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Alert Memo

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SEC Adopts Final Rules under the Investment Advisers Act of 1940 Implementing Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act

On June 22, 2011, the Securities and Exchange Commission (the "SEC") adopted final rules and rule amendments (the "Final Rules") under the Investment Advisers Act of 1940 (the "Advisers Act") to implement provisions of Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), specifically Title IV's repeal of the "15-client exemption."[1]

Although the July 21, 2011 deadline set by Dodd-Frank (marking the repeal of the "15-client exemption") has been extended, the Final Rules will ultimately result in the registration of many hedge fund and private equity advisers, as well as non-U.S. advisers with limited activities involving U.S. clients or the management of funds with U.S. investors. While the SEC adopted the Final Rules largely as proposed, the Final Rules do contain some substantive changes, described in more detail below, intended to address concerns raised in the comment letters.

Notable Changes to the Proposed Rules and Rule Amendments

- Compliance Deadline: Under the Final Rules, advisers currently exempted from registration by virtue of the "15-client exemption" will have until March 30, 2012 to become registered. The adopting release notes that, because an initial application for registration can take up to 45 days to become effective, new registrants should file their complete Form ADV by February 14, 2012.[2] All currently registered advisers must file a Form ADV amendment confirming SEC-registration eligibility by March 30, 2012. Advisers no longer qualifying have until June 28, 2012 to withdraw their SEC registration.

- Private Fund Exemption: Under the Final Rules, an adviser will calculate and report its assets under management to determine eligibility on an annual basis rather than quarterly as proposed. An adviser exempt under the Private Fund Exemption that subsequently reports assets under management of greater than $150 million will have 90 days to register with the SEC (unless another exemption applies). The SEC also clarified its interpretation of assets under management in the United States for non-U.S. advisers (see below).

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[1] See Advisers Act Release No. 3098 (Oct. 12, 2010), 75 Fed. Reg. 63753 (Oct. 18, 2010); Advisers Act Release No. 3110 (Nov. 19, 2010), 75 Fed. Reg. 77052 (Dec. 10, 2010); Advisers Act Release No. 3111 (Nov. 19, 2010), 75 Fed. Reg. 77190 (Dec. 10, 2010). See also CGSH Alert Memo, "SEC Proposed Rules: Implementing Title IV of Dodd-Frank Wall Street Reform and Consumer Protection Act," Dec. 3, 2010.

[2] A new registrant should begin preparing its Form ADV well in advance of this date, especially given the additional information required under the Final Rules (see below).

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This memorandum was prepared as a service to clients and other friends of Cleary Gottlieb to report on recent developments that may be of interest to them. The information in it is therefore general, and should not be considered or relied on as legal advice. Throughout this memorandum, "Cleary Gottlieb" and the "firm" refer to Cleary Gottlieb Steen & Hamilton LLP and its affiliated entities in certain jurisdictions, and the term "offices" includes offices of those affiliated entities.

- Foreign Private Adviser Exemption: Under the Final Rules, non-U.S. advisers will not need to count toward the 14 U.S.-client/investor limit U.S. investors in private funds who are knowledgeable persons as originally proposed. The SEC also provided some clarification as to what would constitute a "place of business" for purposes of the requirement that the non-U.S. adviser have no "places of business" in the United States under this exemption (see below).

- Venture Capital Fund Exemption: The Final Rules define "venture capital fund" as a fund that holds no more than 20% of its capital commitments (not including short term holdings) in "non-qualifying assets" (determined at the time of acquisition) rather than a fund that invests solely in certain qualifying investments, as proposed, allowing venture capital fund advisers hoping to avail themselves of this exemption more investment flexibility. Other modifications to the proposed venture capital fund definition include a change in the required representation under the proposal that the fund identifies itself as a venture capital fund to a representation that the fund pursues a venture capital strategy, and the elimination of the managerial assistance requirement in the proposal.

- Relationships with Affiliated Advisers: The adopting release generally affirms the Unibanco line of no-action letters as applicable to foreign advisers (conspicuously absent in the proposing release) sanctioning, under certain conditions, interactions between a non-U.S. unregistered adviser and its U.S. registered affiliate.[3] In addition, the adopting release notes the Richard Ellis no-action guidance providing certain requirements for recognizing the separateness of affiliated entities.[4]

- Family Office Exclusion: The SEC made significant modifications to its proposed rule regarding the family office exclusion, including changing the focus for determining who the family members that can be advised by the family office are at any given moment from a "founder" concept, as proposed, to a "common ancestor" approach, which is not as static. Under the Final Rules, a family can "designate" and "redesignate" the common ancestor for purposes of the exclusion as long as the family members in the family-office-advised fund are within 10 generations of the designated common ancestor. The adopting release specifically notes that it will not require documentation reflecting who the designated common ancestor is, but the family needs to keep track of the descendants to make sure that the youngest descendant is not more than 10 generations from the designated (or redesignated) common ancestor (who can be deceased). As with the other new exemptions,

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[3] The adopting release notes, however, that the *Unibanco* letters were developed by the staff in the context of the private adviser exemption, which was repealed by Dodd-Frank. The release states that, while nothing in the newly adopted rules is intended to withdraw any prior statement of the SEC or the views of the staff as expressed in the *Unibanco* letters, the SEC expects that the staff will provide guidance, as appropriate, based on facts that may be presented to the staff regarding the application of the *Unibanco* letters in the context of the new foreign private adviser exemption and the private fund adviser exemption.

[4] The SEC also mentions several times in the adopting release Section 208(d) of the Advisers Act (the Advisers Act prohibition against doing anything indirectly that the adviser would not be permitted to do directly) and the possibility of conflating entities that, while separately organized, are "operationally integrated" or otherwise appear to be in contravention of Section 208(d).

advisers generally have until March 30, 2012 to restructure, register or apply for an exemptive order to comply with this new exclusion.

Background

- Dodd-Frank requires certain advisers to hedge funds and private equity funds that are currently exempt from registration to register as investment advisers under the Advisers Act.
    - Dodd-Frank eliminates the "15-client exemption" under the Advisers Act, which exempts from registration advisers who (i) during the course of the preceding 12 months have had fewer than 15 clients; (ii) do not hold themselves out to the public as investment advisers; and (iii) do not provide advisory services to funds registered as investment companies under the Investment Company Act of 1940. Many private fund advisers currently rely on this exemption, as a fund can generally be counted as a single client.
- Dodd-Frank adds new exemptions that exempt certain private fund advisers, foreign private advisers, mid-sized advisers and venture capital advisers from registration under the Advisers Act (although certain reporting requirements may still apply). As summarized below, the SEC has now adopted rules and rule amendments implementing these new exemptions as well as other new regulatory requirements.
- Dodd-Frank excludes "family offices" from the definition of investment adviser. The SEC has adopted a rule defining "family office". This rule, as noted above, was modified from the proposal in certain substantive ways that broaden the scope of the exemption.
- The SEC also has adopted rule amendments to the "pay to play" rule, summarized below.

Exemptions from Registration[5]

- Private Fund Adviser Exemption. Dodd-Frank contemplates an exemption from registration under the Advisers Act for advisers that act *solely as advisers to* "private funds" (defined as an issuer that would be required to register as an investment company but for Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 (the "'40 Act")) and have *assets under management* ("AUM") *in the United States* of less than $150 million (the "Private Fund Adviser Exemption").
    - *Assets Under Management.* The Final Rules adopt as proposed the term Regulatory Assets Under Management ("R-AUM") to provide a uniform calculation of an adviser's AUM when determining its eligibility for an exemption from registration

[5] Note that, in addition to those exemptions described below, Dodd-Frank also exempts from registration advisers to small business investment companies that are regulated by the Small Business Administration. Furthermore, the SEC has adopted amendments to three exemptions from the prohibition on SEC registration concerning nationally recognized statistical organizations, pension consultants, and multi-state advisers.

with the SEC. The calculation is determined on the basis of gross assets under management and includes any proprietary assets, assets managed without compensation[6] and assets of non-U.S. clients, all of which an adviser may currently exclude from the calculation of its AUM. Furthermore, in the case of private funds, the calculation must include uncalled capital commitments, must be based on the market value of the assets or fair value where market value is unavailable and, for purposes of the Private Fund Adviser Exemption, must be determined on an annual basis (rather than quarterly as proposed). AUM must be calculated within 90 days of the adviser's filing of its annual updating amendment. Advisers whose AUM fluctuates above the $150 million limit between annual updating amendments will not lose the exemption on this basis.

- *Advisers Solely to "Private Funds".*
  - For non-U.S. advisers, the condition that the adviser advises solely private funds is deemed fulfilled as long as all of the adviser's clients that are U.S. Persons[7] are private funds.
  - Additionally, an adviser relying on this exemption (except as described below) may not advise any managed accounts which do not fit under the definition of a private fund.[8]

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[6] In response to commenters citing the statutory definition of investment adviser (which includes a "for compensation" qualifier), the SEC noted that "[a]lthough a person is not an investment adviser for purposes of the Advisers Act unless it receives compensation for providing advice to others, once a person meets that definition (by receiving compensation from *any* client to which it provides advice), the person is an adviser, and the Advisers Act applies to the relationship between the adviser and any of its clients (whether or not the adviser receives compensation from them)." We presume the SEC is only referring to an adviser's *advisory* clients in this context, *i.e.*, if the adviser receives compensation from any one client to which it provides advice then it is an adviser to each client *to which it provides advice* whether or not compensation is received.

[7] Note that, for purposes of the Private Fund Adviser Exemption, this determination is made at the time the person becomes a client or makes additional investments in a fund and with reference to the Regulation S definition of a U.S. Person, which defines a U.S. Person as (i) any natural person resident in the United States; (ii) any partnership or corporation organized or incorporated under the laws of the United States; or (iii) any estate of which any executor or administrator is a U.S. Person. In this regard, the release notes the no-action positions adopted by the SEC staff in the *Investment Funds Institute of Canada* and *Goodwin Proctor*.

[8] The adopting release states that whether a single-investor fund could be a "private fund" for purposes of the exemption depends on the facts and circumstances. The release notes the SEC's concern that an adviser simply could convert client accounts to single-investor funds–which would be tantamount to separately managed accounts–in order to avoid registering under the Advisers Act. The SEC references Section 208(d) of the Advisers Act as anticipating "these and other artifices" and thus prohibiting a person from doing indirectly anything which it would be unlawful to do directly. Although the release acknowledges that there are circumstances in which it may be appropriate for an adviser to treat a single-investor fund as a private fund for purposes of the rule, these are likely to be limited–such as where a fund

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- *In the United States*. The SEC's interpretation of the phrase "*in the United States"* for purposes of this exemption, while acknowledging that U.S. advisers may have organizationally separate non-US advisory activities, presumes that all assets of a U.S. adviser are managed from a place of business in the United States. Thus, in calculating its AUM for purposes of this exemption, a U.S. adviser must include all private fund assets in its calculation, whereas a non-U.S. adviser is only required to include the amount of private fund assets it manages at a place of business in the United States. For clarification purposes, the SEC changed this wording from the proposal which said "from a place of business in the United States" to more clearly reflect a focus on the location at which management is conducted, which the adopting release distinguishes from research, due diligence and, presumably, marketing and back-office functions.[9]
  - For purposes of this exemption, whether an adviser is a U.S. or non-U.S. adviser depends on where that adviser's "principal office and place of business" is located, which is understood to be the executive office of the investment adviser from which the officers, partners or managers of the investment adviser direct, control and coordinate the activities of the investment adviser.
  - Given the focus on *AUM in the United States* for a non-U.S. adviser, we expect many non-U.S. advisers that do not have investment professionals in the United States may be able to rely on the Private Fund Adviser Exemption instead of the Foreign Private Adviser Exemption (described below).
  - While advisers who rely on the Private Fund Adviser Exemption are exempt from registering under the Advisers Act, they are still required to make limited disclosures with the SEC (as described below).
- *Transition.* The Final Rules provide that an adviser which has complied with its exempt reporting requirements (see below) has a 90-day transition period in which

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that seeks to raise capital from multiple investors has only a single, initial investor for a period of time or where all but one of the investors in a multi-investor fund have redeemed their interests.

[9] The SEC clarified in the adopting release that, for non-U.S. advisers, the analysis likely will not turn on whether the non-U.S. adviser has a place of business in the United States but on whether the adviser manages assets, or has "assets under management", at such a U.S. place of business. "Assets under management", the SEC noted, are securities portfolios for which the adviser provides "continuous and regular supervisory or management services." Contrary to speculation based on the proposing release, the SEC confirmed that, while this is an inherently factual determination it would not view providing research or due diligence at a U.S. place of business to be managing assets in the United States if a person outside the United States makes an independent investment decision and implements those decisions. Presumably, marketing or other client services offices that do not engage in "management" of assets would also be excluded from the calculation of assets under management in the United States for such non-U.S. advisers.

to become registered with the SEC after filing an annual updating amendment reporting AUM greater than $150 million. While the transition time provided has not changed from the proposal, because the eligibility determination is tied to the annual updating amendment rather than a quarterly calculation, this transition period is now the same as the one traditionally provided to advisers who must transition to or from state registration based on a change in their assets under management (90 days from filing, 180 days from the adviser's fiscal year end).

  - *Subadvisers.* The SEC will permit a subadviser to a private fund(s) to rely on this exemption if the subadviser satisfies all terms and conditions of the exemption other than the fact that it has the primary adviser, which is not itself a private fund, as a client, provided that the subadviser's services to the primary adviser relate solely to the private fund(s).[10]

- Foreign Private Adviser Exemption. For non-U.S. advisers, the Advisers Act in general only applies to their relationships with U.S. clients. Dodd-Frank creates an exemption from registration for any investment adviser that is a "foreign private adviser", which it defines as an adviser that (a) has no *place of business in the United States*; (b) during the preceding 12 months has had (i) in total, fewer than 15 *clients* and *investors in the United States* in private funds advised by such investment adviser, and (ii) aggregate *AUM* attributable to clients and investors *in the United States* in private funds advised by such investment adviser of less than $25 million; and (c) neither holds itself out generally to the public *in the United States* as an investment adviser, nor acts as an investment adviser to any investment company registered under the '40 Act (the "Foreign Private Adviser Exemption"). The Final Rules define, largely as proposed, the following terms for this exemption:

  - *Clients*. For purposes of counting clients under the Foreign Private Adviser Exemption, the following count as one client: (1) a natural person and (i) any minor child of the natural person, (ii) any relative, spouse, or relative of the spouse of the natural person who has the same principal residence, and (iii) all trusts and accounts of which the aforementioned individuals are the only primary beneficiaries; (2) any legal organization to which investment advice is provided based on its investment objectives rather than the individual investment objectives of its owners; and (3) two or more legal organizations that have identical shareholders, partners, limited partners, members or beneficiaries. The Final Rules also eliminate a "special rule" under the Advisers Act permitting an adviser not to count as a client any person for whom the adviser provides advisory services without receiving compensation.[11]

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[10] The SEC will also permit subadvisers to rely on the Venture Capital Fund Adviser Exemption (described below) subject to the same conditions.

[11] As noted above, the SEC also determined to include in the calculation of assets under management assets managed without compensation, noting that if an adviser receives compensation from any one client to which it provides advice, then it is an adviser to each advisory client whether or not compensation is received.

- *Investor*. Generally defined as any person that would be included in determining the number or identity of beneficial owners or qualified purchasers under Sections 3(c)(1) and 3(c)(7) of the '40 Act. The adopting release clarifies that an adviser must look through nominee and similar arrangements, total return swaps or similar instruments, as well as through master-feeder structures, to the beneficial owners. The SEC introduced a reasonableness standard for this determination, *i.e.*, the adviser may treat as an investor a person that the adviser reasonably believes is the actual investor. The same standard may be used in determining if a particular investor is "in the United States." The SEC noted that because private fund advisers already need to "look through" and count investors for purposes of their '40 Act exemption, this provides no additional burden to advisers who argue that they may not know the identity or location of each investor.

  However, the Final Rules do not include "knowledgeable employees" in the definition of "investor" as originally proposed. Thus, a non-U.S. adviser need not count U.S. knowledgeable employees toward the 14-U.S. client and investor in private fund limit.

- *In the United States*. Refers to the definition of a U.S. Person as provided for in Regulation S (described in footnote 7 above).

- *Place of Business*. The Final Rules adopt as proposed this definition, which refers to 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.

  - We note that this definition is expansive in its reach and captures advisers with *any* "place of business" in the United States. This approach is particularly broad when compared with the current application of the Advisers Act, which distinguishes between advisers whose *principal* places of business are inside or outside of the United States.

  - As noted above, the SEC clarified in the adopting release that while a "place of business" as defined would include any office where the adviser regularly communicates with U.S. or non-U.S. clients or regularly conducts research, it would likely not include a place of business used solely for administrative or back office activities if such activities are not "intrinsic to providing investment advisory services" and do not involve communicating with clients. A pure marketing or client service office that involves contacting clients, even if it does not provide any investment advice, will likely be captured by this definition of "place of business" for purposes of this exemption, whereas an office that does not conduct advisory activities or communicate with clients likely would not be captured. While the adopting release does provide some assurance that not all offices will count as a "place of business" for purposes of this exemption, this requirement may nevertheless cause many foreign advisers to be ineligible for this exemption,

although if such foreign adviser has no investment professionals in the United States, they may qualify for the Private Fund Adviser Exemption.

- Even with this clarification, determining whether an operation or office in the United States will count as a "place of business" for purposes of this exemption will be a fact intensive and difficult analysis, especially given the breadth of activities one can conduct in an office and the ambiguity inherent in the standard the SEC has cited (*i.e.*, "intrinsic to providing advice").

  - *Assets Under Management*. As with the other exemptions, the definition of Assets Under Management in this context refers to the broader R-AUM definition, which includes uncalled capital commitments for private funds.

  - *Reporting Requirements*. While more narrow in its eligibility than the Private Fund Adviser Exemption, the Foreign Private Adviser Exemption will be preferable, if available, to the Private Fund Adviser Exemption and Venture Capital Adviser Exemption, because Foreign Private Advisers are not subject to the reporting requirements for so-called "exempt reporting advisers" (described below).

- Venture Capital Fund Adviser Exemption. Advisers solely to venture capital funds are exempt from registration with the SEC under Dodd-Frank. The Final Rules modify the definition of venture capital fund to include an allowance for "*non-qualifying investments*" rather than the inclusion of only qualifying investments as proposed. Under the Final Rules, "venture capital fund" is defined as a private fund that (i) holds no more than 20% of the fund's capital commitments in "non-qualifying investments" (other than short-term holdings);[12] (ii) does not borrow or otherwise incur leverage in excess of 15% of the fund's capital contributions and uncalled committed capital, and any such borrowing or leverage (excluding certain guarantees by the fund of qualifying portfolio company obligations) is for a non-renewable term of no longer than 120 calendar days; (iii) does not offer its investors redemption or other similar liquidity rights except in extraordinary circumstances; (iv) represents itself as pursuing a venture capital strategy to investors; and (v) is not registered under the '40 Act and has not elected to be treated as a business development company (a "Venture Capital Fund").

  - *Qualifying Portfolio Companies*. The SEC defines "*qualifying investment*" generally as any equity security acquired directly from a "*qualifying portfolio company*" and, in a modification from the proposal, certain equity securities exchanged for the directly acquired securities. The definition of "*qualifying portfolio company*" was adopted substantially as proposed as one which (i) is not a reporting or foreign traded company and does not have a control relationship with such a company; (ii) does not incur leverage in connection with the investment by the private fund and distribute the proceeds of any such borrowing to the private

[12] The fund's compliance with the 20 percent limit is to be calculated at the time any non-qualifying investment is made, based on the non-qualifying investments then held in the fund's portfolio.

fund in exchange for the private fund investment; and (iii) is not itself a fund (*i.e.,* is an operating company).

- *Managerial Assistance*. The Final Rules omit a requirement included in the original proposal that the venture capital fund or its adviser offer to provide managerial assistance.

- *Non-U.S. Advisers*. A non U.S. adviser may rely on the Venture Capital Fund Exemption if all of its clients, whether U.S. based or otherwise, are venture capital funds.[13]

- *Grandfathering Provision.* Included in the adopted definition of "venture capital fund" is, as proposed, any private fund that (i) represented to investors and potential investors at the time the fund offered its securities that it pursued a venture capital strategy, (ii) has sold securities to one or more investors prior to December 31, 2010, and (iii) does not sell any securities to, including accepting any additional capital commitments from, any person after July 21, 2011.

- Mid-Sized Advisers. Currently, advisers who do not advise any '40 Act-registered funds are required to have at least $25 million AUM to register with the SEC; advisers with less than $25 million in AUM are subject to regulation/registration by the state in which they have their principal place of business.

  - Dodd-Frank maintains this threshold, but also creates a new group of "mid-sized" advisers and shifts primary regulatory oversight from the SEC to the state securities authorities for advisers in this group. An investment adviser that (i) has AUM between $25 million and $100 million and (ii) is regulated or *required to be registered* in the state in which it maintains its principal place of business, and is *subject to examination* as an investment adviser by such state, is prohibited from registering with the SEC. However, mid-sized advisers are not prohibited from registering with the SEC if the adviser would otherwise be required to register in 15 or more states. Other than creating a "*buffer zone*" (as described below), the SEC adopted the related rules substantially as proposed.

    - *Assets Under Management*. As with the other exemptions, the calculation of AUM for this exemption refers to an adviser's R-AUM definition (described above), notably requiring that the calculation include both (i) assets appearing on a private fund's balance sheet and (ii) in the case of private funds, outstanding, uncalled capital commitments.

    - *Required to Be Registered.* A mid-sized adviser that relies on a state law registration exemption, or is otherwise "not required to be registered in a state," must register with the SEC unless another exemption applies. Since

[13] This is notable given it is inconsistent with the SEC's treatment of non-U.S. advisers in other areas (*e.g.*, the Private Fund Adviser Exemption).

most states exempt from state registration advisers with relatively few clients, it is likely a number of advisers with relatively few clients but AUM between $25 million and $100 million will still have to register with the SEC, unless another exemption applies.

- *$90-$110 Million Buffer Zone.* The Final Rules adopt a buffer zone for mid-sized advisers to avoid frequent switching between SEC and state registration, as currently exists for advisers within the $25-$30 million threshold. Advisers with between $90 million and $110 million in AUM can choose between SEC or state registration−the Final Rules will not require SEC registration until a state-registered adviser reaches $110 million and will not require deregistration of an SEC-registered adviser until assets fall below $90 million. This should account, in the SEC's view, for temporary fluctuations in the value of assets.

- *Subject to Examination*. If the state securities authority does not conduct compliance examinations, then the mid-sized adviser must register with the SEC. The SEC has surveyed each state and made available a list of those non-examining states on its website.[14]

- Transition to State Registration. The Final Rules require each adviser registered with the SEC on January 1, 2012 to file an amendment to its Form ADV no later than March 30, 2012, and to report the market value of its AUM determined within 90 days of the filing. This filing and reporting will be used to determine if the adviser must transition from SEC to state registration.

  - If the registered adviser is prohibited from SEC registration, the adviser must withdraw its registration no later than June 28, 2012.

  - To ensure orderly transition and allow time to implement changes to the system for Form ADV filing (the "IARD"), mid-sized advisers registered with the SEC as of July 21, 2011 must remain registered (unless an exemption applies) until at least January 1, 2012. Furthermore, new applicant mid-sized advisers are prohibited from registering with the SEC until after July 21, 2011.

- No Grandfathering. There is no grandfathering rule permitting advisers registered with SEC prior to July 21, 2011 to keep their SEC registration if such adviser is required to switch to state registration under the new rules (except for affiliates of SEC-registered advisers as discussed below).

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[14] Barring other applicable exemptions, a mid-sized adviser with a principal office and place of business in Wyoming, which does not require adviser registration, Minnesota, or New York (which did not confirm with the SEC that advisers registered with them are subject to examination), must register with the SEC regardless of R-AUM.

- Advisory Affiliates. The Final Rules retain the existing rule provision that allows affiliates of SEC-registered advisers to opt for SEC registration even if such affiliate would otherwise be subject to state registration and prohibited from registering with the SEC. This ability will be important to adviser complexes that create separate general partners for each of their clients that would otherwise have to register with state regulators. Note that single purpose general partners for clients that may previously have been exempt under the 15-client exemption each will likely now have to register with the SEC.

Reporting Requirements

- Dodd-Frank requires the SEC to determine reporting requirements as necessary and appropriate for advisers exempt from registration under the Venture Capital Fund Adviser Exemption and the Private Fund Adviser Exemption ("Exempt Reporting Advisers").[15] The reporting requirements, however, do not apply to exempt Foreign Private Advisers.
  - As provided in the rules as originally proposed, Exempt Reporting Advisers must complete limited portions of the SEC's revised Form ADV. As a result, Form ADV serves as both a registration and a reporting form, and is publicly available on the SEC's website. Exempt Reporting Advisers are required to file their initial Form ADV between January 1 and March 30, 2012 (not by August 20, 2011, as proposed).[16]
  - Exempt Reporting Advisers must complete the following seven items in Part 1A of the Form ADV: 1. (Identifying Information), 2.B. (SEC Reporting by Exempt Advisers), 3. (Form of Organization), 6. (Other Business Activities), 7. (Financial Industry Affiliations and Private Fund Reporting), 10. (Control Persons), 11. (Disclosure Information), and the corresponding Schedules A, B, C and D. Exempt Reporting Advisers are not required to complete and file other items in Part 1A or prepare a client brochure.[17]
    - Items 1, 3 and 10 require basic identification details about an Exempt Reporting Adviser such as name, address, contact information, form of

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[15] The SEC noted in the adopting release the possibility of recordkeeping requirements for Exempt Reporting Advisers to be addressed in a future release. In addition, in a separate proposing release, the SEC proposed to require special reporting by Private Fund Advisers (but not Venture Capital Fund Advisers or Foreign Private Advisers) on Form PF. See SEC Advisers Act Release No. 3145 (Jan. 26, 2011), 76 Fed. Reg. 8068 (Feb. 11, 2011).

[16] As a general matter, an Exempt Reporting Adviser must submit an initial Form ADV within 60 days of relying on an exemption.

[17] The SEC noted during the Open Meeting at which the Final Rules were adopted that it will continue to monitor during a one-year evaluation period whether it should also require Exempt Reporting Advisers to complete other Items on Form ADV. In addition, the SEC noted that, while Dodd-Frank allows it to examine Exempt Reporting Advisers, it does not intend to do so absent a strong indication that an exam is necessary, opting to concentrate resources on registered advisers.

organization and who controls the adviser. Items 6 and 7.A. provide details regarding other business activities that the adviser and its affiliates are engaged in. Item 11 requires advisers to disclose the disciplinary history for the adviser and its employees.

- Exempt Reporting Advisers must also complete the newly revised item 7.B. and Section 7.B.(1) of Schedule D, which requires advisers to provide the SEC with basic organizational, operational and investment characteristics of each fund client, the amount of gross (not net) assets held by each fund client,[18] the nature of the fund client's investors, and each fund client's service providers (i.e., auditors, prime brokers, custodians, administrators and marketers).[19]

- The same updating requirements currently imposed on SEC registrants apply to Exempt Reporting Advisers with respect to those Form ADV items Exempt Reporting Advisers must complete (e.g., annually or immediately).

Changes to Form ADV

- The Final Rules amend Form ADV to require advisers to provide additional information about three areas of operation: (i) private funds advised, (ii) advisory activity, including business practices, and (iii) non-advisory activity, including financial industry affiliations. In addition to those changes discussed above, the following items have also been revised:

  - Adopted as proposed, item 5 disclosures are expanded to require additional and more precise information about: (i) the number of employees, (ii) the *approximate* amount of assets managed, (iii) the type and number of clients serviced, and (iv) the nature of the adviser's advisory business.

  - Adopted largely as proposed, amended items 6 and 7 require advisers, including Exempt Reporting Advisers (see above), to report those financial services the adviser or a related person is actively engaged in providing from a list of financial services set forth in the items. The amendments expand the lists in both items 6 and 7 to include more business activities, e.g. activity as a trust company or major security-based swap participant. The new item 7 now requires, among other things, disclosure of accountants, lawyers (or law firms), and related foreign affiliates.

  - Adopted as proposed, the amended item 8 asks for additional information about an adviser's transactions with clients, including (i) whether any of the broker-dealers

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[18] In response to commenters' objections to the extent of public disclosure required of Exempt Reporting Advisers, the final amendments to 7.B. of Form ADV, unlike the proposed ones, do not require an adviser to (i) disclose each private fund's net assets, (ii) report private fund assets and liabilities by class and categorization in the fair value hierarchy established under GAAP, or (iii) specify the percentage of each fund owned by particular types of beneficial owners.

[19] Section 7.B. no longer requires an adviser to report on the funds advised by its related persons.

effecting the transactions are related persons of the adviser, (ii) whether "soft dollar benefits" received qualify for the safe harbor under the Securities Exchange Act of 1934, and (iii) whether an adviser or related person receives compensation for client referrals.

- Adopted as proposed, amended item 9 requires advisers to indicate the *total* number of persons that act as qualified custodians for the adviser's clients in connection with advisory services the adviser provides to its clients.
- Adopted as proposed, new item 1.O. requires an adviser to indicate if it has more than $1 billion in assets, determined in the same manner as the amount in "total assets" on the adviser's balance sheet for its most recent fiscal year end.
- Other technical and conforming amendments are adopted as proposed.

Family Offices

- Dodd-Frank amends the Advisers Act to exclude family offices from the definition of "investment adviser" and directs the SEC to define "family office" in a manner that is consistent with the SEC's "previous exemptive policy."[20] Unlike the exemptions discussed above, as excluded entities rather than exempted advisers, family offices meeting the requirements of the rule will not be subject to any of the provisions of the Advisers Act.
- Family Office Exclusion. The Final Rules define a family office as any firm that (i) has no clients other than "*family clients*", (ii) is wholly owned by "family clients"[21] and controlled (directly or indirectly) exclusively by "*family members*" and/or "*family entities*",[22] and (iii) does not hold itself out to the public as an investment adviser.[23]

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[20] Most family offices have relied on the "15-client exemption", discussed above. However, the SEC has also issued exemptive orders to certain family offices that could not meet the "15-client exemption" excluding these family offices from the definition of investment adviser under Section 202(a)(11) of the Advisers Act. The policy rationale is that the Advisers Act was not intended to regulate families in the management of their own assets. Since Dodd-Frank repeals the "15-client exemption" relied upon by many family offices, it amends the Advisers Act to provide an explicit exclusion for advisers that meet the SEC's definition of family office. Note that the SEC is not rescinding exemptive orders previously issued to family offices, which, according to the SEC, may be slightly broader in some areas, while narrower in others. Family offices currently operating under the exemptive orders can continue to rely on such orders or the exclusion and adopted rule.

[21] Thus, key employees (defined below) can own a non-controlling stake in a family office as part of an incentive compensation package.

[22] This is a change from the proposal which required that "family members" own and control the family office exclusively.

[23] The SEC's previous guidance on the meaning of "ownership and control" and "holding itself out as an investment adviser" in other contexts is applicable in the context of the family office exclusion.

- *Family Clients*. Family clients include (i) *family members* and former family members,[24] (ii) *key employees*[25] of the family office, (iii) non-profits and charities funded exclusively by one or more family clients,[26] (iv) estates of current and former family members or key employees, (v) certain trusts[27], (vi) entities wholly owned by, and operated for the sole benefit of, family clients,[28] and (vii) existing investments by *former key employees*.

- *Family Member*. The SEC defines family member to include all lineal descendants (including by adoption, current and former stepchildren, foster children, and individuals that were a minor when another family member became a legal guardian of that individual) of a *common ancestor* (who may be living or deceased), and such lineal descendants' spouses or spousal equivalents;[29] provided that the common ancestor is no more than 10 generations removed from the youngest generation of family members.

  - *Common Ancestor.* The common ancestor is the reference person chosen by the family office from whom 10 lineal and/or collateral generations is measured. The common ancestor does not need to be alive, or be the founder of the family office or the generator of the family's wealth.

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[24] Under the Final Rules, a former family member is treated as a full family member and may continue to make new investments.

[25] The Final Rules permit the family office to provide investment advice to 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 (i) an executive officer, director, trustee, general partner, or person serving in a similar capacity at the family office or its affiliated family office or (ii) any other employee of the family office or its affiliated family office (other than an employee performing solely clerical, secretarial, or administrative functions) 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 or duties for at least 12 months.

[26] The Final Rules deviate from the proposal which would have permitted charities, including charitable foundations, trusts and organizations, to be treated as family clients even if they are not (i) established by family clients or (ii) funded exclusively by family members and former family members, so long as they are funded exclusively by other family clients.

[27] The Final Rules specify that to be a "family client" the trust must exist for the sole current benefit of family clients or, if both family clients and charitable and non-profit organizations are the sole current beneficiaries, the trust must be funded solely by family clients. Revocable trusts funded solely by family clients, and certain key employee trusts are also included.

[28] Entities wholly owned exclusively by, and operated for, the sole benefit of, other family clients may be treated as family clients even if non-family clients have control over the entity. In addition, if such entity is a pooled investment vehicle it must be excepted from the definition of "investment company" under the '40 Act.

[29] A spousal equivalent means a cohabitant occupying a relationship generally equivalent to that of a spouse, and includes same-sex spousal equivalents.

Additionally, the family office can choose a different common ancestor as its reference person at any time and without any formal notification, in order to fit new generations into the 10 generation window.[30] This approach is a significant change from the "founder" approach contained in the proposed rule.

- *Involuntary Transfer*. If a person who is not a family client becomes a client of the family office as a result of the death of a family member or key employee or other involuntary transfer from a family member or key employee, under the Final Rules, the family office can continue to provide advice to such involuntary transferee for up to one year (rather than 4 months as proposed) following the transfer of assets resulting from the involuntary event, providing time for the assets to be transitioned to another adviser or to allow for other restructuring.

- *No Multifamily Offices*. The SEC declined to extend the family office exclusion to family offices serving multiple families.

- *Transition Period.* Any unregistered company that primarily advises members of a single family and currently relies on the 15-client exemption must be registered by March 30, 2012, if it does not meet the requirements of a family office. From July 21, 2011 until registration, the adviser must continue to comply with the requirements of the 15-client exemption under current law, discussed above.

    - Special Relief for Non-Compliant Non-Profits and Charities. Any adviser that would qualify as a family office on July 21, 2011 but for its having as a client one or more non-profits or charities that are not family clients (see above) is deemed a family office until December 31, 2013. However, the non-compliant non-profit or charity may not accept additional funding from non-family clients 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). This long grace period is intended to give the family office adequate time to either restructure its non-profits and charities to become compliant or choose to register as an adviser.

- Grandfathering Provision. Consistent with the proposed rule, the definition of a family office includes any person not registered or required to be registered under the Advisers Act on January 1, 2010 that would meet all of the required conditions under the rule but for the provision of investment advice to certain clients, including, for example, (i) natural persons who, at the time of their investment, are officers, directors or employees of the family office who have invested with the family office before January 1, 2010 and are accredited investors or (ii) any company owned exclusively and controlled by one or more family members.

[30] This, of course, may cause earlier generations to no longer fit within the definition of family member.

Amendments to the "Pay to Play" Rule

- Rule 206(4)-(5) generally prohibits registered and certain unregistered advisers from engaging directly or indirectly in pay to play practices identified in the rule.[31] The Final Rules adopt, substantially as proposed, two amendments to the "pay to play rule" that the SEC believes are needed as a result of Dodd-Frank:
  - The scope of the pay to play rule is expanded to cover Exempt Reporting Advisers and Foreign Private Advisers.
  - The Final Rules add municipal advisers to the categories of registered entities—referred to as "regulated persons"—who are permitted to solicit advisory business from government entities on their own behalf and on the behalf of other advisers, i.e., third-party solicitation.[32]
- The compliance date for the pay to play rule's ban on third-party solicitation has been extended from September 13, 2011 (as proposed) to June 13, 2012 to allow the Municipal Securities Rulemaking Board ("MSRB") and FINRA time to adopt their own pay to play rules. All other aspects of the amended pay to play rule are effective July 21, 2011.

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[31] The rule prohibits covered advisers from (i) providing advisory services for compensation to a government client for two years after the adviser or certain of its executives or employees makes certain political contributions; (ii) paying any third party to solicit advisory business from any government entity unless the person is a "regulated person," subject to similar pay to play restrictions; and (iii) soliciting others, or coordinating, contributions to certain elected officials or candidates or payments to political parties where the adviser is providing or seeking government business. See CGSH Alert Memo, "SEC Curbs 'Pay to Play' Practices by Investment Advisers," July 13, 2010.

[32] The proposed rule would have limited the exception to the third-party solicitation ban to registered municipal advisers. The Final Rules, however, retains the current rule that permits any "regulated person," not only municipal advisers, to engage in third-party solicitation so long as the regulated person is subject to restrictions at least as stringent as the SEC's pay to play rule, e.g., FINRA's forthcoming rule or a comparable rule adopted by the MSRB.

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