July 28, 2011

Summary and Analysis of Dodd-Frank Rules for Investment Advisers

Registration Requirements, Exemptions, Family Offices, Performance Fee Eligibility

As reported in our June 23 Client Advisory, the Securities and Exchange Commission on June 22 adopted rules defining three new exemptions from investment adviser registration (the Exemptive Rules) mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank). Dodd-Frank raised the threshold of assets under management required for SEC registration to $100 million, and the SEC also has adopted rules (the Implementing Rules) to implement that and other changes related to the registration process, including amendments to Form ADV and the transition to state registration for certain advisers.

In a related action, the SEC adopted rules to implement the exclusion from the definition of investment adviser for family offices (the Family Office Exclusion).

Separately, as directed by Dodd-Frank, the SEC has issued an order raising the eligibility standards for "qualified clients" under the performance fee rule (Qualified Client Standards).

The purpose of this Advisory is to describe in greater detail certain complex provisions of and applicable deadlines for the Exemptive Rules, the Implementing Rules, the Family Office Exclusion and Qualified Client Standards.[1]

Regulatory Assets under Management

A central concept affecting both the availability of the Exemptive Rules and the transition to the $100 million threshold under the Implementing Rules is the calculation of regulatory assets under management (RAUM). For purposes of calculating RAUM, in addition to assets of U.S. clients managed for compensation, advisers are required to include the following categories of assets, the inclusion of which was optional under the previous instructions for Form ADV:

- proprietary assets;
- assets managed without receiving compensation; and
- assets of non-U.S. clients.

[1] The Family Office Rules, the Implementing Rules and the Exemptive Rules were announced in Investment Advisers Act Releases 3220, 3221 and 3222, respectively, all issued June 22, 2011 (each, an adopting release as used herein), and may be found at http://www.sec.gov/rules/final/2011/ia-3220.pdf, http://www.sec.gov/rules/final/2011/ia-3221.pdf and http://www.sec.gov/rules/final/2011/ia-3222.pdf. The order raising the Qualified Client Standards thresholds was issued in Investment Advisers Act Release No. 3236, July 12, 2011, which may be found at http://www.sec.gov/rules/other.shtml.

If you would like to discuss any of the rules described in this Advisory or their application in specific contexts, please contact your Katten Muchin Rosenman LLP attorney, or any of the following members of the **Financial Services Practice**.

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Also, the RAUM calculation must be made on a gross basis; advisers are not permitted to subtract any outstanding indebtedness or other accrued but unpaid liabilities (including accrued fees or expenses) that remain in a client's account. Thus, borrowings to provide trading leverage are included in RAUM. Although RAUM is calculated on a gross basis, an adviser may opt to report AUM on a net basis in Form ADV Part 2, and thus these two disclosures may differ.

With respect to private funds, an adviser is required to:

- include the value of any private fund over which it exercises "continuous and regular supervisory or management services," including the value of non-securities assets held by the fund (although a sub-adviser to a private fund will include in its RAUM only that portion of the fund's portfolio for which it provides sub-advisory services);
- include the value of any uncalled capital commitments made to the fund; and
- use the market value or, if the market value is unavailable, a fair value methodology to value private fund assets, but is not required to determine fair value in accordance with U.S. generally accepted accounting principles (GAAP), and could, for example, utilize a fair value methodology set forth in a fund's governing documents.

Some commenters on the proposed rules objected to the use of both gross assets and fair value for RAUM calculations. The SEC expressed concern that the use of net assets could permit managers of highly leveraged funds to avoid registration, even though their activities might be appropriate for systemic risk reporting, and thus adopted the gross assets calculation methodology. With respect to fair value, the SEC recognized the potential increased cost to certain advisers not currently using U.S. GAAP as a result of the need for an annual determination of fair value and provided flexibility for advisers to use fair value standards other than U.S. GAAP.

The SEC was not persuaded that the requirement to include proprietary assets, assets managed without compensation and assets of foreign clients would be problematic for some firms previously of the view that they did not have assets under management for purposes of investment adviser registration. With respect to proprietary assets, it stated that, although receipt of compensation for providing investment advice is a necessary requisite in order for a person to be considered an adviser under the Advisers Act, once an adviser receives compensation from any client, the SEC views that person as an adviser and deems the Act applicable to the relationship of that adviser and all of its clients. In addition, that adviser is required to include in its RAUM all assets it manages regardless of whether those assets would not previously have been considered client assets (i.e., proprietary assets).

Exemptive Rules

Repeal of Private Adviser Exemption. Title IV of Dodd-Frank, the Private Fund Investment Advisers Registration Act, was intended to require many managers of hedge funds and private equity funds to register with the SEC. Effective July 21, 2011, Dodd-Frank repealed the private adviser exemption from registration under Section 203(b)(3) of the Advisers Act for investment advisers who (i) have had fewer than 15 clients in the preceding 12 months; (ii) do not generally hold themselves out to the public as investment advisers; and (iii) do not act as advisers to registered investment companies or business development companies. Because a pooled investment vehicle was generally counted as a single "client" for purposes of this exemption, many advisers to hedge funds, private equity funds, venture capital funds and other private investment vehicles relied upon it to avoid SEC registration as investment advisers.

New Exemptions from Adviser Registration. Although it repealed Section 203(b)(3), Congress in Dodd-Frank directed the SEC to adopt certain limited exemptions for fund managers. These Exemptive Rules are available to:

(i) advisers solely to "private funds" that have less than $150 million of assets under management (now calculated as RAUM) in the United States (the Private Fund Adviser Exemption);

(ii) non-U.S. advisers that have less than $25 million in RAUM from U.S. clients and U.S. private fund investors and fewer than 15 such clients and investors (the Foreign Private Adviser Exemption); and

(iii) advisers solely to "venture capital funds" (the VC Adviser Exemption, and collectively, the Exemptions).

The effective date of all three Exemptive Rules is July 21, 2011. None of the rules is mandatory. Thus, an adviser that qualifies for any of the Exemptions may choose to register, subject to the $100 million threshold. The deadline for registration by advisers that must register is March 30, 2012.

Private Fund Adviser Exemption

Rule 203(m)-1 under the Advisers Act defines the new Private Fund Adviser Exemption. Under Dodd-Frank, a "private fund" is defined as an issuer that would be an "investment company" within the meaning of the Investment Company Act of 1940, as amended (the Company Act), but for Section 3(c)(1) or 3(c)(7) thereof. The availability of the Private Fund Adviser Exemption differs, depending on whether an adviser has its principal office and place of business in the United States (U.S. Advisers) or outside the United States (non-U.S. Advisers). The SEC states that it considers the 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, though day-to-day management of certain assets may also take place at another location.

U.S. Advisers. The Private Fund Adviser Exemption is available to a U.S. Adviser that:

- acts solely as an adviser to one or more private funds; and
- has private fund RAUM in the United States of less than $150 million.

For purposes of determining the $150 million RAUM limitation, Rule 203(m)-1 deems all of the assets managed by a U.S. Adviser to be managed "in the United States."

Thus, a U.S. Adviser would have to count all assets of the private funds it manages as assets under management "in the U.S." even if it has offices outside the United States from which certain assets are managed. Moreover, a U.S. Adviser would have to count all of the assets (even the assets of non-U.S. person investors) of any offshore fund it manages that relies on Section 3(c)(1) or 3(c)(7) for exclusion from the Company Act because it has U.S. persons as investors. In order to rely on the Private Fund Adviser Exemption, a U.S. Adviser cannot have any clients that are not private funds, whether in the U.S. or elsewhere.

Non-U.S. Advisers. For a non-U.S. Adviser, the SEC will look to the investment management activities that are conducted at a place of business in the United States, although the principal office and place of business are elsewhere. The Private Fund Adviser Exemption for a non-U.S. Adviser is available if:

- all of the adviser's clients that are "U.S. persons" (as defined in Regulation S under the Securities Act of 1933, as amended (Securities Act)) are private funds, without regard to the type or number of its non-U.S. clients; and
- all of the assets it manages at a place of business in the United States are solely attributable to private funds with total RAUM of less than $150 million.

As a result of comments it received, the SEC has made certain clarifications with respect to application of the rule to non-U.S. Advisers. First, it has clarified that a non-private fund client will not be considered a U.S. person for purposes of the rule if it was not a U.S. person when it became a client. In addition, in the adopting release the SEC stated that a non-U.S. Adviser need not have a place of business in the United States to rely on the rule.

The Exemptive Rules do not provide specific guidance for counting assets of non-U.S. Advisers where advice is provided by teams or affiliates located in multiple jurisdictions within and outside the United States. While the SEC requested comment on this and other issues related to the asset calculation for non-U.S. Advisers, it determined to treat "assets under management in the United States" as those assets managed "at" a U.S. place of business. (The proposed rule defined such assets as those managed "from" a U.S. place of business.)

A non-U.S. Adviser will be disqualified from claiming this exemption if it manages any assets at a place of business in the United States for clients other than private funds. Thus, it appears that a non-U.S. Adviser relying upon this exemption could not manage assets for non-U.S. clients (other than private funds) from a place of business in the United States. Conversely, it appears that a non-U.S. Adviser could advise a managed account for a non-U.S. person from a place of business outside the United States and would be able to rely on this exemption.

Single-Investor Funds. Certain commenters asked the SEC to address whether a single investor fund could be a private fund for purposes of the exemption. The SEC expressed concern about advisers converting client accounts to single-investor funds in order to rely on the exemption. It recognized that there may be circumstances where it might be appropriate to treat a single-investor fund as a private fund, for example, in the case of a fund seeking to raise capital from multiple investors that has only a single, initial investor for a period of time.

Annual Determination of Eligibility. Assets attributable to private funds are to be calculated annually for purposes of determining eligibility of an adviser for the Private Fund Adviser Exemption. (This represents a change from the proposed rule, which would have required quarterly calculation.)

Under the Private Fund Adviser Exemption as adopted, an adviser must determine the amount of its RAUM (as described above) attributable to "qualifying private funds," which include funds relying on Sections 3(c)(1) and 3(c)(7) of the Company Act and may include, at the adviser's option, funds relying on other Company Act exclusions (such as Section 3(c)(5)(c) for real estate funds).

Exempt Reporting Advisers. As is discussed more fully below, advisers relying on the Private Fund Adviser Exemption, as well as the VC Adviser Exemption, are now categorized as Exempt Reporting Advisers (as defined below) and are subject to significant SEC reporting and recordkeeping requirements, notwithstanding their exemption from registration.

Transition Period. If a Private Fund Adviser reports on its annual updating amendment to Form ADV that it has $150 million or more in RAUM of "qualifying private funds," it must apply for SEC registration within 90 days after such amendment. If it has complied with all reporting requirements applicable to it as an Exempt Reporting Adviser (as discussed below), it may continue to act as a Private Fund Adviser during this period. The 90-day transition period is not available to any Private Fund Adviser that has not complied with all such reporting requirements or has accepted a client that is not a private fund.

Foreign Private Adviser Exemption

Rule 202(a)(30)-1 under the Advisers Act defines the Foreign Private Adviser Exemption. This exemption is available to an adviser that:

- has no place of business in the United States;
- has fewer than 15 clients and private fund investors in the United States;
- has less than $25 million of aggregate RAUM attributable to such U.S. clients and investors; and
- does not hold itself out generally to the U.S. public as an investment adviser.

Client and Investor Counting Rules. Section 202(a)(30) of the Advisers Act provides that to be eligible for the exemption, a foreign private adviser cannot have more than 14 clients or "investors in the U.S. in private funds advised by the adviser." For purposes of counting the number of U.S. clients advised by a foreign private adviser, advisers must apply counting rules substantially similar to those currently contained in the "safe harbor" counting provisions under Advisers Act Rule 203(b)(3)-1, with slight modifications. Thus, the rule permits advisers to count as a single client:

- a natural person and various family members and related accounts or trusts of which they are the only primary beneficiaries;
- a corporation, general partnership, limited partnership, limited liability company, trust or other legal organization to which the adviser provides investment advice based on the organization's investment objectives; and
- two or more legal organizations that have identical ownership.

The Foreign Private Adviser Exemption also requires that the adviser count "investors in the U.S." in private funds advised by the adviser for purposes of determining the adviser's eligibility for the exemption. The rule defines "investor" to include any person that would be included in determining the number of beneficial owners of a Section 3(c)(1) fund or required to meet the definition of a "qualified purchaser" in a Section 3(c)(7) fund. In addition, the SEC's definition requires the adviser to count beneficial owners of debt securities (including "short-term paper") issued by the private fund, as well as "voting securities," as under current law.

In a change from the rule as proposed, the final rule does not treat as investors beneficial owners who are knowledgeable employees with respect to the private fund, and certain other persons related to such employees.

Advisers also have to count underlying owners of fund interests, including:

- beneficial owners in nominee or similar arrangements;
- holders of instruments (such as total return swaps) that effectively transfer the risk of investing in the private fund to such holder; and
- in the case of master-feeder structures, the holders of the securities of feeder funds formed or operated for the purpose of investing in the master fund.

To avoid double-counting, the adviser may count a person who has invested in two or more private funds advised by the adviser as a single investor. The Foreign Private Adviser Exemption also allows an adviser to omit counting a private fund as a separate client if the adviser has already counted any investor in that private fund.

The Foreign Private Adviser Exemption uses the term "in the United States" in a number of contexts. The SEC has defined that term in accordance with the definition of "U.S. person" and "United States" under Regulation S. However, under the rule, a person that would be deemed "in the United States" at the time of any calculation of assets or investors may be excluded if such person was not "in the United States" at the time of becoming a client or investing in the private fund.

Place of Business. An adviser with a "place of business" in the United States may not rely on the Foreign Private Adviser Exemption. The Exemptive Rules define "place of business" as "any office where the investment adviser regularly provides advisory services, solicits, meets with, or otherwise communicates with clients, and any location held out to the public as a place where the adviser conducts any such activities," which is consistent with current definitions used by the SEC and state authorities to determine regulatory jurisdiction.

Threshold Jurisdictional Question. Commenters observed that enactment of the Foreign Private Adviser Exemption in Dodd-Frank presupposed a conclusion that foreign advisers to foreign funds with U.S. investors would be subject to investment adviser registration in the United States. In the adopting release, the SEC acknowledged the jurisdictional question and stated that whether a non-U.S. Adviser with no U.S. clients (but which may have U.S. investors in a non-U.S. fund client) would be subject to U.S. registration "depends on whether there is sufficient use of U.S. jurisdictional means."

Venture Capital Adviser Exemption

The SEC also adopted the VC Adviser Exemption, although with certain significant changes from the proposal. First, the final rule eliminates the requirement that the venture capital fund provide managerial assistance to or otherwise control its qualifying portfolio companies. Also in response to comments, the SEC modified its previously proposed definition such that up to 20% of a VC Fund's aggregate holdings and uncalled capital commitments may be held in assets other than "qualifying investments." Thus, final Rule 203(l)-1 generally defines a venture capital fund as a private fund that:

- represents to investors and potential investors that it pursues a venture capital strategy;
- invests only in "qualifying investments" (discussed below) or short-term holdings (including money market fund shares), except that up to 20% of the amount of the fund's aggregate capital contributions and uncalled committed capital (other than short-term holdings) may be in a "basket" of non-qualifying investments, with assets valued for these purposes at cost or fair value, consistently applied by the fund;
- does not borrow or otherwise incur leverage (other than limited short-term borrowing or guarantees of its portfolio company's obligations);
- does not offer its investors redemption or other similar liquidity rights except in extraordinary circumstances; and
- is not registered under the Company Act and has not elected to be treated as a business development company.

Investment in Qualifying Portfolio Companies. "Qualifying investments" for a venture capital fund are certain equity securities in a "qualifying portfolio company" or its parent company.

Rule 203(l)-1(c)(4) defines a "qualifying portfolio company" as any company that:

- is not a reporting or foreign traded company (as defined in the rule);
- does not incur leverage in connection with the private fund's investment in such company and distribute the proceeds of such borrowing in exchange for the private fund's investment; and
- is not itself an investment company, a private fund, an issuer of asset-backed securities under Rule 3a-7 of the Company Act, or a commodity pool.

A company will not cease to be a qualifying portfolio company because it is "taken public" after the investment is made by the venture capital company.

The purpose of the restrictions on portfolio company leverage was to preclude leveraged buyout funds that finance their investments in portfolio companies with borrowed money from relying on the definition of venture capital fund.

Representation as a Venture Capital Fund. As indicated, an eligible venture capital fund also must represent to investors and potential investors that it pursues a venture capital strategy. The SEC stated that an adviser relying upon the VC Adviser Exemption cannot, for example, identify a fund advised by such adviser as a "hedge fund" or "multi-strategy fund" or include the fund in a hedge fund database or hedge fund index. It is not necessary, however, for the fund name to include the term "venture capital fund" in order for it to rely on the exemption.

Application to Non-U.S. Advisers. A non-U.S. Adviser may rely upon the VC Adviser Exemption if all of its U.S. and non-U.S. clients are venture capital funds, as defined.

Grandfathering Provision. The SEC's definition includes a grandfathering provision that includes within the definition of "venture capital fund" any private fund that: (i) represented itself as a venture capital fund to investors and potential investors at the time the fund offered its securities; (ii) has sold securities (including through the acceptance of capital commitments) to one or more investors unrelated to the adviser prior to December 31, 2010; and (iii) does not sell any securities to, or accept any additional capital commitments from, any person after July 21, 2011.

Reporting by Exempt Reporting Advisers

Dodd-Frank authorizes the SEC to require Private Fund Advisers and VC Fund Advisers relying on registration exemptions (Exempt Reporting Advisers) to maintain certain records and to submit such reports as the SEC determines "necessary or appropriate in the public interest," notwithstanding their unregistered status.

Limited Reporting. The SEC has determined to use Form ADV as the primary means for collecting required information from Exempt Reporting Advisers. Accordingly, such advisers must complete a limited subset of items from Part 1A of Form ADV and file this information through the Investment Adviser Public Disclosure system. Exempt Reporting Advisers must, among other things, identify their organizational and ownership information, provide details regarding financial industry activities and other business activities, including acting as a commodity pool operator, commodity trading advisor, security-based swap dealer or major security-based swap participant; provide the disciplinary histories of the adviser and its affiliates; and furnish information regarding the private funds advised by such adviser. These reports will be publicly available, though this was not specifically mandated by Dodd-Frank.

Exempt Reporting Advisers would not be required to complete the remaining items in Part 1A or to prepare a client brochure (Form ADV Part 2).

Initial Reporting, Updating Requirements and Final Reports. Exempt Reporting Advisers are required to file their initial report on Form ADV no later than March 30, 2012. An Exempt Reporting Adviser thereafter is required to amend its Form ADV at least annually, within 90 days of the end of the adviser's fiscal year, and promptly if its responses to certain items become inaccurate.

When an adviser ceases to be an Exempt Reporting Adviser, it is required to file an amendment to its Form ADV indicating that it is filing a final report. An Exempt Reporting Adviser wishing to register with the SEC can file a single amendment to its Form ADV that will serve both as a final report as an Exempt Reporting Adviser and as an application for registration under the Advisers Act.

Examinations. The SEC does not anticipate that it will conduct compliance examinations of Exempt Reporting Advisers on a regular basis, but has the authority to do so, and will use that authority when there are indications of wrongdoing.

Subadvisers and Advisory Affiliates: *Unibanco* and Related Letters

The adopting release offers commentary on the application of the Exemptive Rules to subadvisory relationships and the applicability of the registration requirements to affiliates of registered advisers.

With respect to subadvisers, the SEC stated that subadvisers may rely on each of the new Exemptions, provided that they satisfy all terms and conditions of the applicable rule. It noted that in many subadvisory relationships, a subadviser has contractual privity with a private fund's primary adviser rather than the private fund itself. Although both the private fund and the fund's primary adviser may be viewed as clients of the subadviser, the SEC said it would consider a subadviser eligible to rely on the

Private Fund Adviser Exemption if the subadviser's services to the primary adviser related solely to private funds and the other conditions of the rule were met. Similarly, a subadviser may rely on the VC Adviser Exemption if its services to the primary adviser related solely to VC funds and the other conditions of the rule were met.

In proposing the rules, the SEC had cast doubt about the continued viability of the line of no-action letters originating with *Unibanco*.[2] In those letters, the staff provided assurances that it would not recommend enforcement action against an unregistered non-U.S. Adviser that was affiliated with a U.S. registered adviser, despite their sharing of personnel and resources. In adopting the Exemptive Rules, the SEC responded to support in many comments for the continuation of *Unibanco*. However, separate from the discussion of *Unibanco* and the foreign/domestic context, the SEC stated that the determination of whether the advisory businesses of two separate affiliates may be required to be integrated is based on facts and circumstances and cited *Richard Ellis, Inc.*, a 1981 no-action letter, for factors relevant to a determination of whether a separately formed advisory entity operates independently of an affiliate.

Family Office Exclusion

In separate action, the SEC also adopted rules to implement the Family Office Exclusion from the definition of investment adviser enacted by Dodd-Frank. In response to commenters, the SEC expanded the Family Office Exclusion rules significantly from what originally was proposed. Under the new Rule 202(a)(11)(G)-1, a "family office" is excluded from the definition of an investment adviser if it meets the following conditions:

- its clients consist solely of "family clients";
- it is wholly owned by "family clients" and is exclusively controlled (directly or indirectly) by one or more "family members" and/or "family entities"; and
- it does not hold itself out to the public as an investment adviser.

Family offices have until March 30, 2012, to meet the conditions of the Family Office Exclusion or to register under the Advisers Act. Like other exclusions provided in the Advisers Act, the Family Office Exclusion is self-executing. A family office is not required to notify the SEC of its reliance on the Family Office Exclusion.

Who Is the Family? Unlike the proposal, which defined the family based on the concept of a founder, the Family Office Exclusion allows a family office to designate a "common ancestor" (living or deceased) to define its family, provided the ancestor is no more than ten generations removed from the youngest generation.

"Family members" are all of the lineal descendants of this designated common ancestor and such descendants' spouses or spousal equivalents. Lineal descendants include adopted children, stepchildren, foster children and any individual that was a minor when another family member became that individual's legal guardian. The Family Office Exclusion also contemplates that the family office may re-designate a new common ancestor over time to allow for new generations of family clients.

Family Clients. The Family Office Exclusion defines a "family client" as including:

- "family members" (as defined above) and former family members;
- "key employees" (which include executive officers, directors, trustees, general partners or persons serving in a similar capacity for the family office or its affiliated office (other than an employee only performing clerical, secretarial or administrative functions), who, in connection with his or her regular duties, has participated in the investment activities of the family office or affiliated family office, or performed similar functions or duties for another company, for at least 12 months), and former key employees;
- any nonprofit or charitable organization funded exclusively by family clients;
- any estate of a family member, former family member, key employee or, subject to certain conditions, former key employee;
- certain trusts of, or in favor of, family clients and key employees; and
- any company that is wholly owned (directly or indirectly) exclusively by, and operated for the sole benefit of, family clients.

[2] Uniao de Bancos de Brasileiros S.A., SEC No-Action Letter (July 28, 1992). See also, e.g., Royal Bank of Canada, SEC No-Action Letter (June 3, 1998); ABN AMRO Bank, SEC No-Action Letter (July 1, 1997); Murray Johnstone Holdings Ltd., SEC No-Action Letter (Oct. 7, 1994); Mercury Asset Management plc., SEC No-Action Letter (Apr. 16, 1993); The National Mutual Group, SEC No-Action Letter (Mar. 8, 1993).

Ownership and Control of Family Offices. The Family Office Exclusion requires a family office to be wholly owned by "family clients." This provision is broader than the proposal, which would have limited a family office's owners to the narrower category of family members. This expanded definition allows, for example, for key employees to have non-controlling ownership stakes in the family office.

The Family Office Exclusion requires that a family office be exclusively controlled by family members and/or family entities. Family entities are a subset of family clients and include (i) any nonprofit or charitable organization funded exclusively by family clients; (ii) any estate of a family member or former family member; (iii) certain trusts of, or in favor of, family clients; and (iv) any company that is wholly owned (directly or indirectly) exclusively by, and operated for the sole benefit of, family clients; but, for the purposes of defining a family entity, key employees and their trusts are not included as family clients. "Control" is defined by the Family Office Exclusion to mean the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of being an officer of such company.

Multi-Family Offices. Despite the requests of commenters, the SEC did not expand the Family Office Exclusion to include multi-family offices. Accordingly, family offices with the same or substantially the same employees advising multiple unrelated families will not qualify under the Family Office Exclusion.

Grandfathering and Transitioning. The rules also provide certain grandfathering and transition for certain family offices that have previously provided advice to family offices but are not squarely within the rules.

Current SEC Exemptive Orders. The SEC has determined not to rescind existing exemptive orders granted to family offices. Family offices operating under such orders may rely on the Family Office Exclusion or may continue to rely on the exemptive orders, although the orders may be broader or narrower than the Family Office Exclusion.

Mid-Sized Adviser Registration

Section 410 of Dodd-Frank increases the threshold for eligibility to register (or remain registered) as an investment adviser with the SEC. Prior to the effective date of the Implementing Rules, Section 203A of the Advisers Act provided that an investment adviser regulated by the state in which it maintains its principal office and place of business would be ineligible to register with the SEC unless it had at least $25 million of AUM. SEC registration previously was optional for advisers with between $25 million and $30 million of AUM and mandatory for advisers with $30 million or more of AUM and more than 15 clients. AUM has now been replaced with RAUM, as more fully described above.

Dodd-Frank raised the level of RAUM required for SEC registration generally to $100 million. The SEC estimates that the new threshold will require approximately 4,100 advisers with RAUM of between $25 million and $100 million (Mid-Sized Advisers) that are currently registered with the SEC to withdraw their SEC registrations and re-register in the relevant states, provided the adviser would be subject to state registration and examination.

State Registration Requirements. Section 203A(a)(2) of the Advisers Act, as amended by Dodd-Frank, prohibits a Mid-Sized Adviser from registering with the SEC if:

- it is required to be registered as an investment adviser with the state in which it maintains its principal office and place of business; and
- upon registering in the state, it would be subject to examination as an investment adviser by that state.

Under the Implementing Rules, a Mid-Sized Adviser is not deemed to be "required" to register in the state where it maintains its principal office and place of business if an exemption from state registration is available. In that case, the adviser is required to register with the SEC (absent an exemption from SEC registration), and cannot avoid SEC registration by voluntarily registering at the state level. A Mid-Sized Adviser that registers with the SEC on this basis is required to affirm in its initial Form ADV and annual updates thereafter that it is not required to be registered as an adviser with the state where it maintains its principal office and place of business.

The SEC has determined that New York is the only state that registers investment advisers but does not subject state-registered advisers to examination.[3] In addition, the SEC has recognized that Wyoming does not have any regulatory scheme for advisers, so Mid-Sized Advisers with their principal offices and places of business in New York and Wyoming must register with the SEC.

3 At the time of adoption of the rules, Minnesota was also named in this category, but it is no longer included. *See* Division of Investment Management Frequently Asked Questions Regarding Mid-Sized Advisers.

Initial Transition to State Regulation. The SEC has adopted Rule 203A-5, which provides for a two-step "grace period" to facilitate the transition for advisers that will be required to deregister with the SEC and re-register with the states:

- First, each investment adviser registered with the SEC on January 1, 2012, will be required to file an amendment to its Form ADV no later than March 30, 2012, responding to new items on Form ADV (discussed below). These amended forms will identify Mid-Sized Advisers no longer eligible to remain registered with the SEC.
- Second, a Mid-Sized Adviser that is no longer eligible for SEC registration based on the RAUM reported on March 30, 2012, is required to file a Form ADV-W to withdraw its SEC registration no later than June 28, 2012, and will be subject to both the Advisers Act and relevant state law during the interim period. Mid-Sized Advisers registered with the SEC as of July 21, 2011, must remain so registered until January 1, 2012. New advisers that qualify as Mid-Sized Advisers are prohibited from registering with the SEC and, except for those in New York and Wyoming, must register with the state securities authorities.

Ongoing Transition Rules Between State and Federal Registration. The SEC has replaced provisions making SEC registration optional for advisers having AUM between $25 million and $30 million with a similar permissive registration "buffer" for Mid-Sized Advisers. Once registered with the SEC, an adviser will be required to withdraw its SEC registration only if its RAUM falls below $90 million. Similarly, under the Implementing Rules, a Mid-Sized Adviser is *required* to register with the SEC only once its RAUM is at least $110 million (an increase from the proposed mandatory registration threshold of $100 million).

The SEC noted that advisers are required to assess their eligibility for registration only on an annual basis and, therefore, are not required to change their registration status as a result of intra-year RAUM fluctuations (except for advisers who register with the expectation that they will have the requisite RAUM within 120 days). Under the revised rule, state-registered advisers that become eligible for SEC registration and are not relying on the Exemptions for VC Fund Advisers or Private Fund Advisers must apply for SEC registration within 90 days of filing an annual updating amendment to Form ADV reporting eligibility. The annual updating amendment must be filed within 90 days of the adviser's fiscal year end, and thus the grace period is effectively 180 days.

Advisers moving from SEC to state registration have 180 days from their fiscal year end to withdraw from registration unless they are again eligible for SEC registration on the date of required withdrawal. These grace periods have not changed from current requirements. Similarly, an SEC registered adviser that takes advantage of the 180-day grace period to deregister with the SEC will be deemed registered with both the SEC and the state of its principal office and place of business, and both the Advisers Act and state law will apply to its advisory activities during the grace period, as is the case under existing rules.

Permissive Registration Categories

The SEC will continue to allow registration for five categories of advisers that do not meet the $100 million RAUM threshold:

- pension consultants who provide investment advice with respect to at least $200 million (increased from $50 million previously);
- advisers in the same controlled group with a registered adviser;
- advisers expecting to be eligible for SEC registration within 120 days;
- advisers that would be required to register with 15 or more states (reduced from 30 states currently); and
- internet investment advisers.

Enhanced Information Required of Both Registered and Exempt Reporting Advisers

The SEC also has adopted, substantially as proposed, substantive changes to the Form ADV that require both registered advisers and Exempt Reporting Advisers to provide additional information about three specified areas of their business for risk monitoring purposes:

- information regarding private funds they advise;
- expanded information about their advisory business and their business practices that may present significant conflicts of interest; and
- additional information about their non-advisory activities and their financial industry affiliations.

Private Fund Reporting. The Implementing Rules provide for a revised Item 7.B of Form ADV that, among other things, expands the information that registered advisers must provide regarding the private funds they advise and extends these requirements to Exempt Reporting Advisers. Item 7.B now requires an adviser to provide information regarding all private funds it advises (irrespective of their form of organization and not only limited partnerships and limited liability companies as was previously required), but no longer requires the adviser to provide information regarding funds advised by its affiliates (because in most cases the affiliates will be subject to registration and reporting requirements directly). A separate Schedule D to Form ADV is required for each such private fund, but advisers are permitted to submit a single Schedule D for all funds within the same "master-feeder" structure for which the information is substantially identical. Sub-advisers may exclude certain reporting information with respect to those private funds for which another adviser is already reporting on Schedule D. Non-U.S. Advisers are not required to submit a Schedule D for a private fund that is neither organized in the United States nor offered to or owned by "United States persons." For this purpose, "United States person" is defined in substantially the same manner as "U.S. Person" under Regulation S under the Securities Act, provided that the SEC has included an exception for those discretionary accounts managed by non-U.S. persons for the account of U.S. Persons if the account manager is affiliated with the adviser.

Some of the newly required information about private funds includes:

- the name of the fund, organizational information and information about the identity of its management;
- the nature of the fund as a part of a master-feeder arrangement or a fund of funds;
- the regulatory status of the fund (e.g., the exclusion from the Investment Company Act and/or exemption from the Securities Act on which the fund relies, identification of any foreign regulatory body with jurisdiction over the fund);
- the identities of all sub-advisers;
- the general category of investment strategy employed by the fund (i.e., (i) hedge fund, (ii) liquidity fund, (iii) private equity fund, (iv) real estate fund, (v) securitized asset fund, (vi) venture capital fund or (vii) other private fund);
- the amount of the fund's gross assets;
- an indication of whether the fund invests in securities of U.S. registered mutual funds;
- the number and type of investors in the private fund (e.g., individuals, government entities, broker-dealers, pension plans, banking entities, other private funds) and the approximate percentage owned by U.S. persons and non-U.S. persons;
- the approximate percentage owned by the adviser and its related persons;
- the minimum amount required to be invested; and
- an indication of whether the fund relies on a private placement exemption in the United States and if so, the file number of any Form D on file.

An adviser that seeks to preserve the anonymity of a private fund client may identify the client using a code name.

Advisers also are required to provide basic identifying information regarding the fund's auditors, prime brokers, custodians, administrators and marketers, the status of such service providers as related persons of the adviser and other specified information.

Foreign funds not offered to U.S. persons need not be reported in response to Item 7.B because a non-U.S. fund whose interests are not offered to U.S persons is not a "private fund."

$1 Billion in Adviser's Own Assets. As revised by the Implementing Rules, Item 1.O of Form ADV requires an adviser to indicate whether its own balance sheet reflects $1 billion or more in total assets as of the last day of the adviser's most recent fiscal year. The SEC indicated that the response to this item would be used to identify advisers that will be subject to restrictions on incentive-based excessive compensation arrangements that are subject of a separate rule proposal.[4]

"Pay-to-Play" Amendments

The Implementing Rules make three amendments to Advisers Act Rule 206(4)-5 (Pay-to-Play Rule), which generally prohibits registered and certain unregistered advisers from engaging in providing advisory services to a government entity (as defined in the rule) within two years after a contribution by the adviser or certain covered associates to an official of such entity.

4 Securities Exchange Act Release No. 64140, March 29, 2011.

The amended Pay-to-Play Rule (i) applies to Exempt Reporting Advisers and Foreign Private Advisers, in addition to registered advisers; (ii) permits an adviser to pay "regulated persons" for soliciting government entities if they are subject to restrictions at least as stringent as the Pay-to-Play Rule; and (iii) adds municipal advisors to the category of "regulated persons" that are excepted from the Pay-to-Play Rule's prohibition on advisers paying third parties to solicit government entities. (To qualify as a municipal adviser, the soliciting entity must be registered under Section 15B of the Exchange Act and subject to pay-to-play rules adopted by the Municipal Securities Rulemaking Board.)

The compliance date for the ban on third-party solicitation under the Pay-to-Play Rule has been extended to June 13, 2012.

Increased Qualified Client Standards

On July 12, the SEC issued an order raising the thresholds for determining who is a "qualified client" for purposes of Rule 205-3 under the Advisers Act. Rule 205-3 permits an investment adviser to charge performance fees to qualified clients. Under the order, a qualified client is one who: (1) has at least $1 million under the management of the adviser immediately after entering into the advisory contract or (2) the adviser reasonably believes has a net worth of more than $2 million at the time the contract is entered into. These thresholds were raised from $750,000 and $1,500,000, respectively, to adjust for inflation, as required by Dodd-Frank. The SEC's order becomes effective on September 19.

In its proposal to increase the qualified client thresholds, the SEC also proposed, among other things, to: (1) exclude the value of a person's primary residence from the test of whether a person has sufficient net worth to be considered a qualified client, and (2) add certain transition provisions to the rule to allow an investment adviser and its clients to maintain existing performance fee arrangements that were permissible when the advisory contract was entered into, even if performance fees would not be permissible if the contract were entered into at a later date. The SEC has not yet addressed these additional proposals. ■

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