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Overview of New Investment Adviser Oversight Rules

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On June 22, 2011, the Securities and Exchange Commission (SEC) adopted new rules and rule and form amendments under the Investment Advisers Act of 1940, as amended (Advisers Act), that are designed to implement and give effect to the provisions of Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).[1] The new rules adopted by the SEC (New Rules) have far-reaching implications for registered as well as unregistered investment advisers, both in the United States and abroad.

This article describes how the New Rules: (i) establish new exemptions and exclusions from Advisers Act registration and reporting requirements for certain advisers; (ii) extend the compliance date for registration of certain previously unregistered advisers until March 30, 2012; (iii) amend Form ADV Part 1; (iv) create a new category of exempt advisers that are subject to limited SEC reporting; (v) reallocate regulatory responsibility for advisers between the SEC and the states; and (vi) define a "family office" that is excluded from the definition of an investment adviser under the Advisers Act.

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Background

Effective July 21, 2011, the Dodd-Frank Act repealed the "private adviser exemption" (which previously was set forth in Section 203(b)(3) of the Advisers Act) that many advisers to private funds and certain other clients relied on in order to avoid registration under the Advisers Act. The private adviser

exemption allowed an investment adviser to avoid SEC registration if, among other requirements, the adviser did not hold itself out to the public as an investment adviser and had fewer than 15 clients during the preceding 12 months. A private fund typically qualified as a single client for purposes of the private adviser exemption. Thus, advisers to private funds avoided registration under the Advisers Act by limiting themselves to no more than 14 private funds and other client accounts. With the elimination of the private adviser exemption, these advisers generally will be required to register with the SEC, unless they can rely on another exemption.

The Dodd-Frank Act offers three new exemptions from registration under the Advisers Act to certain advisers that previously relied on the private adviser exemption.[2] Additionally, the Dodd-Frank Act offers an exclusion from the definition of "investment adviser" under the Advisers Act to family offices.

Venture Capital Fund Exemption

The Dodd-Frank Act provides an exemption to advisers that solely advise venture capital funds (Venture Capital Fund Exemption). The New Rules define a "venture capital fund" as a private fund that:

(i) Represents to investors that it pursues a venture capital strategy;
(ii) Holds, at the time of acquisition of any asset other than "qualifying investments" and short-term holdings, no more than 20 percent of the amount of the fund's aggregate capital contributions and uncalled committed capital (Total Capital) in assets (other than short-term holdings) that are not "qualifying investments" (Miscellaneous Assets);
(iii) Does not borrow, incur indebtedness, provide guarantees or otherwise incur leverage in excess of 15 percent of the fund's Total Capital, and any such borrowing, indebtedness, guarantee or leverage is for a non-renewable term of no longer than 120 calendar days;[3]
(iv) Does not offer its investors redemption or other similar liquidity rights except in extraordinary circumstances; and
(v) Is not registered under the Investment Company Act of 1940, as amended (1940 Act), and has not elected to be treated as a business development company.

Qualifying Investments. Qualifying investments must be equity securities issued by: (i) a qualifying portfolio company and acquired directly from the qualifying portfolio company (directly acquired equity); (ii) the qualifying portfolio company in exchange for a direct equity investment in that same qualifying portfolio company (exchanged equity investment); or (iii) a company of which the qualifying portfolio company is a majority-owned subsidiary or predecessor company, if acquired in exchange for directly acquired equity or an exchanged equity investment.[4] The inclusion of the latter two categories allows venture capital funds to participate in reorganizations of a portfolio company or mergers or acquisitions of a portfolio company. In the case of a merger or acquisition, the New Rules enable a venture capital fund to hold as a "qualifying investment" securities of a reporting or foreign-traded company when such securities represent an exchanged equity investment. However, following the merger or reorganization, any additional interests in a reporting or foreign-traded company, as well as any secondary market purchases, would need to be held as Miscellaneous Assets.

20 Percent Limit. The New Rules make an important departure from the proposed rules by introducing a 20 percent limit, so that no more than 20 percent of a venture capital fund's portfolio will consist of assets other than "qualifying investments" or "short-term holdings." Each venture capital fund may choose whether to calculate its 20 percent limit on Miscellaneous Assets based on the cost or fair value of its assets. Once a method is chosen by a venture capital fund, it must be consistently applied to the fund's assets. Importantly, because the measurement of the 20 percent limit is made at the time of acquisition of a Miscellaneous Asset, a venture capital fund would not be required to dispose of a Miscellaneous Asset as a result of an increase in the value of that asset after acquisition. However, if the venture capital

fund has chosen to base the measurement of its 20 percent limit on fair value rather than cost, increases in the fair value of its existing Miscellaneous Assets could have the effect of filling the 20 percent Miscellaneous Asset bucket, thereby restricting the venture capital fund from acquiring new Miscellaneous Assets until existing Miscellaneous Assets are sold or depreciate in value.[5]

Short-Term Holdings. As under the proposed rules, the New Rules allow a venture capital fund to invest in short-term holdings, generally for cash management purposes. Short-term holdings will not affect the 20 percent limit on Miscellaneous Assets. Under the New Rules, short-term holdings of a venture capital fund are limited to cash, bank deposits, certificates of deposit, bankers acceptances and similar bank instruments, US Treasury securities with remaining maturities of 60 days or less, and shares of registered money market funds.[6]

"Holding Out." The New Rules require that a venture capital fund "represents to investors and potential investors that it pursues a venture capital strategy." The New Rules do not require that a venture capital fund include the term "venture capital" in its name, nor do they explicitly prohibit an adviser from including terms like "private equity" or "growth capital" in the fund's name. Rather, the determination of whether a venture capital fund represents that it "pursues a venture capital strategy" focuses on "all of the statements (and omissions) made by the fund to its investors and prospective investors. While this includes the fund name, it is only part of the analysis." As a result, advisers to venture capital funds that desire to rely on the new Venture Capital Fund Exemption should carefully review the fund's marketing materials and disclosure documents in light of the SEC's expectation that "an investor's understanding of the fund and its investment strategy must be consistent with an adviser's reliance on the exemption."

Exclusion of Certain Guarantees from Time Limits on Leverage. In response to commenters' concerns that a proposed strict 120-day limitation on leverage could interfere with a venture capital fund's ability to guarantee certain obligations of portfolio companies (that often secure longer-term borrowings for working capital), the New Rules exclude such guarantees (up to the value of the venture capital fund's investment in the portfolio company). However, these guarantees remain subject to the 15 percent of Total Capital limitation on fund borrowings.[7]

Restrictions on Liquidity. Venture capital funds are limited, except in extraordinary circumstances, from providing liquidity (that is, withdrawal, redemption or repurchase rights) beyond *pro rata* distributions to investors. The Exemptions Release indicates that both (i) periodic withdrawal rights, even if subject to an initial lock-up or other restrictions, or (ii) "regularly identifying potential investors on behalf of fund investors seeking to transfer or redeem fund interests" would be impermissible. By contrast, consents to transfer "to accommodate an investor's internal corporate restructurings, bankruptcies or portfolio allocations rather than to provide investors with liquidity from the fund" as well as rights that are contingent on changes in law or fact that are foreseeable, but unexpected as to timing or scope (for example, tax law changes or regulatory or legal changes that prohibit an investor from participating in certain fund investments), generally would be permissible.

Application to Non-US Advisers. The Exemptions Release specifies that a "non-[US] adviser" (that is, an adviser whose principal office and place of business[8] is outside the United States) may rely on the Venture Capital Fund Exemption, provided that the non-US adviser solely advises funds that are venture capital funds or grandfathered funds.[9] Accordingly, a non-US adviser may not rely on the Venture Capital Fund Exemption if it advises other client accounts (such as separately managed accounts), even if such clients are outside of the United States. Additionally, the New Rules clarify that an adviser may treat as a "private fund"[10] for purposes of the Venture Capital Fund Exemption any non-US fund that is not offered in the United States but that would be a private fund if the issuer were to conduct a private offering in the United States. However, the adviser would be required to treat the fund as a private fund for all purposes under the Advisers Act.[11]

Private Fund Adviser Exemption

A second exemption provided by the Dodd-Frank Act exempts from registration any adviser that acts solely as an adviser to "qualifying private funds," provided such adviser's "Regulatory AUM" (as described further below) in the United States is less than $150 million (Private Fund Adviser Exemption). A "qualifying private fund"[12] is defined as any private fund that is not registered or required to be registered with the SEC under the 1940 Act and has not elected to be treated as a business development company. The New Rules permit a non-US adviser (that is, an adviser with its principal office and place of business outside the United States) to count only qualifying private fund assets that are managed from a place of business within the United States towards the $150 million Regulatory AUM limit. On the other hand, a US adviser must consider all of its management activities worldwide in determining the $150 million Regulatory AUM limit.

Specifically, under the Private Fund Adviser Exemption, a US adviser is not permitted to (i) advise any client that is not a qualifying private fund and (ii) have total Regulatory AUM that exceeds $150 million regardless of where the adviser's qualifying private funds are domiciled or where the management activity occurs.

By contrast, a non-US adviser (i) can manage an *unlimited* amount of qualifying private fund assets, *provided its principal office and place of business is outside the United States* and (ii) cannot manage any assets for US persons other than qualifying private funds. In terms of the limit on Regulatory AUM of $150 million, a non-US adviser must count *only* those qualifying private fund assets that are managed *at a place of business* in the United States. Thus, a non-US adviser would not lose its ability to rely on the Private Fund Adviser Exemption as a result of the size or nature of its advisory or other business activities outside the United States.

The reason for this distinction in treatment is because Section 203(m) of the Advisers Act directs the SEC to provide an exemption to any adviser that act solely as an adviser to qualifying private funds and has AUM *in the United States* of less than $150 million.

Practical Applicability of the Exemption. A non-US adviser can rely on the Private Fund Adviser Exemption, while managing any number of US-domiciled qualifying private funds (but not other US clients) together with any number and kind of clients that are not US persons, provided that (i) *without regard to where management activities take place*, every US client is a qualifying private fund and (ii) *with respect to assets managed from within the United States*, all such assets are attributable to qualifying private funds and the total value of such assets does not exceed the $150 million Regulatory AUM limit. As a result, the Private Fund Adviser Exemption is available to any non-US adviser that does not provide advisory service to US clients other than qualifying private funds but is unable to meet the more restrictive Foreign Private Adviser Exemption (discussed below) because, for example, the adviser manages offshore funds that have significant investments by US persons.

The additional flexibility provided to a non-US adviser with respect to the Private Fund Adviser Exemption applies to a non-US adviser that maintains its *principal place of business* outside of the United States. However, a non-US adviser having its principal place of business outside the United States should be careful to limit its investment advisory activities that occur within the United States so that no US office is deemed to be its principal office or a place of business at which clients (other than qualifying private funds) or assets above the Regulatory AUM limit are managed.

In addition, a non-US adviser that manages more than $25 million in Regulatory AUM for US persons (that is, the amount allowed under the Foreign Private Adviser Exemption (as discussed below)) will be required to register with the SEC if any of its US person clients is not a qualifying private fund, even if the non-US adviser does not have a place of business in the United States.[13]

Foreign Private Adviser Exemption

The third new exemption from registration provided by the Dodd-Frank Act is an exemption for foreign private advisers (Foreign Private Adviser Exemption).[14] The Dodd-Frank Act defines a "foreign private adviser"

as any investment adviser that, among other requirements:

(i) Has *no place of business* in the United States;
(ii) Has *fewer than 15 clients and investors in the United States in private funds* advised by the adviser;
(iii) Has aggregate Regulatory AUM of *less than $25 million* attributable to clients in the United States (including US-domiciled private funds) and US investors in private funds advised by the adviser;
(iv) *Does not hold itself out* generally to the public in the United States as an investment adviser; and
(v) Does not advise *registered investment companies or registered business development companies.*

A person is only considered "in the United States" if such person is deemed to be in the United States at the time the person becomes a client of an adviser or, in the case of an investor in a private fund, each time the investor acquires securities of the fund.[15] Advisers may treat an investor as being not "in the United States" if the adviser has a reasonable belief that an investor was not in the United States at the relevant measurement points (that is, at the time the investor becomes a client or, in the case of a fund, each time an investor makes an investment).

Additionally, the Exemptions Release sets forth circumstances where an adviser must "look through" certain structures and count as clients and investors for purposes of the 15 person threshold: (i) each beneficial owner of an investor that is a nominee account; (ii) each US investor in a feeder fund, if the feeder fund is formed or operated for the purpose of investing in the master fund; and (iii) each holder of a total return swap or other instrument that effectively transfers the risk of investing in the private fund to the holder. In response to similar guidance in the proposing release, a number of commenters expressed concern that these "look through" requirements could be difficult to apply or impose unfair consequences on an adviser where, for example, the adviser had no knowledge of persons having an indirect interest in a fund or that a structured product had been created. In response to these comments, the Exemptions Release indicates that an adviser is required to "look through" only those structures that the adviser knows, or should have known, introduce additional indirect beneficial owners to a fund.[16] Additionally, an adviser is required to treat as an investor only those persons the adviser reasonably believes (based upon the exercise of reasonable due diligence) are investors. An adviser's reliance on the Foreign Private Adviser Exemption would not be jeopardized as a result of the unknown actions of third-party investors. Advisers that are able to comply with the requirements of the Foreign Private Adviser Exemption are not subject to SEC registration and reporting requirements.

Foreign Private Adviser Exemption Likely to be of Limited Use. While this exemption is attractive due to the limited requirements imposed on advisers relying on the exemption, the Foreign Private Adviser Exemption is quite narrow and likely will be unavailable to most foreign advisers that generally accept US persons as clients or investors in private funds.[17] Each of the strict conditions of the Foreign Private Adviser Exemption must be met in order for an adviser to rely on the exemption.[18] As a result, a foreign private adviser must monitor and limit both (i) the number of clients and investors in the United States and (ii) the amount of assets attributable to such clients and investors.[19] The limit on assets attributable to clients or investors in the United States may present particular difficulty for a foreign private adviser because the $25 million limit does not distinguish between a client's or investor's initial commitment of capital to the adviser's management and subsequent increases in such capital resulting from, among other things, an adviser's successful asset management.

Participating Affiliates

The Exemptions Release reiterates the SEC's position that it would treat as a single adviser two or more affiliated advisers that are separately organized but operationally integrated, which could require one or more of such advisers to register with the SEC. Although advisers that meet the draconian and out dated guidelines set forth in *Richard Ellis, Inc.*[20] will

clearly be considered to be separate entities, the determination of whether affiliates, which are established as legally separate entities, in fact are separate entities is based on the facts and circumstances surrounding the operational relationship between the affiliates.

Additionally, the SEC confirmed the applicability of the established alternative to the *Richard Ellis* factors—known as the participating affiliate doctrine—under which the SEC Staff would not recommend enforcement action against the non-US unregistered affiliate of a registered adviser, even if the affiliates share personnel and resources and provide certain services through the non-US unregistered affiliate.[21] The non-US unregistered affiliate, often called a "participating affiliate," would not be subject to the substantive provisions of the Advisers Act with respect to its relationships with its non-US clients, provided the limitations in the participating affiliate no-action letters are observed.[22]

Regulatory AUM

The New Rules require every adviser to calculate Regulatory AUM using a new uniform methodology. An adviser's Regulatory AUM will be based on the value of the securities portfolios for which the adviser provides continuous and regular supervisory or management services, including proprietary assets, assets managed without receiving compensation and assets of non-US clients (if such assets are managed in the United States).[23] Regulatory AUM also includes: (i) the value of any private fund over which an adviser exercises continuous and regular supervisory or management services; (ii) the amount of any uncalled capital commitments of any private fund (a new concept intended to capture, among others, private equity fund managers); (iii) the fair value of private fund assets; and (iv) the value of any proprietary, employee or other assets managed for no compensation or for knowledgeable employees.

Amended Form ADV

The New Rules also include substantial amendments to Form ADV Part 1 (Amended Form ADV) that impact registered advisers as well as advisers relying on the Venture Capital Fund Exemption or the Private Fund Adviser Exemption (together, Exempt Reporting Advisers). The Amended Form ADV greatly expands the reporting information required of registered advisers by requiring public disclosure of information regarding (i) the private funds they advise, (ii) their advisory businesses and related conflicts of interests, and (iii) their non-advisory activities and financial industry affiliations.[24]

Reporting Requirements for Exempt Reporting Advisers

The New Rules require Exempt Reporting Advisers to submit to the SEC, and update at least annually, certain reports on Part 1 of Amended Form ADV[25] disclosing organizational and operational information, including:

- Basic identifying information, such as name, address, contact information, form of organization, and who controls the adviser;
- Other business activities engaged in by the adviser and its affiliates, and information about potential conflicts of interests, as well as the detailed private fund reporting described above; and
- The disciplinary history of the adviser and certain of its related persons and personnel.

The information reported by Exempt Reporting Advisers (i) will be publicly available and (ii) may be used by the SEC and other regulators to determine whether the activities of an Exempt Reporting Adviser warrant further attention, as these advisers would be subject to examination by US regulators (although the SEC has indicated that it does not expect to subject Exempt Reporting Advisers to routine examinations).

New Registration Threshold and Timing of Registration

The Advisers Act prohibits an adviser from registering with the SEC unless the adviser

meets certain criteria, one of which is the amount of the adviser's Regulatory AUM.[26] While the Dodd-Frank Act generally raises the threshold of AUM used to determine whether an adviser may register with the SEC from $25 million to $100 million, it does not affect the other criteria used by advisers to determine whether they are eligible to register with the SEC.

Although advisers that have less than $25 million of Regulatory AUM (and do not meet any other registration criteria) are still prohibited from registering with the SEC, a new category of "mid-sized advisers" with Regulatory AUM between $25 million and $100 million was created by the Dodd-Frank Act.[27] These mid-sized advisers will be: (i) required to register with the SEC if the adviser is not required to be registered as an adviser in its home state or is registered in its home state, but not subject to examination;[28] (ii) prohibited from registering with the SEC if the adviser is required to be registered in its home state and is subject to examination in its home state; and (iii) permitted to register with the SEC if it is required to register in 15 or more states.

To assure compliance with the registration thresholds and criteria, the New Rules require each adviser that is registered with the SEC as of January 1, 2012, to file an Amended Form ADV no later than March 30, 2012. An adviser no longer eligible for SEC registration must withdraw its SEC registration and register with all necessary states by no later than June 28, 2012. An adviser registered with the SEC as of July 21, 2011, must remain registered with the SEC until January 1, 2012, unless an exemption from SEC registration is applicable. An unregistered adviser that, as of July 20, 2011, was relying on the private adviser exemption and now must register with the SEC, must so register by March 30, 2012.[29] Importantly, it may take 45 days for the SEC to approve an initial application for registration. Therefore, an adviser that must register with the SEC should file a complete Form ADV (Parts 1 and 2) no later than February 14, 2012. Exempt Reporting Advisers must file their first reports on the Amended Form ADV by March 30, 2012.

Family Office Rule

Entities meeting the definition of "family office" in newly adopted Rule 202(a)(11)(G)-1 (Family Office Rule) are deemed not to be investment advisers for purposes of the Advisers Act and, consequently, are not subject to any of the requirements of, or rules under, the Advisers Act (including the registration provisions).[30] Moreover, such a "family office" cannot be required to register with a state as an investment adviser, and its "supervised persons"[31] cannot be required to register with a state as investment adviser representatives. On the other hand, a family office that does not meet the definition in the Family Office Rule will be required to register as an investment adviser with the SEC, or one or more state securities regulators, unless the family office: (i) satisfies the requirements of another exemption from registration under the Advisers Act; (ii) is able to rely on its own exemptive relief;[32] or (iii) restructures in order to satisfy the definition of family office in the Family Office Rule.

Under the Family Office Rule, a family office is excluded from the definition of an investment adviser under the Advisers Act if it:

(i) Has no clients other than family clients (subject to the involuntary transfer exception discussed below);
(ii) Is wholly-owned by family clients and is exclusively controlled by family members or family entities; and
(iii) Does not hold itself out to the public as an investment adviser.

Family Clients. "Family clients" are: (i) family members and former family members; (ii) key employees, certain former key employees and certain key-employee related trusts; or (iii) family entities.

Family Members. Under the Family Office Rule, the term "family member" means all lineal descendants of a designated common ancestor[33] (who may be living or deceased) and such lineal descendants' spouses or spousal equivalents; provided that the family member is no more than 10 generations removed from the common ancestor. This allows a family office to choose a common ancestor (who

may be deceased) and define family members by reference to the degree of lineal kinship to the designated ancestor. As a result, a family office may choose its common ancestor now and may change that designation over time, thereby giving the family office flexibility to serve its family clients as the scope or demands of the family office change.

Former Family Members. The definition of "former family member" includes a spouse, spousal equivalent, or stepchild that was a family member but is no longer a family member due to a divorce or other similar event. Former family members may continue to make new investments through the family office after they leave the family.

Key Employees. Under the Rule, the term "key employee" means: (i) any natural person (including any key employee's spouse or spousal equivalent who holds a joint, community property, or other similar shared ownership interest with that key employee) who is an executive officer, director, trustee, general partner, or person serving in a similar capacity for the family office or its affiliated family office;[34] and (ii) any employee of the family office or its affiliated family office (other than an employee performing solely clerical, secretarial or administrative functions with regard to the family office) who, in connection with his or her regular functions or duties, participates in the investment activities of the family office or affiliated family office, provided that such employee has been performing such functions and duties for or on behalf of the family office or affiliated family office, or substantially similar functions or duties for or on behalf of another company, for at least 12 months.

In addition, under the Family Office Rule, the definition of "family client" includes any trust of which (i) each trustee or other person authorized to make decisions with respect to the trust is a key employee and (ii) each settlor or other person who has contributed assets to the trust is a key employee or the key employee's current and/or former spouse or spousal equivalent who, at the time of contribution, holds a joint, community property, or other similar shared ownership interest with the key employee. By including such trusts in the definition of family clients, the Family Office Rule enables key employees to conduct standard estate planning.

Former Key Employees. As with former family members, former key employees may be considered "family clients" provided that upon the end of such individual's employment by the family office, the former key employee does not receive investment advice from the family office (or invest additional assets with a family office-advised trust, foundation or entity) other than with respect to assets advised (directly or indirectly) by the family office immediately prior to the end of such individual's employment. Nevertheless, the family office is permitted to provide investment advice to a former key employee with respect to additional investments that (i) the former key employee was contractually obligated to make and (ii) relate to a family office-advised investment existing prior to the time the person became a former key employee.

Family Entities. Under the Family Office Rule, the following "family entities" are considered family clients: (i) non-profit organizations, charitable foundations, charitable trusts (including charitable lead trusts and charitable remainder trusts whose only current beneficiaries are other family clients and charitable or non-profit organizations), or other charitable organizations, in each case funded exclusively by one or more family clients;[35] (ii) estates of family members, former family members, key employees, or former key employees (subject to the conditions discussed above); (iii) irrevocable trusts in which one or more other family clients are the only current beneficiaries; (iv) irrevocable trusts funded exclusively by one or more other family clients, in which other family clients and non-profit organizations, charitable foundations, charitable trusts, or other charitable organizations are the only current beneficiaries; (v) revocable trusts of which one or more other family clients are the sole grantors; and (vi) companies wholly-owned exclusively by, and operated for the sole benefit of, one or more other family clients, provided that if any such entity is a pooled investment vehicle, it is excepted from the definition of "investment company" under the 1940 Act.

Ownership and Control. The Family Office Rule requires that a family office be wholly-owned by family clients and exclusively

controlled by one or more family members and/or their related family entities. This allows a family office to be owned by one or more family trusts and enables key employees to take non-controlling stakes in the family office. Such an equity interest in a family office could serve as a significant enticement to attract and retain highly skilled investment professionals.

No Holding Out. The Family Office Rule prevents a family office from holding itself out to the public as an investment adviser. However, the SEC clarified that a family office that is currently registered as an investment adviser and expects to de-register in reliance on the Family Office Rule will not be prohibited from relying on the Family Office Rule solely because it had held itself out to the public as an investment adviser while it was registered under the Advisers Act.

Multi-Family Offices. The Family Office Rule's exclusion is not available to a family office that provides services to more than one family. The Family Office Release clarified that, if several families were to (i) establish separate family offices for each family and (ii) staff these separate family offices with "the same or substantially the same employees," such employees may be deemed to be managing a *de facto* multi-family office. In these cases, the family office exclusion would be unavailable.

Involuntary Transfers from a Family Client. In order to allow for the orderly transition of management services with respect to assets involuntarily transferred to a person or entity that is not a family client, the Family Office Rule permits a family office to continue to provide advice to such recipient with respect to assets involuntarily transferred, for up to one year following the completion of the transfer of legal title with respect to such assets.[36]

Compliance Date. The Family Office Rule goes into effect on August 29, 2011. However, the Family Office Rule adds a transition period to allow family offices sufficient time to consider whether they qualify as "family offices" under the Family Office Rule. As a result, an entity that currently is exempt from registration under the Advisers Act in reliance on the "private adviser exemption" previously set out in Section 203(b)(3) of the Advisers Act will need to register with either the SEC or one or more states prior to March 30, 2012, unless it: (i) is within the Family Office Rule's definition of a "family office" or meets the grandfathering requirements; (ii) has individual exemptive relief (and continues to comply with the terms and conditions of that relief); or (iii) is able to rely on another exemption from registration, such as the Venture Capital Fund Exemption, the Private Fund Adviser Exemption, or the Foreign Private Adviser Exemption.

Conclusion

The New Rules will significantly impact many investment advisers, even if such advisers are currently registered with the SEC, because they (i) will be required to include significantly more information in Amended Form ADV regarding any private funds they advise, their advisory businesses, conflicts of interests, non-advisory activities and financial industry affiliations, (ii) may face SEC registration as a result of the elimination of the private adviser exemption, (iii) may face state registration, or (iv) operate inside the United States or outside the United States or both. Advisers are encouraged to review the new exemptions and exclusion and the requirements of the Amended Form ADV to evaluate if and how the changes in the new regulatory landscape will affect their day-to-day operations, registration and annual reporting requirements.

NOTES

1. The New Rules were presented in three separate releases: *Rules Implementing Amendments to the Investment Advisers Act of 1940,* Release No. IA-3221 (June 22, 2011), available at *www.sec.gov/rules/final/2011/ia-3221.pdf; Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers,* Release No. IA-3222 (June 22, 2011) (Exemptions Release), available at *www.sec.gov/rules/final/2011/ia-3222.pdf;* and *Family Offices,* Release No. IA-3220 (June 22, 2011) (Family Office Release), available at *www.sec.gov/rules/final/2011/ia-3220.pdf.*

2. New Rule 203-1(e) provides transition relief allowing an adviser, in effect, to continue to rely on the private adviser exemption until March 30, 2012, provided that the adviser complies with the terms of that exemption (*i.e.*, has not had 15 or more clients during the prior 12 month period, does not hold itself out to the public as an investment adviser, and does not advise a registered investment

company or business development company). Advisers whose business or marketing activities change before March 30, 2012, will need to consider whether they can continue to rely on the transition guidance.

3. As discussed herein, certain guarantees are not subject to the 120 calendar day limit.

4. A "qualifying portfolio company" is any company that: (i) at the time of any investment by the venture capital fund, is not reporting or foreign-traded and does not control, is not controlled by, or is not under common control with another company, directly or indirectly, that is reporting or foreign-traded; (ii) does not borrow or issue debt obligations in connection with the fund's investment in such company and does not distribute to the venture capital fund the proceeds of such borrowing or issuance in exchange for the venture capital fund's investment; and (iii) is not an investment company, a private fund, an issuer that would be an investment company but for the exemption provided by Rule 3a-7 under the 1940 Act, or a commodity pool. The last prong of this definition is meant to ensure that qualifying portfolio companies are operating companies as opposed to investment companies. While other types of entities excepted from the definition of an investment company under Section 3 of the 1940 Act could be qualifying portfolio companies, the Exemptions Release suggests that a fund whose strategy involves investment in the types of issuers that are excepted from the definition of an "investment company" (other than through Section 3(c)(1) or Section 3(c)(7) of, or Rule 3a-7 under, the 1940 Act) may bar its adviser from relying on the Venture Capital Fund Exemption.

5. Because the 20 percent limit will be applied to current investments of the venture capital fund, liquidated Miscellaneous Assets are excluded from the calculation.

6. The SEC refused to extend the definition of short-term holdings to allow venture capital funds to invest in US Treasuries with more than 60 days to maturity, foreign sovereign debt, repurchase agreements and commercial paper.

7. To prevent advisers to leverage buyout funds from relying on the Venture Capital Fund Exemption, the SEC did not otherwise expand a venture capital fund's ability to borrow or use leverage for other purposes (such as capital call lines of credit or borrowings to satisfy fee or expense obligations) or to generally increase the 15 percent or 120-day limitations.

8. An adviser's principal office and place of business is the location where the adviser controls, or has ultimate responsibility for, the management of assets.

9. By contrast, the Private Fund Adviser Exemption requires an adviser to consider only those funds or accounts that are managed (i) at a place of business in the United States or (ii) for US persons. As a result, a non-US venture capital fund adviser who provides additional services in its home jurisdiction may be able to rely on the Private Fund Adviser Exemption (assuming the conditions for that exemption, described herein, are met) but not the Venture Capital Fund Exemption.

A "grandfathered fund" is a private fund in existence and with third-party investors prior to December 31, 2010, that does not fully meet the definition of a venture capital fund under the New Rules, but will nevertheless be treated as a venture capital fund provided that it conforms to the holding out requirement and does not sell interests, or accept any committed capital, after July 21, 2011.

10. The Dodd-Frank Act amended the Advisers Act to define a "private fund" as any issuer that would be an "investment company" under the 1940 Act but for Section 3(c)(1) or 3(c)(7) of the 1940 Act.

11. This would require the non-US adviser to report such funds on the Amended Form ADV (as discussed herein) and would subject disclosures made by the adviser to investors in such funds to Rule 206(4)-8 under the Advisers Act, which generally prohibits advisers to pooled investment vehicles from engaging in any fraudulent, deceptive or manipulative act with respect to any investor or prospective investor in a pooled investment vehicle.

12. Under the New Rules, an adviser may also include as a "private fund" any fund that qualifies for an exclusion from the definition of an "investment company" in the 1940 Act (in addition to the exclusions in Sections 3(c)(1) and 3(c)(7)). This expanded approach from the proposed rule, which limited "qualifying private funds" to private funds that rely on the exclusions provided by Sections 3(c)(1) or 3(c)(7), now assures that advisers to funds that could rely, for example, on Section 3(c)(5)(C) (certain real estate funds) or Section (3)(c)(9) (oil, gas, or mineral fund) of the 1940 Act or Rule 3a-7 (asset-backed issuers) under the 1940 Act will not be precluded from relying on the Private Fund Adviser Exemption. If an adviser elects to treat such a fund as a private fund for this purpose, however, the adviser must treat such fund as a private fund for all purposes under the Advisers Act.

13. Such an adviser will be unable to qualify for either the Private Fund Adviser Exemption or the Foreign Private Adviser Exemption. Advisers seeking to rely on either the Private Fund Adviser Exemption or the Foreign Private Adviser Exemption must fully meet each element of the respective exemption. Advisers may not "mix-and-match" elements of the exemptions.

14. Because the Foreign Private Adviser Exemption is codified in Section 203(b) of the Advisers Act, advisers relying on the exemption will be exempt from all registration, reporting and recordkeeping requirements of the Advisers Act. However, advisers relying on the Foreign Private Adviser Exemption are subject to the anti-fraud provisions of Section 206 of the Advisers Act and Rules 206(4)-5 (Pay-to-Play Rule) and 206(4)-8 (which prohibits an adviser from making false or misleading statements to investors in a pooled vehicle) under the Advisers Act.

15. The Exemptions Release identifies a specific exemption for Canadian retirement accounts (consistent with Rule 7d-2 under the 1940 Act) to the general rule that a person must be considered "in the United States," and therefore count towards the 15 client and investor limit and $25 million Regulatory AUM limit, if the initial investment in a

non-US fund was made while the investor was outside of the United States but subsequent investments were made after the investor moved to the United States.

16. *See* Exemptions Release at n.443.

17. Foreign private advisers are exempt from registration and reporting requirements but remain within the Advisers Act's definition of an "investment adviser." As a result, foreign private advisers are subject to the anti-fraud provisions of the Advisers Act, including principally Section 206, and Rules 206(4)-5 and 206(4)-8, thereunder. However, such advisers would not be subject to other anti-fraud rules, such as those governing advertising and custody by investment advisers, adopted under Section 206 nor to the SEC's general examination authority.

18. The Foreign Private Adviser Exemption is unavailable if: (i) an adviser has 15 or more clients/investors in the United States (even if the assets attributable to those clients/investors is below $25 million); and (ii) an adviser has $25 million or more in assets attributable to clients/investors in the United States.

19. The Exemptions Release is silent as to whether the $25 million threshold for assets attributable to a US person should be monitored on a continuous basis or whether it should be measured annually. Based on the guidance provided for the annual threshold measurement for the Private Fund Adviser Exemption and the instructions in the Amended Form ADV relating to the annual measurement of Regulatory AUM, it may be reasonable for an adviser relying on the Foreign Private Adviser Exemption to only measure its AUM on an annual basis for purposes of complying with the exemption. *See* Exemptions Release at text accompanying n.372 and Part 1A Instruction 5.b.(4) of Amended Form ADV. The number of clients and investors threshold, however, appears to be continuous.

20. Richard Ellis, Inc., SEC No-Action Letter (pub. avail. Sept. 17, 1981). Under *Richard Ellis*, an advisory entity would avoid integration with its parent company where the subsidiary: (1) is adequately capitalized; (2) has a board or similar governance buffer the majority of the members of which are independent of the parent; (3) has advisory personnel who are not engaged in the parent's advisory business; (4) makes investment decisions independently from the parent and does not rely solely on information provided by the parent; and (5) keeps its investment advice confidential until communicated with the client. It would appear that advisers meeting these factors would be considered separate. However, the Exemptions Release does not indicate that the failure to meet any particular factor precludes a separateness determination.

21. *See, e.g.,* Royal Bank of Canada, SEC No-Action Letter (pub. avail. June 3, 1998), ABN AMRO Bank, N.V., SEC No-Action Letter (pub. avail. Jul. 7, 1997); Murray Johnstone Holdings Limited, SEC No-Action Letter (pub. avail. Oct. 7, 1994); Kleinwort Benson Investment Management Limited, SEC No-Action letter (pub. avail. Dec. 15, 1993); Mercury Asset Management plc, SEC No-Action Letter (pub. avail. Apr. 16, 1993) and Uniao de Bancos de Brasileiros S.A., SEC No-Action Letter (pub. avail. Jul. 28, 1992) (Participating Affiliate Letters).

22. However, in these circumstances the non-US participating affiliates could continue to receive investments from US investors in non-US private funds in reliance upon the Private Fund Adviser Exemption discussed above. The Exemptions Release also states, however, that reliance on a "participating affiliate" arrangement prevents the participating affiliate from having any US clients other than through the registered affiliate.

23. Notably, accounts other than private funds are considered securities portfolios only if 50 percent or more of the total value of such account consist of securities. As a result, client accounts that hold more than 50 percent of their AUM in "non-securities," such as collectibles, commodities or real estate, can be excluded entirely from Regulatory AUM, whereas the entire value of a private fund must be attributed to an adviser's Regulatory AUM, even if such private fund similarly contains more than 50 percent of "non-securities." Further, Regulatory AUM requires that client assets be calculated on a "gross" basis. As described by the SEC, Regulatory AUM requires an adviser to include total assets under management and reflected on a client's balance sheet, without regard to any corresponding liabilities incurred to acquire or carry the assets.

24. With respect to each private fund an adviser manages, the Amended Form ADV will require basic organizational, operational and investment information about the private funds, such as information regarding: (i) the gross asset value of the fund; (ii) the type of investment strategy employed by the fund (to be identified from a list of available options); (iii) the number of beneficial owners of the fund and the percentage of the fund beneficially owned by the adviser and its related persons, funds-of-funds and non-US persons; (iv) the minimum investment requirements of the fund; (v) whether clients are solicited to invest in the fund and what percentage of the adviser's other clients are invested in the fund; and (vi) the identity, location, and other information regarding certain "gatekeeper" service providers of the fund (*i.e.*, auditors, prime brokers, custodians, administrators and marketers). These reporting requirements would apply to non-US advisers required to file an Amended Form ADV, but the reporting requirements with respect to such advisers would apply only to private funds that are organized in the United States or are offered to, or owned by, US persons.

The advisory business information required by the Amended Form ADV will specifically require an adviser to disclose: (i) the approximate number of clients; (ii) the types of clients it advises and the approximate amount of its Regulatory AUM attributable to each type of client; (iii) the percentage of clients that are not U.S. persons; (iv) the specific number of investment personnel and their advisory activities; (v) the types of advisory services it provides; and (vi) its business practices that may present conflicts of interest, such as the use of affiliated brokers, soft dollar arrangements, and compensation for client referrals.

25. Exempt Reporting Advisers would not be obligated to prepare, file or deliver to clients the narrative brochure required of registered advisers by Part 2 of the Form ADV.

26. Other criteria used to determine eligibility for SEC registration include acting as an adviser to a registered investment company or registered business development company, or qualifying for an exemption adopted by the SEC. The New Rules alter certain of these exemptions, including increasing the threshold of plan assets that a pension consultant advises to $200 million when determining a pension consultant's eligibility to register with the SEC. While pension consultants do not technically "manage" pension plan assets, the SEC has required certain pension consultants to register because their activities have a direct effect on the management of pension plan assets.

27. The New Rules eliminate the current $5 million buffer to the previous statutory registration threshold of $25 million and replace it with a similar buffer for "mid-sized advisers" to achieve the same purpose of avoiding frequent switching between state and SEC registration. A mid-sized adviser must register with the SEC if it has $110 million Regulatory AUM, but, once registered, an adviser need not withdraw its registration until it has less than $90 million Regulatory AUM.

28. Advisers with New York or Wyoming as their home state will be considered "not subject to examination" for purposes of the New Rules.

29. The New Rules also amend Rule 204-2 under the Advisers Act (the "books and records" rule) to clarify that unregistered advisers that will be required to register with the SEC as of July 21, 2011, are not obligated to maintain certain performance-related records for any period in which they were not registered with the SEC. However, the adviser must continue to preserve any such records it currently retains.

30. Certain grandfathered family offices are subject to the Advisers Act's anti-fraud provisions (except for the Section 206(3) restrictions on principal and agency cross transactions). The Dodd-Frank Act prohibits the SEC from excluding from the definition of "family office" any family office that was not registered or required to be registered under the Advisers Act on January 1, 2010 and would meet all of the required conditions of the Family Office Rule, solely because such family office provides investment advice to, and was engaged before January 1, 2010 in providing investment advice to: (i) natural persons who, at the time of their applicable investment, were officers, directors or employees of the family office, who have invested with the family office before January 1, 2010 and are accredited investors, as defined in Regulation D under the Securities Act of 1933; (ii) any company owned exclusively and controlled by one or more family members; or (iii) any investment adviser registered under the Advisers Act that provides investment advice to the family office and that identifies investment opportunities to the family office, and invests in such transactions on substantially the same terms as the family office invests, but does not invest in other funds advised by the family office, and whose assets as to which the family office directly or indirectly provides investment advice represent, in the aggregate, not more than five percent of the value of the total assets as to which the family office provides investment advice.

31. Under Section 202(a)(25) of the Advisers Act, a "supervised person" of an investment adviser is "any partner, officer, director (or other person occupying a similar status or performing similar functions), or employees of an investment adviser, or other person who provides advice on behalf of the investment adviser and is subject to the supervision and control of the investment adviser."

32. The SEC noted that it will not rescind exemptive orders previously issued to a family office, which was deemed outside the definition of an investment adviser under the Advisers Act, even if such an office does not meet the definition of a "family office" under the Family Office Rule. Therefore, a family office relying on such a previously-issued order may continue to do so, or may comply with the Family Office Rule.

33. Under the Family Office Rule, lineal descendants of a common ancestor include adopted children, stepchildren, foster children, and any individual that was a minor when another family member became a legal guardian of that individual.

34. "Affiliated family office" means "a family office wholly-owned by family clients of another family office and that is controlled (directly or indirectly) by one or more family members of such other family office and/or family entities affiliated with such other family office and has no clients other than family clients of such other family office."

35. The Family Office Rule includes a transition period until December 31, 2013, during which any company that would otherwise qualify as a family office but for it having as a client one or more non-profit or charitable organizations that have received funding from individuals or companies that are not family clients will be deemed to be a family office, provided that such non-profit or charitable organization(s) do not accept any additional funding from any non-family client after August 31, 2011 (other than funding received prior to December 31, 2013, and provided in fulfillment of any pledge made prior to August 31, 2011).

36. Involuntary transfers include those received as a result of a gift or bequest made by a family member, key employee or his or her estate.

Applicability of Advisers Act to Different Types of Advisers

The Dodd-Frank Act's repeal of the private adviser exemption will require many advisers who were previously unregistered to either: (i) register with the SEC; (ii) qualify as an Exempt Reporting Adviser; or (iii) qualify for the Foreign Private Adviser Exemption. Regardless of which category an adviser falls into, it is important for such adviser to understand the applicable duties and obligations. The chart below identifies the requirements of the Advisers Act as applicable to the various categories of advisers created by the Dodd-Frank Act.

	Registered Advisers	**Exempt Reporting Advisers**	**Foreign Private Advisers**
Form ADV, Part 1	X	X(Limited)	
Rule 204-3 (Form ADV, Part 2)	X		
Form PF (as proposed)	X		
Subject to Examination	X	X (Limited)	
Rule 204-2 Books and Records Rule	X	X	
Anti-Fraud Provisions (Section 206)	X	X	X
Rule 206(4)-1 Advertising Rule	X		
Rule 206(4)-2 Custody Rule	X		
Rule 206(4)-3 Cash Solicitation Rule	X		
Rule 206(4)-5 Pay-to-Play Rule	X	X	X
Rule 206(4)-6 Proxy Voting	X		
Rule 206(4)-7 Compliance Procedures and Practices	X		
Rule 206(4)-8 Pooled Investment Vehicles	X	X	X

Registration Matrix for Private Fund Advisers

The following table highlights different circumstances in which private fund advisers based in certain popular jurisdictions (*i.e.*, New York, Connecticut and London) will be affected by the New Rules and with which governing entity (if any) such an adviser will be required to register.

Location of Adviser	Nature of Business	Regulatory AUM and Leverage	Registration Status
Based in NY	Solely manages private funds ($80mm AUM)	$80mm AUM with no leverage = $80mm Regulatory AUM	Exempt from all registration
Based in NY	Manages private funds ($50mm AUM) and separately managed accounts ($30mm AUM)	$80mm AUM with no leverage = $80mm Regulatory AUM	Must register with SEC (Private Fund Adviser Exemption not available)
Based in CT	Solely manages private funds ($80mm AUM)	$80mm AUM with no leverage = $80mm Regulatory AUM	Must register with CT (SEC exemptions do not preempt state law)
Based in CT	Manages private funds ($50mm AUM) and separately managed accounts ($30mm AUM)	$80mm AUM with no leverage = $80mm Regulatory AUM	Must register with CT
Based in CT	Manages private funds ($80mm AUM) and separately managed accounts ($30mm AUM)	$110mm AUM with no leverage = $110mm Regulatory AUM	Must register with SEC (Private Fund Adviser Exemption not available)
Based in CT	Solely manages private funds ($80mm AUM)	$80mm AUM with 2x leverage = $160mm Regulatory AUM	Must register with SEC
Based in London, with no U.S. office	Solely manages private funds ($80mm AUM) with 15 or more U.S. investors	$80mm AUM with 2x leverage = $160mm Regulatory AUM	May rely on Private Fund Adviser Exemption
Based in London, with no U.S. office	Manages private funds ($80mm AUM) and separately managed accounts for U.S. persons ($30mm AUM)	$80mm private fund AUM with 2x leverage + $30mm separate account AUM with no leverage = $190mm Regulatory AUM	Must register with SEC (Private Fund Adviser Exemption not available)
Principal place of business in London; manages solely private funds in U.S.	Manages solely private funds ($160mm AUM), of which $90mm managed at a U.S. office	$160mm AUM, of which $90mm managed at U.S. office with no leverage = $90mm Regulatory AUM (only assets managed at a U.S. office are included in Regulatory AUM for this purpose)	May rely on Private Fund Adviser Exemption