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SEC Finalizes Dodd-Frank Rules Affecting Investment Advisers: Private Fund Adviser Exemption and Reporting Requirements

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Introduction

At an open meeting June 22, 2011 (the "June 22 Meeting"), the Securities and Exchange Commission (the "SEC" or the "Commission") voted to adopt new rules and rule amendments under the Investment Advisers Act of 1940 (the "Advisers Act") that will:

- Require certain advisers to hedge funds and other private funds to register with the SEC
- Establish new exemptions from SEC registration and reporting requirements for certain advisers that are exempt from registration
- Reallocate regulatory responsibility for advisers between the SEC and the states[1]

In addition, the Commission amended rules and Form ADV to expand the disclosure provided by registered investment advisers and to require certain items of Form ADV to be completed and reported by Exempt Reporting Advisers (as defined below). The SEC also adopted a new rule that exempts "family offices" from regulation under the Advisers Act and provides a definition of such entities.[2] All of the new rules and rule and form amendments arise out of Congressional directives contained in Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").

Below, we cover the (i) elimination of the "private adviser exemption" pursuant to Section 203(b)(3) of the Advisers Act; (ii) creation of new exemptions from registration for advisers that advise solely venture capital funds (the "Venture Capital Fund Exemption"), and for advisers that advise solely private funds[3] and have less than $150 million in assets under management (the "Private Fund Adviser Exemption"); (iii) imposition of a new reporting requirement for advisers that are relying on the Venture Capital Fund Exemption and the Private Fund Adviser Exemption (collectively, the "Exempt Reporting Advisers"); and (iv) Form ADV disclosure requirements with respect to Exempt Reporting Advisers.[4]

Elimination of the Private Adviser Exemption and Creation of New Exemptions

Section 203(b)(3) of the Advisers Act currently exempts from registration any investment adviser who, during the course of the preceding 12 months, has had fewer than 15 clients, and who neither holds itself out generally to the public as an investment adviser nor acts as an investment adviser to any investment company registered under the Investment Company Act of 1940 (the "Investment Company Act") or to any business development company. Many investment advisers to hedge funds and other pooled investment vehicles currently rely on this so-called private adviser exemption to avoid registration with the SEC. However, effective July 21, 2011, Section 403 of the Dodd-Frank Act eliminates the private adviser exemption, and in its place will be three more limited exemptions from registration under the Advisers Act.

Specifically, the Commission at the June 22 Meeting adopted (i) new Rule 203(1)-1 under the Advisers Act to define "venture capital fund" for purposes of the Venture Capital Fund Exemption, (ii) new Rule 203(m)-1 under the Advisers Act to address the Private Fund Adviser Exemption, and (iii) new Rule 202(a)(30)-1 under the Advisers Act that defines certain terms for use by advisers seeking to avail themselves of the "foreign private adviser" exemption afforded by amended Section 203(b)(3) of the Advisers Act.

Venture Capital Fund Adviser Exemption

New Section 203(l) of the Advisers Act provides an exemption from registration for investment advisers who provide advice *solely* to "venture capital funds." Rule 203(l)-1, as adopted by the Commission at the June 22 Meeting, generally defines a "venture capital fund" as a private fund that:

- Immediately after the acquisition of any asset, other than "qualifying investments"[6] or "short-term holdings,"[7] holds no more than 20 percent of the fund's aggregate capital contributions and uncalled committed capital in non-qualifying investments ("Non-Qualifying Basket") (other than short-term holdings) valued at cost or fair value, as consistently applied by the fund
- Does not incur leverage in excess of 15 percent of the fund's aggregate capital contributions and uncalled committed capital, and subject to an exception for guarantees of portfolio company indebtedness up to the value of the investment in the portfolio

company, any such borrowing, debt or leverage is for a non-renewable term of no longer than 120 calendar days

- Does not offer redemption or similar liquidity rights to investors except under extraordinary circumstances
- Is not registered under the Investment Company Act and has not elected to be treated as a business development company under the Investment Company Act
- Holds itself out to investors and prospective investors as pursuing a venture capital strategy

The concept of Non-Qualifying Basket was not contained in the SEC's rule proposal with respect to Rule 203(l)-1, but was adopted in the final rule to provide greater investment flexibility for venture capital funds while maintaining the scope of the Venture Capital Fund Exemption. Specifically, the Non-Qualifying Basket permits a venture capital fund to invest up to 20 percent of its aggregate capital contributions and uncalled capital commitments in the assets that are not equity securities of qualifying portfolio companies. Under this approach, the 20 percent threshold is tested whenever the fund makes an investment in a non-qualifying investment (other than short-term holdings), although after the acquisition, the fund need not dispose of the non-qualifying investment if it increases in value. A qualifying fund, however, could not purchase additional other non-qualifying investments until the value of its then-existing non-qualifying investments fell below 20 percent. The rule also permits the adviser to the venture capital fund to determine the fund's compliance with the Non-Qualifying Basket based on either the investment's historical cost or fair value, provided that the method is applied consistently to all such investments.

In addition, the SEC did not include in the "venture capital fund" definition a requirement that venture capital funds or their advisers provide management assistance to their portfolio companies, as originally contemplated in the proposed rule.

Rule 203(l)-1 also permits an adviser to treat any existing fund as a venture capital fund if the fund meets the following elements of the grandfathering provision of the rule: (i) it represented to investors and potential investors at the time the fund offered its securities that it pursues a venture capital strategy; (ii) it has sold securities to one or more third-party investors prior to December 31, 2010; and (iii) it does not sell any securities to any person after July 21, 2011, including accepting any additional capital commitments from existing investors. A grandfathered

fund would thus include any private fund that has accepted all capital commitments by July 21, 2011, even if none of the capital commitments has been called by that date, as long as the investor became obligated by July 21, 2011 to make future capital contributions.

Private Fund Adviser Exemption

New Section 203(m) of the Advisers Act directs the Commission to provide an exemption from registration to any investment adviser that *only* advises private funds and has assets under management in the United States of less than $150 million. Accordingly, the Commission adopted new Rule 203(m)-1 under the Advisers Act at the June 22 Meeting for purposes of implementing the Private Fund Adviser Exemption.

Since the Private Fund Adviser Exemption is available to advisers that only have private funds as clients, an adviser that has one or more clients that are not private funds is not eligible for the exemption and must register under the Advisers Act unless another exemption is available.[8] Additionally, an adviser may advise an unlimited number of private funds, provided the aggregate value of the assets of the private funds is less than $150 million.[9]

Rule 203(m)-1 provides for bifurcated treatment of U.S. advisers (those with a principal office and place of business in the United States) and non-U.S. advisers (those with a principal office and place of business outside the United States). Specifically, a U.S. adviser, when determining its assets under management for purposes of the Private Fund Adviser Exemption, must include the assets of all private funds it advises worldwide, irrespective of whether it may manage those assets from a foreign office. A non-U.S. adviser, however, must only count the assets of the private funds it manages at a "place of business"[10] in the United States.

The principal office and place of business of an adviser is the executive office from which the officers, partners or managers of the adviser direct, control and coordinate its activities. This location can be different from where day-to-day management of certain assets takes place. Thus, a non-U.S. adviser solely to private funds in the United States and that either has no place of business in the United States or does not manage assets from such U.S. place of business may rely on the Private Fund Adviser Exemption without consideration of the size of its investments managed from abroad. This allows a foreign adviser to enter the U.S. market and

take advantage of the Private Fund Adviser Exemption without regard to the type or number of non-U.S. clients or the amount of assets it manages outside the United States.

Importantly, in the final rule, the SEC added a note that clarifies that a client will not be considered a U.S. person if the client was not a U.S. person at the time of becoming a client of the adviser. This will permit a non-U.S. adviser to continue to rely on Rule 203(m)-1 if a non-U.S. client that is not a private fund, such as a natural person residing abroad, relocates to the United States or otherwise becomes a U.S. person.

Calculation of Private Fund Assets. Rule 203(m)-1 requires an adviser 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 and thus continues to qualify for the Private Fund Adviser Exemption. Assets must be valued on an annual basis (the proposed rule required quarterly valuation) at market value, or at fair value where market value is unavailable, in each case pursuant to the instructions to the revised Form ADV. Specifically, the instructions to Form ADV require, among other things, the calculation of "assets under management" to consist of the securities portfolios and value of any private fund with respect to which an adviser provides continuous and regular supervisory or management services, regardless of whether such assets are proprietary, managed without compensation, or are assets of foreign clients, each of which may be currently excluded. Further, the SEC will now require (i) outstanding indebtedness and other accrued but unpaid liabilities that remain in a client's account and are managed by the adviser, and (ii) any uncalled capital commitments of a private fund, to be included in the calculation of assets under management.

Frequency of Calculation and Transition Period. An adviser relying on the Private Fund Adviser Exemption must annually calculate the amount of the private fund assets it manages and report the amount in its annual updating amendments to its Form ADV. If an adviser reports in its annual updating amendment that it has $150 million or more of private fund assets under management, the adviser is no longer eligible for the Private Fund Adviser Exemption. Such adviser thus may be required to register under the Advisers Act as a result of increases in its private fund assets that occur from year to year, but changes in the amount of its private fund

assets between annual updating amendments will not affect the availability of the Private Fund Adviser Exemption.

If an adviser no longer qualifies for the Private Fund Adviser Exemption and therefore is required to register with the SEC, the adviser may apply for registration with the SEC up to 90 days after filing the annual updating amendment, and may continue to act as a private fund adviser during the transition period[11]; *provided*, that such adviser has complied with all of its reporting obligations as an Exempt Reporting Adviser, as described below.

Reporting Requirements for Exempt Reporting Advisers

Both new Section 203(l) and new Section 203(m) of the Advisers Act require advisers relying on the Venture Capital Fund Adviser Exemption and the Private Fund Adviser Exemption, respectively, to submit such reports "as the Commission determines necessary or appropriate in the public interest." To comply with the foregoing, the Commission adopted new Rule 204-4 under the Advisers Act to require Exempt Reporting Advisers to file with the Commission the following items of Part 1A of Form ADV: Items 1 (Identifying Information), 2.B. (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), 11 (Disclosure Information) and the corresponding sections of Schedules A, B, C and D.

An Exempt Reporting Adviser must submit its initial Form ADV within 60 days of first relying on the Venture Capital Fund Adviser Exemption and the Private Fund Adviser Exemption, with the first such filing required to be made between January 1, 2012 and March 30, 2012, and then annually thereafter (subject to interim amendment requirements). An Exempt Reporting Adviser, like a registered adviser, is required to amend its reports on Form ADV: (i) at least annually, within 90 days of the end of its fiscal year; and (ii) more frequently, if required by the instructions to Form ADV. Additionally, an Exempt Reporting Adviser, like a registered adviser, is required to update promptly Items 1 (Identification Information), 3 (Form of Organization), and 11 (Disciplinary Information) if they become inaccurate in any way, and to update Item 10 (Control Persons) if it becomes materially inaccurate. All reports filed by an Exempt Reporting Adviser with the SEC will be made publicly available.

When an adviser ceases to be an Exempt Reporting Adviser, Rule 204-4 requires the adviser to file an amendment to its Form ADV to indicate that it is filing a final report that will allow the SEC to distinguish such a filer from one that is failing to meet its filing obligations. In some cases, an Exempt Reporting Adviser will file a final report because it ceases to do business as an investment adviser and thus is no longer subject to reporting under the Advisers Act. In other cases, an Exempt Reporting Adviser will file a final report in connection with becoming registered with the SEC, in which case it will continue to periodically update its Form ADV, but as a registered adviser.

An Exempt Reporting Adviser wishing to register with the Commission can file a single amendment to its Form ADV that will serve both as a final report as an Exempt Reporting Adviser and an application for registration under the Advisers Act. While an application is pending, but before it is approved, an adviser may continue to operate as an Exempt Reporting Adviser in accordance with the terms of the relevant exemption. In addition, General Instruction 15 to Form ADV provides a safe harbor for certain Exempt Reporting Advisers relying on the Private Fund Adviser Exemption. Such an adviser that has complied with all of its reporting obligations as an Exempt Reporting Adviser may continue advising private fund clients for up to 90 days after filing an annual updating amendment indicating that it has private fund assets of $150 million or more before filing its final report and application for registration. This transition period is designed to accommodate events that may be beyond the adviser's control, such as an increase in the value of the adviser's assets under management, but it is not available to an adviser that otherwise would not qualify for the exemption provided by Rule 203(m)-1. The transition period also is not available to advisers relying on the Venture Capital Fund Adviser Exemption. Advisers seeking to rely on that exemption may not accept a client that is not a venture capital fund without first registering under the Adviser Act.

The SEC also noted that Exempt Reporting Advisers would be subject to recordkeeping rules to be adopted in the future and would be subject to limited SEC examination oversight. While there is no current intention by the SEC to subject Exempt Reporting Advisers to routine examinations by the SEC staff, the SEC retains the authority to conduct "cause" examinations of Exempt Reporting Advisers where there are indications of wrongdoing.

Form ADV Amendments

Although the SEC adopted various amendments to Form ADV at the June 22 Meeting, only certain of those amendments relate to Exempt Reporting Advisers. As such, the discussion below addresses only the types of information that Exempt Reporting Advisers are required to report on its Form ADV.

General Information. Exempt Reporting Advisers will be required to provide the following categories of information:

- Basic identifying information about the Exempt Reporting Adviser, its owners and affiliates, and their respective business models
- Information about each private fund the Exempt Reporting Adviser manages, including information about the gross asset value of the fund, its organization, the type of investment strategy the fund employs, and whether the fund invests in securities of registered investment companies and information about the fund's business practices that may present significant conflicts of interest (such as the use of affiliated brokers, soft dollar arrangements, and compensation for client referrals) to clients
- Limited information regarding investors in its private fund(s), including the minimum amount that investors are required to invest; the approximate number of beneficial owners of each fund and the approximate percentage of each fund beneficially owned by the adviser and its related persons, funds of funds and non-U.S. persons, and the extent to which the clients of the adviser are solicited to invest, and have invested in the fund(s)
- Identification of and certain other information for five types of service providers to funds (such as auditors, prime brokers, custodians, administrators and marketers) that perform important roles as "gatekeepers" for the private funds
- Information about the Exempt Reporting Adviser's non-advisory activities and its financial industry affiliations
- Disciplinary history of the Exempt Reporting Adviser and its employees

Item 7.B. of Schedule D. Exempt Reporting Advisers will also be required to (i) provide a separate Section 7.B of Schedule D of Part 1A for each private fund that the adviser manages (previously, Item 7.B had required an adviser to complete Section 7.B of Schedule D for each "investment-related" limited partnership or limited liability company that it or a related person advises), and (ii) report whether the private fund is part of a master-feeder arrangement or a fund of funds, and to provide information about the regulatory status of the fund (*e.g.*, the exclusion from the Investment Company Act on which the fund relies), whether the fund is

subject to the jurisdiction of a foreign regulatory authority, and whether the fund relies on an exemption from registration under the Securities Act of 1933 with respect to its securities.[12]

Items 6 and 7. Amendments to Items 6 and 7 of Part 1A require an Exempt Reporting Adviser to disclose any services that the adviser or a related person provides as, among other things, a trust company, registered municipal advisor, registered security-based swap dealer, or major security-based swap participant, as well as additional information regarding its financial industry affiliations. Advisers that engage in other businesses under a different name are required to disclose that fact and identify the other lines of business in which the adviser engages using that name, as well as other details.

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1. *See* Investment Advisers Release No. 3221, Rules Implementing Amendments to the Investment Advisers Act of 1940, available at: www.sec.gov/rules/final/2011/ia-3221.pdf (June 22, 2011); Investment Advisers Release No. 3222, Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers, available at: www.sec.gov/rules/final/2011/ia-3222.pdf, (June 22, 2011).

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

3. 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 of 1940 (15 U.S.C. 80a-3), but for Section 3(c)(1) or 3(c)(7) of that Act." However, see footnotes 5 and 8 below.

4. Please check our website, www.reedsmith.com, under the "Publications" tab for our client alerts relating to foreign advisers, mid-size advisers (advisers with $25 million to $100 million in assets under management) and family offices.

5. As noted in footnote 3 above, the term "private fund" is defined to mean an issuer that would be an investment company, as defined in Section 3 of the Investment Company Act, but for

Section 3(c)(1) or 3(c)(7) of that Act. However, for purposes of the Venture Capital Fund Adviser Exemption, an adviser (including a non-U.S. adviser) may treat as a "private fund" (and thus a "venture capital fund" if the adviser meets the other criteria of Rule 203(l) 1) any non-U.S. fund that is not is offered through the use of U.S. jurisdictional means but that would be a private fund if the issuer were to conduct a private offering in the United States (*e.g.*, by relying on Section 3(c)(1) or 3(c)(7)); provided, that the adviser treats the non-U.S. fund as a private fund under the Advisers Act for all purposes. See Note to Rule 203(l)-1.

6. Rule 203(l)-1(c)(3) under the Advisers Act defines **"qualifying investment"** as: (i) any equity security issued by a qualifying portfolio company that is directly acquired by the private fund from the company ("directly acquired equity"); (ii) any equity security issued by a qualifying portfolio company in exchange for directly acquired equity issued by the same qualifying portfolio company; and (iii) any equity security issued by a company of which a qualifying portfolio company is a majority-owned subsidiary, or a predecessor, and that is acquired by the fund in exchange for directly acquired equity.

"Qualifying portfolio company," in turn, is defined in Rule 203(l)-1(c)(4) under the Advisers Act as any company that: (i) at the time of any investment, is not reporting or foreign-traded and does not control, is not controlled by or under common control with a reporting or foreign-traded company; (ii) does not borrow or issue debt obligations in connection with the investment by the private fund and distribute to the private fund the proceeds of any such borrowing or debt issuance in exchange for the private fund investment; and (iii) is not itself an investment company, fund or commodity pool (*i.e.*, is an operating company).

7. Rule 203(l)-1(c)(6) under the Advisers Act defines **"short-term holdings"** as cash and cash equivalents, U.S. Treasuries with a remaining maturity of 60 days or less, and shares of registered money market funds.

8. For purposes of Rule 203(m)-1, an investment adviser may treat as a private fund an issuer that qualifies for an exclusion from the definition of "investment company," as defined in Section 3 of the Investment Company Act of 1940, in addition to those provided by Section 3(c)(1) or Section 3(c)(7).

9. It should be noted, however, that depending on the facts and circumstances, the SEC staff may view one or more separately formed advisory entities that each has less than $150 million in private fund assets under management as a single adviser for purposes of assessing the availability of the Private Fund Adviser Exemption.

10. Rule 222-1 under the Advisers Act defines a **"place of business"** as any office at which, or a location held out to the general public as a location at which, the adviser regularly provides advisory services, solicits, meets with, or otherwise communicates with clients.

11. In effect, an adviser that no longer qualifies for the Private Fund Adviser Exemption will have up to 180 days after the end of its fiscal year to become registered with the SEC.

12. An Exempt Reporting Adviser managing a master-feeder arrangement may submit a single Section 7.B.(1) for the master fund and all of the feeder funds if these fund would otherwise report substantially identical information.