CLEARY GOTTLIEB Alert Memo

DECEMBER 3, 2010

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SEC Proposed Rules:

Implementing Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act

The Securities and Exchange Commission (the "SEC") proposed new rules and rule amendments 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."

Context

- 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). Summarized below is each of these new exemptions as well as certain new regulatory requirements.
- The SEC has also proposed rule amendments to the pay to play rule, summarized below.

Exemptions from Registration[1]

- 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)

[1] Note that, in addition to those exemptions described below, Dodd-Frank also exempts from registration advisers to any family office and advisers to small business investment companies that are regulated by the Small Business Administration. The SEC proposed rules for advisers to family offices on October 12, 2010. See Advisers Act Release No. 3098 (Oct. 12, 2010), 75 Fed. Reg. 63753 (Oct. 18, 2010).

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 SEC has proposed the term Regulatory Assets Under Management ("R-AUM") to provide a uniform calculation of an adviser's AUM when determining an adviser's eligibility for an exemption from registration with the SEC. The calculation includes any proprietary assets, assets managed without receiving compensation and assets of non-U.S. clients, all of which an adviser may currently exclude from its calculation of its AUM. Furthermore, in the case of private funds, the calculation must include uncalled capital commitments, must be based on the fair value of the assets and, for purposes of the Private Fund Adviser Exemption, must be determined on a quarterly basis, though only reported on an annual basis.

- *Advisers Solely to "Private Funds".*

  - For non-U.S. advisers, the SEC has proposed that the condition that the adviser advise solely private funds be deemed fulfilled as long as all of the adviser's clients that are U.S. Persons[2] are private funds.

  - Under the proposed rule, the requirement that an adviser advise solely private funds requires that an adviser relying on this exemption (except as described below) not advise any managed accounts which do not fit under the definition of a private fund.

- *In the United States.* The SEC's proposed interpretation of the phrase *in the United States* turns on whether the adviser is a U.S. or non-U.S. adviser. In calculating its AUM for purposes of this exemption, a U.S. adviser would be required to include all private fund assets in its calculation, whereas a non-U.S. adviser would only be required to include the amount of private fund assets it manages from a place of business in the U.S.[3]

  - 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

[2] Note that, for purposes of the Private Fund Adviser Exemption, the proposed rule refers to the Regulation S definition of a U.S. Person, which defines such 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.

[3] It is unclear what the phrase "manages from a place of business in the U.S" would include. If, for example, an adviser holds a U.S. office solely for marketing and client services, it is unclear if assets serviced by that office would need to be included in the calculation.

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 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 proposed rules would give an adviser one calendar quarter to register with the SEC after becoming ineligible to rely on the exemption due to an increase in the value of its private fund assets. This brief transition period may create practical difficulties because the registration process can take as long as six months.

- Foreign Private Adviser Exemption. For non-U.S. based advisers, the Advisers Act in general only applies to their relationships with U.S. clients. Dodd-Frank exempts from registration 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 SEC's proposed rulemaking defines the following terms for this exemption:

  - *Clients*. Defined expansively to include: (i) a natural person and (1) any minor child of the natural person, (2) any relative, spouse, or relative of the spouse of the natural person who has the same principal residence and (3) all trusts and accounts of which the aforementioned individuals are the only primary beneficiaries; and (ii) any legal organization to which investment advice is provided based on its investment objectives rather than the individual investment objectives of its owners.

  - *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.

  - *In the United States*. Refers to the definition of a U.S. Person as provided for in Regulation S (described in footnote 2 above).

  - *Place of Business*. 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 U.S. 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.

- Furthermore, a pure marketing or client service office, even if it does not provide any investment advice, will likely be captured by this definition of "place of business." This may cause many foreign advisers to be ineligible for this exemption, although they may now qualify for the Private Fund Adviser Exemption.

- *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, exemption from registration under the Foreign Private Adviser Exemption is preferred to the Private Fund Adviser Exemption and Venture Capital Adviser Exemption, as 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 SEC proposed to define a venture capital fund as a private fund that (i) invests in equity securities of private companies in order to provide operating and business expansion capital (i.e., "*qualifying portfolio companies*,"), with at least 80 percent of each company's securities owned by the fund acquired directly from the *qualifying portfolio company*; (ii) directly, or through its investment advisers, offers or provides significant *managerial assistance* to, or controls, the *qualifying portfolio company*; (iii) does not borrow, provide guarantees or otherwise incur leverage in excess of 15% of the fund's capital contributions and committed capital (other than limited short-term borrowing); (iv) does not offer its investors redemption or other similar liquidity rights except in extraordinary circumstances; (v) represents itself as a venture capital fund to investors; and (vi) 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 proposes to define a qualifying portfolio company as one which (i) is not publicly traded; (ii) does not incur leverage in connection with the investment by the private fund; (iii) uses the capital provided by the fund for operating or business expansion purposes rather than to buy out other investors; and (iv) is not itself a fund (*i.e.*, is an operating company).

  - *Managerial Assistance*. To qualify for the venture capital exemption, the fund or its adviser must also (i) have an arrangement under which it offers to provide

significant guidance and counsel concerning the management, operations or business objectives and policies of the portfolio company or (ii) control the portfolio company.

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

- *Grandfathering Provision.* Included in the definition of "venture capital fund" is any private fund that (i) represented to investors and potential investors at the time the fund offered its securities that it is a venture capital fund, (ii) has sold securities to one or more investors prior to 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.

    - *Assets Under Management*. As with the other exemptions, the calculation of AUM for this exemption has been proposed to refer to an adviser's R-AUM definition (described above), notably requiring 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 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.[4]

- *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 will correspond with each state and make available a list of those non-examining states on its website.[5]

- Transition to State Registration. The proposed rules require each adviser registered with the SEC on July 21, 2011 to file an amendment to its Form ADV no later than August 20, 2011 and to report the market value of its AUM determined within 30 days of the filing. This filing and reporting would 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 October 19, 2011. During the period from July 21, 2011 to withdrawal, the Advisers Act and applicable state law would apply to the adviser's advisory activities.

- 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.

- Advisory Affiliates. The proposed 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.[6]

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"). The reporting requirements, however, do not apply to exempt Foreign Private Advisers.

  - Under the proposed rules, Exempt Reporting Advisers would be required to complete a limited subset of the SEC's revised Form ADV. As a result, the Form

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[4] Barring other applicable exemptions, a mid-sized adviser with a principal office and place of business in Wyoming, which does not require any adviser registration, must register with the SEC regardless of its R-AUM.

5 The SEC expects to populate a list of states that do not meet this requirement.

6 Note that, single purpose general partners for clients that may previously have been exempt under the 15-client exemption will likely now have to register with the SEC.

ADV would serve as both a registration and a reporting form, with the reporting section to be made publicly available on the SEC's website.[7] Exempt reporting advisers would be required to file the reporting section of the Form ADV by August 20, 2011.

- The rules propose that Exempt Reporting Advisers complete the following seven items in Part 1A of the Form ADV: 1. (Identifying Information), 2.C. (Checkbox regarding Exemption Qualifications), 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. The proposed rule would not require Exempt Reporting Advisers to complete and file other items in Part 1A or prepare a client brochure.

    - Items 1, 3 and 10 require basic identification details about an Exempt Reporting Adviser such as name, address, contact information, form of organization and who owns 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 would also be required to complete the newly revised item 7.B. which requires advisers to provide the SEC with basic organizational, operational and investment characteristics of each fund client, the amount of assets held by each fund client, the nature of the fund client's investors, and each fund client's service providers (i.e., auditors, prime brokers, custodians, administrators and marketers).

- The proposed rules would extend the same updating requirements currently imposed on SEC registrants 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 proposed rules would amend Form ADV to require advisers to provide additional information about three areas of operation: (1) private funds advised, (2) advisory activity, including business practices and (3) non-advisory activity, including financial industry affiliations. In addition to those changes discussed above, the following items would also be revised:

    - The rules would expand item 5 disclosures to require additional and more precise information about: (1) the number of employees, (2) the amount of assets managed, (3) the type and number of clients serviced and (4) the nature of the advisor's advisory business.

[7] Rules regarding recordkeeping for Exempt Reporting Advisers are forthcoming.

- Items 6 and 7 would require advisers, including Exempt Reporting Advisers, 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 proposed rule would 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 would also require, among other things, disclosure of accountants, lawyers (or law firms), and related foreign affiliates.

- The new item 8 would ask for additional information about an adviser's transactions with clients, including (1) whether any of the broker-dealers effecting the transactions are related persons of the adviser, (2) whether "soft dollar benefits" received qualify for the safe harbor under the Securities Exchange Act of 1934 and (3) whether an advisor or related person receives compensation for client referrals.

- The new item 1 would require 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.

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.[8] The rule proposes three 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 would be expanded to cover exempt reporting advisers and foreign private advisers.

  - The rule would be amended to permit an adviser to pay any "regulated municipal advisor" to solicit government entities on its behalf. This amendment would be in addition to the class of SEC-registered advisers who are currently permitted to solicit government entities.

Next Steps

The SEC has requested comments on the proposed rules within 45 days of their publication in the Federal Register. After processing any such comments, the SEC may (i) re-open the comment period for the proposed rules as currently drafted, (ii) propose amended rules and re-open the

[8] 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.

comment period or (iii) adopt the rules either as drafted or as amended. Regardless of the approach taken, registration with the SEC won't be required until July 21, 2011, although advisers should anticipate an internal processing time of up to six months to prepare for registration with the SEC.

Please feel free to contact any of your regular contacts at the firm or any of our partners and counsel listed under Private Equity under the "Practices" section of our website if you have any questions.

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