swaps, with respect to which the adviser provided advice in the prior fiscal year.

C. Other Business Activities and Financial Industry Affiliations

The SEC proposes amendments to expand the list of business activities and financial industry affiliations with respect to which an investment adviser must provide disclosure. Each revised list would include the following additions: a registered municipal advisor, registered security based-swap

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120 Implementing Release at 52.

121 Implementing Release at 56.

dealer, major security-based swap participant (each of which is a new SEC registrant under the Dodd-Frank Act's amendments to the Exchange Act), trust company, lawyers (or law firms) and accountants (or accounting firms).

D. Participation in Client Transactions

The SEC proposes amendments to Item 8 that would require the investment adviser to disclose: (1) whether a broker or dealer that the adviser or any of its related persons has discretionary authority to select is a related person; (2) if any "soft dollar benefits" that the investment adviser or any of its related persons receives qualify for the safe harbor under section 28(e) of the Exchange Act; and (3) whether the investment adviser or any of its related persons receives compensation in connection with client referrals.[122]

VII. Other Amendments to Form ADV

In addition to the amendments to Form ADV described above, the SEC is proposing additional amendments to the form that would, among other things, require an investment adviser to: (1) disclose whether it has $1 billion or more of assets (in order to identify advisers subject to section 956 of the Dodd-Frank Act regarding excessive incentive-based compensation arrangements); (2) provide the contact information for its chief compliance officer (or with respect to an exempt reporting adviser, contact information for its designated person); (3) indicate whether it, or any of its control persons, is a public reporting company; and (4) indicate the total number of persons that act as qualified custodians for its clients.[123] The SEC also is proposing several technical amendments with respect to the reporting of disciplinary events.[124]

VIII. Other Amendments to Advisers Act Rules

The SEC also is proposing a number of other technical and conforming amendments to Advisers Act rules in order to implement provisions of the Registration Act. For example, the SEC is proposing to amend rule 204-2 under the Advisers Act to add a transition rule that would apply the "books and records" requirements relating to performance records for investment advisers currently exempt from SEC registration under the Private Adviser Exemption who will be required to register with the SEC by the Registration Act. [125] These advisers who were not registered would not be obligated to keep performance-related records unless they already had preserved them in which case they would be required to continue to preserve them.

The SEC seeks comments generally on the many proposals described in the Exemptions Release and the Implementing Release as well as comments in response to the multitude of specific questions they raise throughout. Comments on these proposals must be received on or before January 24, 2011. The Exemptions Release is available at http://sec.gov/rules/proposed/2010/ia-3111.pdf. The Implementing Release is available at http://sec.gov/rules/proposed/2010/ia-3110.pdf, and Appendices A-G (which include the proposed Form ADV, its Glossary of Terms and Instructions and which appendices are referenced in the Implementing Release) are available at http://sec.gov/rules/proposed.shtml in the hyperlink immediately below Release No. 1A-3110.

Please see page 20 to view attorney contacts in the Investment Management Group.

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122 Proposed Form ADV, Part 1A, Items 8.C.(3), 8.G. and 8.I.

123 Proposed Form ADV, Part 1A, Items 1.O; 1.J and 1.K.; 1.N and 10.B; and 9.F.

124 Implementing Release at 65-66.

125 17 C.F.R. § 275.204-2(a)(16) (2010); proposed rule 204-2(e)(3)(ii).

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