Securities and Exchange Commission Issues Rule Proposals to Implement Dodd-Frank Act for Investment Advisers, Advisers to Private Funds, Venture Capital Funds, and Foreign Private Advisers

On Nov. 19, 2010, the Securities and Exchange Commission (the "SEC") issued two separate releases under the Investment Advisers Act of 1940 (the "Advisers Act") to implement provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). The first release described in this briefing, Advisers Act Release IA-3110 ("Release IA-3110"), includes rules and rule amendments that are designed to give effect to provisions of the Dodd-Frank Act that, among other things, would increase the statutory threshold for registration by investment advisers with the SEC from $25 million to $100 million, would require advisers to many hedge funds and other private funds to register with the SEC, and would require SEC reporting by certain investment advisers that are exempt from registration.[1] The second release described in this briefing, Advisers Act Release IA-3111 ("Release IA-3111"), includes rules that would implement new exemptions from the registration requirements of the Advisers Act for advisers to certain privately offered investment funds that were enacted as part of the Dodd-Frank Act.[2] As required by Title IV of the Dodd-Frank Act – the Private Fund Investment Advisers Registration Act of 2010, the new rules would define "venture capital fund" and provide for an exemption for advisers with less than $150 million in private fund assets under management in the United States. Release IA-3111 also includes new rules that would clarify the meaning of certain terms included in a new exemption for "foreign private advisers." As a result of these changes, nearly every investment adviser that does business in the United States would be required to register either with the SEC or state securities authorities, or if exempt from SEC registration, would still be required to submit reports to the SEC. The SEC is requesting comment on the rules, and rule and form amendments proposed in the releases, suggestions for additional changes to the existing rules, and comment on other matters that might have an effect on the proposals contained in the releases. Comments should be received on or before the date which is 45 days after the releases are published in the federal register. The comment process affords affected parties an opportunity to provide the SEC with alternatives that improve and/or clarify the proposals.

Release IA-3110: Rules Implementing Amendments to the Investment Advisers Act of 1940

Eligibility for SEC Registration. Section 203A 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

[1] Investment Advisers Act Release No. IA-3110. This release includes other amendments, including amendments to the SEC's pay to play rule, that address a number of other changes to the Advisers Act made by the Dodd-Frank Act.
[2] Investment Advisers Act Release No. IA-3111.

SEC. The Dodd-Frank Act expands the universe of advisers subject to state regulation by creating a new category of "mid-sized advisers" that have assets under management of between $25 million and $100 million and placing the responsibility for the regulatory oversight of these advisers with state securities authorities.[3] It does this by generally prohibiting an investment adviser that is registered as an investment adviser in the state in which it maintains its principal office and place of business (the "Home State") and that has assets under management between $25 million and $100 million from registering with the SEC. However, a mid-sized adviser is not prohibited from registering with the SEC if any of the following conditions are present:

- the adviser is not required to be registered as an investment adviser with the state securities authority of its Home State;
- if registered, the adviser would not be subject to examination as an investment adviser by that securities authority, or
- if the adviser is required to register in 15 or more states.

Thus, for example, an adviser that has $65 million in assets under management that is not required to register under the Investment Company Act of 1940 (the "ICA"), and which is exempt from registration in its Home State (because, for example all of its clients are certain exempt institutions), would, under the SEC proposal, be required to register with the SEC, unless there is another exemption from SEC registration that is applicable to such adviser, such as the exemption for advisers to "private funds" (discussed below) (as defined in the Dodd-Frank Act)[4] with less than $150 million in assets under management. As a result, the adviser in this example must register with the SEC by default, even though it is not specifically required to do so under the Advisers Act.

Transitional Rules. As a result of the creation of the new category of mid-sized adviser, many advisers that are currently eligible for SEC registration will no longer be eligible.[5] To address this change in regulation, the SEC has provided a process for advisers to transition to state registration. The first step of this process requires each adviser that is registered with the SEC on July 21, 2011 to file an amendment to its Form ADV no later than Aug. 20, 2011 and to report the market value of its assets under management determined within 30 days of the filing. Each adviser will need to determine whether it continues to be eligible for SEC registration, and if it is not, to withdraw from SEC registration by Oct. 19, 2011.[6] During this 60-day period from Aug. 20, 2011 to Oct. 19, 2011, an adviser that is no longer eligible for SEC registration would need to register in the states and to arrange for its associated persons to qualify for investment adviser representative registration, which may include preparing for and passing an examination, before withdrawing from SEC registration.

Assets Under Management. Generally, whether an adviser is eligible for SEC registration will depend on the amount of assets an adviser has under management ("AUM"). Section 203A(a)(2) of the Advisers Act defines "assets under management" as the "securities portfolios" with respect to which an adviser provides "continuous and regular supervisory or management services." The instructions to Form ADV provide advisers with guidance in applying this provision, including a list of certain types of assets that advisers may (but are not required to) include. The SEC is proposing revisions to these instructions in order to implement a uniform method to calculate what it describes as "regulatory AUM" that can be used under the Advisers Act for the purpose of assessing whether an adviser is eligible to register with the SEC. The SEC is proposing to require all advisers to include in their regulatory AUM securities portfolios for which they provide continuous and regular supervisory or management services, regardless of whether these assets are proprietary assets, assets managed without receiving compensation, or assets of foreign clients, all of which an adviser currently may (but is not required to) exclude. In addition, the SEC is proposing to not allow an adviser to subtract outstanding indebtedness and other accrued but unpaid liabilities, which remain in a client's account and are managed by the adviser. As a result of these changes, advisers will have less flexibility in determining their regulatory AUM, which will affect their eligibility for SEC registration.

Calculation of AUM for Private Funds. Further, the SEC is proposing to provide guidance regarding how an adviser that advises private funds determines its regulatory AUM. First, the SEC is proposing that an adviser include in its regulatory AUM the value of any private fund over which it exercises continuous and regular supervisory or management services, regardless of the

[3] The Dodd-Frank Wall Street Reform and Consumer Protection Act, Section 410 ("Dodd-Frank Act").

[4] The Dodd-Frank Act defines a "private fund" as a pooled investment vehicle that qualifies for one of the exclusions from the definition of investment company found in Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 (the "ICA"). *See* the Dodd-Frank Act, Title IV, Regulation of Advisers to Hedge Funds and Others, Section 402(a).

[5] The SEC estimates that as a consequence of Section 410 of the Dodd-Frank Act, approximately 4,100 SEC-registered advisers will be required to withdraw their registrations and register with one or more state securities authorities.

[6] Included in Release IA-3110 are Appendices to the release that include amendments to Form ADV that, among other things, give effect to the changes to the method of determining eligibility for SEC registration.

nature of the assets held by the fund. In addition, a sub-adviser to a private fund would include in its AUM only that portion of the value of the portfolio for which it provides sub-advisory services. Second, the SEC is proposing to require such adviser to include in its calculation of regulatory AUM the amount of any uncalled capital commitments made to the fund. Third, the SEC is proposing that advisers use fair value methodologies in valuing AUM, rather than determining AUM on a cost basis or in accordance with GAAP.[7]

Switching between State and Federal Registration. SEC Rule 203A-1 currently provides two means of preventing 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. First, the rule provides for a $5 million buffer that permits an investment adviser having between $25 million and $30 million of AUM to remain registered with the states and does not subject the adviser to cancellation of its SEC registration until its AUM fall below $25 million. Second, the rule permits an adviser to rely on the AUM reported annually in the firm's annual updating amendments for purposes of determining its eligibility to register with the SEC, thus allowing an adviser to avoid the need to change registration status based upon fluctuations that occur during the course of the year. If an adviser is no longer eligible for SEC registration, the rule provides a 180-day grace period from the adviser's fiscal year end to allow it to switch to state registration. The SEC is proposing to amend rule 203A-1 to eliminate the $5 million buffer for advisers having between $25 million and $30 million of AUM, but to retain the ability of an adviser to avoid the need to change registration status based upon intra-year fluctuations in its AUM for purposes of determining its eligibility to register with the SEC.

Exemptions from Prohibition on SEC Registration. Section 203A(c) of the Advisers Act provides the SEC with the authority to permit investment advisers to register with the SEC, even though they would be prohibited from doing so otherwise. Pursuant to this authority, the SEC has provided exemptions for six types of investment advisers: (i) nationally recognized statistical rating organizations ("NRSROs"); (ii) pension consultants; (iii) investment advisers affiliated with an adviser registered with the SEC; (iv) investment advisers expecting to be eligible for SEC registration within 120 days of filing Form ADV; (v) multi-state investment advisers; and (vi) Internet advisers. A mid-sized adviser that qualifies for one of these exemptions would be eligible to register with the SEC, notwithstanding that it is registered and subject to examination in its Home State. The SEC is now proposing amendments to three of these exemptions.

NRSROs. The SEC is proposing an amendment to eliminate the exemption in rule 203A-2(a) from the prohibition on SEC registration for NRSROs because Congress amended the Advisers Act to exclude NRSROs from the definition of investment adviser and provided for a separate regulatory regime for NRSROs under the Securities Exchange Act of 1934 (the "Exchange Act").

Pension Consultants. The SEC is proposing to amend the exemption available to pension consultants in rule 203A-2(b) to increase the minimum value of plan assets from $50 million to $200 million, to correspond to the change from $25 million to $100 million in the threshold for SEC registration established by the Dodd-Frank Act.

Multi-State Advisers. The SEC is proposing to amend the multi-state adviser exemption to align the rule with the multi-state exemption Congress built into the mid-sized adviser provision under section 410 of the Dodd-Frank Act. Under rule 203A-2(e), the prohibition on registration with the SEC does not apply to an investment adviser that is required to register in 30 or more states. Once registered with the SEC, the adviser remains eligible for SEC registration as long as it would be obligated, absent the exemption, to register in at least 25 states. The Dodd-Frank Act provides that a mid-sized adviser that otherwise would be prohibited may register with the SEC if it would be required to register with 15 or more states. As a result, the SEC is proposing to amend rule 203A-2(e) to permit all investment advisers required to register as an investment adviser with 15 or more states to register with the SEC. The SEC is also proposing to eliminate the provision in the rule that permits advisers to remain registered until the number of states in which they must register falls below 25 states, and is not proposing a similar cushion for the 15-state threshold.

Elimination of Safe Harbor. The SEC is also proposing to eliminate the safe harbor afforded under Rule 203A-4 for an investment adviser that is registered with the state securities authority of the state in which it has its principal office and place of business, based on a reasonable belief that it is prohibited from registering with the SEC because it does not have sufficient assets under management. The SEC is eliminating this exemption because it believes that advisers should know with certainty when their regulatory AUM exceeds $100 million because of its changes to the calculation of regulatory AUM (discussed above).

<u>Exempt Reporting Advisers.</u> The Dodd-Frank Act provided exemptions from registration under the Advisers Act for certain

[7] Advisers would also use this methodology of calculating regulatory AUM for purposes of the new exemptions for foreign private advisers and certain private fund advisers, which are discussed in this briefing.

categories of advisers while also providing that the SEC require such advisers to maintain certain records, which the SEC may examine, and to submit certain reports, as the SEC deems necessary or appropriate in the public interest. The SEC refers to such advisers as "exempt reporting advisers."[8] The Dodd-Frank Act did not specify the types of information that the SEC could require in the reports nor the purpose for which the SEC would use the information. To implement the reporting requirement the SEC is proposing a new rule to require exempt reporting advisers to submit electronically, and to periodically update, reports to the SEC by completing a limited subset of items on Form ADV.[9] The filing would be submitted to the Investment Adviser Registration Depository ("IARD") site maintained by the Financial Industry Regulatory Authority ("FINRA"), in the same manner as Form ADV is now submitted by applicants for registration with the SEC and state authorities.[10] The SEC is also proposing amendments to Form ADV to permit the form to serve as a reporting, as well as a registration, form.

An exempt reporting adviser will be required to identify the exemption that it is relying upon to report, rather than register with the SEC. Such advisers also will be required to complete a subset of Form ADV items, which is intended to provide the SEC and the public with basic information about the adviser and its business, but will not include all of the information that the SEC requires registered advisers to submit. As proposed, exempt reporting advisers will be required to file their initial report with the SEC on Form ADV no later than Aug. 20, 2011, 30 days after the July 21, 2011 effective date of the Dodd-Frank Act.

The information required of exempt advisers includes the following items in Part 1A of Form ADV: Items 1 (Identifying Information), 2.C. (SEC Reporting by Exempt Reporting Advisers), 3 (Form of Organization), 6 (Other Business Activities), 7 (Financial Industry Affiliations and Private Fund Reporting), 10 (Control Persons), and 11 (Disciplinary Information). In addition, exempt reporting advisers would have to complete corresponding sections of Schedules A, B, C, and D, which elicit detailed information about the adviser, its ownership and affiliated parties generally, the private funds the adviser manages, and about other business activities that the adviser and its affiliates are engaged in that present conflicts of interest that may suggest significant risk to clients. The SEC is not proposing that exempt reporting advisers complete and file with the SEC other Items in Part 1A or prepare a client brochure (Part 2). By way of explanation for such a broad, arguably burdensome request for information from advisers not subject to registration, the SEC explains that it is seeking information that it believes would assist it in identifying the exempt reporting advisers, their owners, and their business models.[11] According to the SEC, the Form ADV items on which these advisers would be required to report also would provide the SEC with information as to whether these advisers or their activities might present sufficient concerns as to warrant further attention from the SEC in order to protect clients, investors, and other market participants. The SEC further explained that it considered the broader public interest in making this information generally available and believes there may be benefits of providing information about the activities of exempt advisers to the public. Exempt reporting advisers would be subject to the same requirements to update their reports on Form ADV as registered advisers.

Amendments to Form ADV. The SEC is proposing amendments to Form ADV that would require advisers, including exempt reporting advisers, to provide it with additional information regarding three areas of their operations.

- Private funds they advise (including information about the fund's organization, gross and net assets, and type of investment strategy);
- Their advisory business, (including data about the types of clients they have, their employees, and their advisory activities), as well as about their business practices that may present significant conflicts of interest (such as the use of affiliated brokers, soft dollar arrangements, and compensation for client referrals); and
- Non-advisory activities and their financial industry affiliations.[12]

Amendments to Pay-to-Play Rule. In July 2010, the SEC adopted rule 206(4)-5, which generally prohibits registered and certain unregistered advisers from engaging directly or indirectly in certain pay to play practices identified in the rule.[13] The rule prohibits covered advisers from (i) providing advisory services

[8] *See* Sections 407 and 408 of the Dodd-Frank Act, adding Advisers Act sections 203(l) and (m). Section 203(l) of the Advisers Act provides an exemption for an adviser that advises solely one or more "venture capital funds" and Section 203(m) of the Advisers Act which instructs the SEC to exempt any adviser that acts solely as an adviser to private funds and has assets under management in the United States of less than $150 million.
[9] The SEC is planning to address the recordkeeping requirement for exempt reporting advisers in a future release.
[10] As is the case with registered advisers, the reports submitted by exempt reporting advisers would be publicly available on the SEC's Web site and exempt reporting advisers would be required to pay a filing fee to FINRA, which administers the IARD.
[11] According to Commissioner Casey's statement in the open meeting at which the proposals were approved, the reporting requirements for exempt reporting advisers blur the distinction between registered advisers and exempt advisers.
[12] The SEC is also proposing certain additional changes intended to improve its ability to assess compliance risks and also to identify advisers that are subject to the Dodd-Frank Act's requirements concerning certain incentive-based compensation arrangements.

for compensation to a government client for two years after the adviser or certain of its executives or employees make certain political contributions; (ii) paying any third party to solicit advisory business from any government entity unless the person is a "regulated person," subject to similar pay-to-play restrictions; and (iii) soliciting others', or coordinating, contributions to certain elected officials or candidates or payments to political parties where the adviser is providing or seeking government business. The SEC is now proposing three amendments to the rule that it believes are needed as a result of the enactment of the Dodd-Frank Act:

- To amend the scope of the rule to make it apply to exempt reporting advisers and foreign private advisers;
- To amend the provision of rule 206(4)-5 that prohibits advisers from paying persons such as solicitors or placement agents to solicit government entities unless such persons are "regulated persons" (*i.e.*, registered investment advisers or broker-dealers subject to rules of a registered national securities association, such as FINRA, that restricts its members from engaging in pay to play activities), to permit an adviser to pay any "regulated municipal advisor" to solicit government entities on its behalf (a regulated municipal advisor under the proposed rule would be a person that is registered under section 15B of the Exchange Act and subject to pay to play rules adopted by the MSRB); and
- To amend rule 206(4)-5's definition of a "covered associate" of an investment adviser to clarify that a legal entity, not just a natural person, that is a general partner or managing member of an investment adviser would meet the definition.

Release IA-3111: Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less Than $150 Million in Assets Under Management, and Foreign Private Advisers

The SEC also is proposing rules that would implement new exemptions from the registration requirements of the Advisers Act for advisers to certain privately offered investment funds that were enacted as part of the Dodd-Frank Act, that would define "venture capital fund" and provide for an exemption for advisers with less than $150 million in private fund assets under management in the United States. The SEC is requiring advisers relying on these exemptions to provide the SEC with reports and keep records as the SEC determines necessary or appropriate in the public interest or for the protection of investors. Notably, these new exemptions do not limit the SEC's statutory authority to examine the advisers relying upon them. These advisers are considered "exempt reporting advisers," as described above in this briefing. The new rules would also clarify the meaning of certain terms included in a new exemption for foreign private advisers. These exemptions are not mandatory, and an adviser may choose to register with the SEC notwithstanding the availability of an exemption provided that it is eligible for SEC registration under Section 203A of the Advisers Act. Nor do these exemptions preempt any state registration requirements.

Venture Capital Funds. The Dodd-Frank Act amended the Advisers Act to create new Section 203(l), which provides that an investment adviser that solely advises venture capital funds is exempt from registration under the Advisers Act and directed the SEC to define "venture capital fund" within one year. The SEC is now proposing new rule 203(l)-1 to provide such a definition.

The SEC is proposing to define a venture capital fund as a private fund that: (i) invests in equity securities[14] of private companies in order to provide operating and business expansion capital (*i.e.*, "qualifying portfolio companies" – discussed below) and at least 80 percent of each company's securities owned by the fund were acquired directly from the qualifying portfolio company; (ii) directly, or through its investment advisers, offers or provides significant managerial assistance to, or controls, the qualifying portfolio company; (iii) does not borrow or otherwise incur leverage (other than limited short-term borrowing)[15]; (iv) does not offer its investors redemption or other similar liquidity rights except in extraordinary circumstances; (v) represents itself as a venture capital fund to investors[16]; and (vi) is not registered under the ICA and has not elected to be treated as a "business development company" under the ICA. The SEC is also proposing to grandfather an existing fund as a venture capital fund if it satisfies certain criteria under the grandfathering provision. A non-U.S. adviser may rely on the venture capital exemption provided that all of its clients, whether U.S. or non-U.S., are venture capital funds.

Qualifying Portfolio Company. The SEC is generally defining a "qualifying portfolio company" to mean any company that: (i) is

[13] *See* Political Contributions by Certain Investment Advisers, Investment Advisers Act Release No. 3043 (July 1, 2010).

[14] The SEC is proposing to use the definition of equity security in Section 3(a)(11) of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 3a11-1 thereunder that includes common stock as well as preferred stock, warrants, and other securities convertible into common stock in addition to limited partnership interests. In addition to equity securities, the venture capital fund may also hold cash (and cash equivalents) and U.S. Treasuries with a remaining maturity of 60 days or less.

[15] The definition of qualifying portfolio company would only exclude companies that borrow in connection with a venture capital fund's investment, but would not exclude companies that borrow in the ordinary course of their business (*i.e.*, to finance inventory or capital equipment, manage cash flows, and meet payroll).

[16] The SEC release said that a private fund could satisfy this definitional element by, for example, describing its investment strategy as venture capital investing or as a fund that is managed in compliance with the elements of our proposed rule. See IA-3111, Section II.A.5.

itself not publicly traded (nor can it control, be controlled by, or be under common control with a public company)[17]; (ii) does not incur leverage in connection with the investment by the private fund; (iii) uses the capital provided by the fund for operating or business expansion purposes rather than to buy out other investors; and (iv) is not itself a fund (*i.e.*, is an operating company).

Grandfathering Provision. The SEC is proposing to include in the definition of venture capital fund any fund that (i) represented to investors and potential investors at the time the fund offered its securities that it is a venture capital fund; (ii) has sold securities to one or more investors prior to Dec. 31, 2010; and (iii) does not sell any securities to, including accepting any additional capital commitments from, any person after July 21, 2011 (the "grandfathering provision"). The grandfathering provision thus would include any fund that has accepted capital commitments by the specified dates even if none of the commitments has been called. For example, a venture capital fund could begin a capital raise in 2010, obtain capital commitments up until July 21, 2011, not call in capital commitments until 2012, and still qualify under the grandfathering provision.

Private Fund Advisers with Less Than $150 AUM. The Dodd-Frank Act amended the Advisers Act to create new section 203(m) that exempts from registration under the Advisers Act an adviser that solely advises private funds if the adviser has assets under management in the United States of less than $150 million. The SEC is now proposing new rule 203(m)-1 to provide such a definition. The exemption is not available to an adviser that manages any other type of client. The exemption is not limited by the number of private funds managed, provided that the aggregate regulatory AUM of the managed private funds is less than $150 million.

In the case of an adviser with a principal office and place of business outside of the United States (a "non-U.S. adviser"), the SEC is proposing to provide the exemption as long as all of the adviser's clients that are United States persons are qualifying private funds.[18] According to the SEC, as a consequence, a non-U.S. adviser could enter the U.S. market and take advantage of the exemption without regard to the type or number of its non-U.S. clients.

Under proposed rule 203(m)-1, an adviser would have to aggregate the value of all assets of private funds it manages in the United States to determine if the adviser remains below the $150 million threshold. Proposed rule 203(m)-1 would require advisers to calculate the value of private fund assets by reference to Form ADV, under which the SEC is proposing to provide a uniform method of calculating AUM for regulatory purposes under the Advisers Act. In the case of a sub-adviser, it would have to count only that portion of the private fund assets for which it has responsibility. Uncalled capital commitments would be included. Under proposed rule 203(m)-1, each adviser would have to determine the amount of its private fund assets quarterly, based on the fair value of the assets at the end of the quarter, rather than the cost basis.

For purposes of determining which assets are managed in the United States, under proposed rule 203(m)-1, all of the private fund assets of an adviser with a principal office and place of business in the United States would be considered to be managed in the United States, even if the adviser has offices outside of the United States. A non-U.S. adviser, however, would need only count private fund assets it manages from a place of business in the United States toward the $150 million asset limit under the exemption.[19] The SEC stated that it will look to an adviser's principal office and place of business as the location where the adviser controls, or has ultimate responsibility for, the management of private fund assets, as the place where all the advisers' assets are managed, although day-to-day management of certain assets may also take place at another location. Thus, an adviser with a principal office and place of business outside of the United States could manage an unlimited number of private funds in the United States, even if it has branch offices in the United States (provided that it does not manage in excess of $150 million from those offices), since none of the funds managed from outside the U.S. would count toward the $150 million limit.[20]

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[17] A venture capital fund could continue to hold securities of a portfolio company that subsequently becomes public.

[18] A qualifying private fund is defined to mean any private fund that is not registered under Section 8 of the ICA and has not elected to be treated as a business development company pursuant to Section 54 of that act. IA-3111; Proposed Rule 203(m)-1(e)-5.

[19] The SEC stated in Release IA-3111 that the definition of U.S. person in Regulation S should be used for purposes of determining whether a client is a U.S. person, subject to an exception for discretionary accounts maintained outside of the U.S. for the benefit of U.S. persons.

[20] The SEC notes that, because its proposed rule is designed to encourage the participation of non-U.S. advisers in the U.S. market, it anticipates that it would have minimal regulatory and operational burdens on foreign advisers and their U.S. clients. The SEC further notes that because non-U.S advisers would be able to rely on proposed Rule 203(m)-1 if they manage U.S. private funds with more than $150 million in assets from a non-U.S. location as long as the private fund assets managed from a U.S. place of business are less than $150 million, this could affect competition with U.S. advisers, which must register when they have $150 million in private fund assets under management regardless of where the assets are managed. Release IA-3111, Section V, Cost-Benefit Analysis.

Foreign Private Advisers. The Dodd-Frank Act amended the Advisers Act to create a new section 203(b) that exempts from registration under the Advisers Act an investment adviser that has no place of business in the United States, has fewer than 15 clients in the United States and investors in the United States in private funds advised by the adviser, and less than $25 million in aggregate assets under management from such clients and investors. The SEC is now proposing new rule 202(a)(30)-1, which would define a number of terms included in the statutory definition of foreign private adviser.

Because eligibility for the new foreign private adviser exemption, like the private adviser exemption in section 203(b) of the Advisers Act prior to the Dodd-Frank amendments, is determined, in part, by the number of clients an adviser has, the SEC is proposing to include in rule 202(a)(30)-1 the safe harbor rules and many of the client counting rules that appear in rule 203(b)(3)-1, as currently in effect. In addition, the SEC is proposing to define other terms used in the definition of "foreign private adviser" in section 202(a)(30), including: (i) "investor;" (ii) "in the United States[21];" (iii) "place of business;[22]" and (iv) "assets under management.[23]

The SEC is proposing in, new rule 202(a)(30)-1, to allow an adviser to treat as a single client a natural person and: (i) that person's minor children (whether or not they share the natural person's principal residence); (ii) any relative, spouse, or relative of the spouse of the natural person who has the same principal residence; (iii) all accounts of which the natural person and/or the person's minor child or relative, spouse, or relative of the spouse who has the same principal residence are the only primary beneficiaries; and (iv) all trusts of which the natural person and/or the person's minor child or relative, spouse, or relative of the spouse who has the same principal residence are the only primary beneficiaries. Proposed rule 202(a)(30)-1 would also retain other provisions of rule 203(b)(3)-1 that permit an adviser to treat as a single "client" (i) 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 (ii) two or more legal organizations that have identical shareholders, partners, limited partners, members, or beneficiaries. The SEC is not including in the proposal the "special rule" providing advisers with the option of not counting as a client any person for whom the adviser provides investment advisory services without compensation; such persons should be counted as clients and their assets should be included in the adviser's regulatory AUM.

The SEC is proposing to define "investor" in a private fund to mean any person who would be included in determining the number of beneficial owners of the outstanding securities of a private fund under section 3(c)(1) of the ICA, or whether the outstanding securities of a private fund are owned exclusively by qualified purchasers under section 3(c)(7) of that Act. Under the proposed rule, an adviser would determine the number of investors in a private fund based on facts and circumstances and in light of the applicable prohibition not to do indirectly, or through or by any other person, what is unlawful to do directly.[24] The SEC is proposing to count as investors beneficial owners who are "knowledgeable employees" or holders of "short-term paper" issued by such fund.

Application to Subadvisers. The SEC generally interprets advisers to include subadvisers and is allowing subadvisers to rely on each of the new exemptions, provided that they satisfy all of the terms and conditions of sections 203(l) and 203(m) of the Advisers Act and the rules that the SEC is proposing under these sections.

Application to Advisory Affiliates. The SEC is requesting comment on whether any proposed rule should provide that an adviser must take into account the activities of its advisory affiliates when determining eligibility for an exemption. In discussing this issue, the SEC referred to the staff's position in a no-action letter issued in 1981 to Richard Ellis, Inc., for information on the factors relevant to the determination of whether a separately formed advisory entity operates independently of an affiliate.[24]

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[21] The phrase "in the United States" is generally being defined by reference to Regulation S. See proposed Rule 202(a)(30)-1.

[22] Proposed Rule 203(a)(30)-1, by reference to proposed Rule 222-1, defines "place of business" to mean any office where the investment adviser regularly provides advisory services, solicits, meets with, or otherwise communicates with clients, and any location held out to the public as a place where the adviser conducts any such activities.

[23] The SEC is proposing to define assets under management by reference to the revised definition in Form ADV.

[24] *See* Richard Ellis, Inc., SEC Staff No-Action Letter (Sept. 17, 1981).

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The Financial Services Practice Group of Winston & Strawn represents a broad range of financial institutions on all aspects of their businesses, including regulatory matters, legislative developments, and proposals affecting the financial industry. If you have questions regarding the new rules, if you need advice with respect to how those rules may affect you, or if you need advice or assistance in preparing policies and procedures to address the new rules, please contact any of the Winston & Strawn attorneys listed below or your usual Winston & Strawn contact:

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