

Client Memorandum

Final Rules for the Private Fund Investment Advisers Registration Act of 2010

August 8, 2011

The Securities and Exchange Commission (the "SEC") has adopted rules to implement the Private Fund Investment Advisers Registration Act of 2010 (the "Advisers Registration Act" or the "Act"), which was signed into law as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act"). The SEC's adoption of rules to implement the Act will have a significant effect on many private fund managers. Not only will many advisers that were previously exempt from registration be required to register, but certain advisers that will be exempt from registration will now be subject to SEC examination and reporting requirements (including a fund-by-fund reporting obligation under the modified Form ADV, Part 1A).¹ The SEC also amended its rule regarding political contributions (the "Pay-to-Play Rule") to provide that advisers taking advantage of certain new exemptions from registration are subject to the Pay-to-Play Rule.

This Memorandum discusses key issues for private fund managers regarding (i) registration under the Investment Advisers Act of 1940 (the "Advisers Act"); (ii) the rules regarding the new exemptions from registration under the Advisers Act; (iii) regulatory requirements for "Exempt Reporting Advisers"; (iv) private fund reporting on new Form ADV, Part 1A; and (v) additional changes to Form ADV.

Registration of Advisers to Private Funds

Under the Act, the minimum threshold for investment adviser registration has changed. There are two categories of advisers that are eligible for registration on Form ADV: (i) larger advisers, which are advisers with regulatory assets under management ("Regulatory AUM") of \$100 million or more and (ii) mid-sized advisers, which are advisers with Regulatory AUM between \$25 million and \$100 million and that (a) are not required to be registered in the state in which they maintain their principal office and place of business,² (b) are not subject to examination as investment advisers by such state;³ (c) are required to register in 15 or more states; or (d) are advisers to registered investment companies or business development companies. Larger advisers and mid-sized advisers that rely on exemptions in the state in which they have their principal place of business are required to register with the SEC unless an exemption from registration is available.

¹ An adviser with no place of business in the United States will either be required to register or be subject to SEC examination and reporting requirements if it cannot rely on the exemption for foreign private advisers. See "Exemptions from Registration— Exemption for Foreign Private Advisers" for a discussion of the Foreign Private Adviser Exemption. Additionally, advisers solely to "venture capital funds" as defined by Rule 203(l)-1 will be exempt from SEC registration. See "Exemptions from Registration—Exemption for Advisers to Venture Capital Funds" for a discussion of the Venture Capital Fund Exemption.

² See "Exemptions from Registration— Exemption for Foreign Private Advisers—Meaning of 'Place of Business' " for the definition of place of business.

³ The SEC contacted each state and has identified states without examination programs. Currently, advisers with their principal place of business in Minnesota, New York and Wyoming, with AUM between \$25 million and \$100 million, must register with the SEC (subject to any applicable exemptions).

In addition, the SEC will permit the following types of advisers to register under the Advisers Act: (i) nationally recognized statistical rating organizations; (ii) pension consultants; (iii) investment advisers affiliated with registered advisers; (iv) advisers expecting to be eligible for registration within 120 days of filing Form ADV; (v) multi-state advisers; and (vi) internet advisers.

Regulatory Assets Under Management

The SEC is requiring a single method of calculation for an adviser's assets under management for various purposes under the Advisers Act, including determining whether an adviser is eligible for SEC registration or for an exemption from registration. Form ADV, Part 1A will refer to "regulatory assets under management" to distinguish this amount from the assets under management reported in Part 2 of Form ADV. Under the Instructions to Item 5, "regulatory assets under management" are calculated by determining the market value of the securities portfolios to which the adviser provides continuous and regular supervisory or management services or the fair value of such assets where market value is unavailable.⁴ The definition requires advisers to calculate regulatory assets under management on a gross basis — advisers cannot deduct outstanding indebtedness or other accrued but unpaid liabilities, including accrued fees, expenses or the amount of any borrowing, from the calculation of regulatory assets under management. In contrast to the current Form ADV, the new definition of regulatory assets under management does not provide advisers with the option of excluding family or proprietary accounts or accounts for which the adviser receives no compensation for its services. The new method also requires managers to include in their Regulatory AUM any uncalled capital commitments to a private fund. As a result, Regulatory AUM will typically be different than the calculation advisers use in reporting their assets under management to their investors, and the adopting release⁵ notes that the word "regulatory" has been used to clarify that this calculation may be different than the calculation used by an adviser in its Form ADV, Part 2.

Transition to SEC Registration

The SEC has provided a transition period for advisers previously relying on the "private adviser" exemption from registration under Section 203(b)(3) of the Advisers Act.⁶ Any adviser relying on Section 203(b)(3) as of July 20, 2011, may delay registration with the SEC until March 30, 2012. In order to take advantage of the transition period, advisers relying on Section 203(b)(3) must have fewer than 15 clients for the 12 months preceding March 30, 2012 and must not hold themselves out generally to the public as an investment adviser or act as an adviser to a registered investment company or business development company during that period. Advisers seeking to register by March 30, 2012 must file Parts 1 and 2A of Form ADV by Feb. 14, 2012 to allow 45 days for SEC approval. Note that new advisers that begin managing assets after July 20, 2011 are not able to rely on the transition rule, though they may be able to take advantage of the Private Fund Adviser Exemption described below, which was effective July 21, 2011.

Each adviser registered with the SEC on Jan. 1, 2012 will be required to file an amendment on Form ADV by March 30, 2012 to report its Regulatory AUM and determine its eligibility to remain registered with the SEC. If the adviser is no longer eligible, it will have to withdraw its registration by June 28, 2012.

Additionally, Rule 203A-1 provides a buffer for advisers with Regulatory AUM close to \$100 million to determine when to switch between registration with a state authority and the SEC. An adviser *may* register with the SEC with Regulatory AUM of at least \$100 million, but *must* register with Regulatory AUM of \$110 million or greater. Once registered with the SEC, an adviser does not need to withdraw its registration until the adviser has less than \$90 million in Regulatory AUM.

⁴ An investment adviser that does not use generally accepted accounting principles ("GAAP") or another international accounting standard may rely on another process it uses for calculating fair value as long as it does so consistently and in good faith.

⁵ Securities and Exchange Commission Release No. IA-3221 available at <http://www.sec.gov/rules/final/2011/ia-3221.pdf>.

⁶ Rule 203-1(e).

State Registration Issues Raised by Transition to SEC Registration

Since Section 203(b)(3) of the Advisers Act was repealed at the beginning of the transition period, on July 21, 2011, advisers that are delaying their registration should evaluate the state registration requirements of the state in which their business is located.

New York's investment adviser registration regulations, for example, provide for an exemption from state registration for a person who is registered with the SEC or would be required to register with the SEC "were it not for the exemption under Section 203(b)(3)."⁷ Because the SEC transition rule applies to those advisers relying on Section 203(b)(3) as of July 20, 2011, such advisers will continue to be persons who would be required to register with the SEC "were it not for the exemption under Section 203(b)(3)" until the transition rule expires on March 30, 2012. In addition, advisers located in New York, including those that commence business on or after July 21, 2011, may rely on New York's de minimis exemption, which exempts from registration "a person who sells investment advisory services to less than six (6) persons in this state exclusive of financial institutions and institutional buyers."⁸

Exemptions from Registration

The Advisers Registration Act eliminated the "private adviser exemption" in Section 203(b)(3) of the Advisers Act, which exempted from registration managers who did not hold themselves out to the public as investment advisers and had fewer than 15 clients. Many investment advisers that have been exempt under Section 203(b)(3) will be required to register by March 30, 2012. However, the Act created three new exemptions from registration: (i) an exemption for an adviser that acts solely as an adviser to private funds that manages Regulatory AUM of less than \$150 million (if the adviser's principal place of business is in the United States) or that manages Regulatory AUM of less than \$150 million from a place of business in the United States (if the adviser's principal place of business is not in the United States);⁹ (ii) an exemption for an adviser that manages *only* venture capital funds; and (iii) an exemption for a foreign private adviser with de minimis U.S. investors, clients and assets. An adviser that is exempt from the registration requirements of the Advisers Act in reliance on the Private Fund Adviser Exemption or the Venture Capital Fund Exemption will still be subject to SEC examination and must comply with the new reporting requirements described in more detail below under "Exempt Reporting Advisers." The SEC will separately propose and adopt rules requiring Exempt Reporting Advisers to maintain records subject to examination in future releases.¹⁰

Exemption for Advisers that Manage Less Than \$150 Million in the United States (the "Private Fund Adviser Exemption")

The SEC adopted Rule 203(m)-1 to implement the exemption from registration for any investment adviser that acts solely as an adviser to qualifying private funds¹¹ and manages less than \$150 million from a place of business in the United States. Unlike the private adviser exemption that many managers have previously relied on (Section 203(b)(3)), under the new rules, the number of private funds managed is not relevant; only the aggregate Regulatory AUM and the fact that the manager acts solely as an adviser to qualified private funds. In the adopting release,¹² the SEC notes that there may be situations where a single investor fund may

⁷ N.Y. Comp. Codes R. & Regs. tit. 13, § 11.13(a)(6) (2011).

⁸ N.Y. Comp. Codes R. & Regs. tit. 13, § 11.13(a)(5) (2011).

⁹ The method for determining Regulatory AUM for the Private Fund Adviser Exemption is based on the location of the principal place of business of the adviser and the place from where the adviser manages client assets, not the location of the assets and is discussed in detail below in the section entitled "Exemption for Advisers with Less Than \$150 Million AUM in the United States."

¹⁰ See SEC Rel. No. IA-3221, fn. 163.

¹¹ Rule 203(m)-1(e)(5) defines a "qualifying private fund" as "any private fund that is not registered under Section 8 of the Investment Company Act of 1940, as amended (the "Investment Company Act"), and has not elected to be treated as business development company pursuant to Section 54 of that Act." Rule 203(m)-1 also includes in its definition of "qualifying private fund" any fund that qualifies for an exclusion from the investment company definition in Section 3 of the Investment Company Act; Section 3 includes certain real estate funds. An adviser relying on this exemption must treat the fund as a private fund under the Advisers Act and must comply with all the rules under the Advisers Act to rely on this exemption. "Private fund" is defined in the Advisers Act as an issuer that would be an investment company, as defined in Section 3 of the Investment Company Act, but for Section 3(c)(1) or 3(c)(7) of that Act. Only funds that are offered in the United States typically need to rely upon these exemptions.

¹² SEC Rel. No. IA-3222 available at <http://www.sec.gov/rules/final/2011/ia-3222.pdf>.

be a private fund depending on the facts and circumstances, but only provides two narrowly defined examples. The examples cited as being appropriate are when (i) a fund seeks to raise capital from multiple investors but only has a single, initial investor for a period of time or (ii) a fund has only one investor left as a result of redemptions. The SEC declined to provide comfort that single investor funds formed at the request of an investor would qualify as a private fund for purposes of the Private Fund Adviser Exemption.

The SEC has premised its approach in determining whether a manager advises solely qualifying private funds and the assets managed by an adviser in the United States¹³ based on the location of the principal office and place of business of the manager.¹⁴ Consequently, the adopted rule contains separate tests for U.S. advisers¹⁵ and non-U.S. advisers.¹⁶

- **U.S. Advisers.** The adopted rule presumes that a U.S.-based adviser manages all of its assets from the United States. Accordingly, a U.S. adviser must look at its U.S. and non-U.S. clients to determine whether it is eligible for the Private Fund Adviser Exemption. A U.S. adviser generally must count private fund assets in non-U.S. countries in determining its assets under management in the United States even if those funds are managed through affiliates located outside of the United States. So long as all of the adviser's clients are qualifying private funds and it manages less than \$150 million in the aggregate, a U.S. adviser can rely on the exemption.

An affiliated advisory entity may, in certain circumstances, be treated independently for purposes of determining whether it meets an exemption from registration. The SEC staff has provided guidance as to whether two advisory businesses are required to be integrated for registration purposes (See Richard Ellis, Inc., SEC Staff No-Action Letter (Sept. 17, 1981), which was later supplemented by the staff's position in the Unibanco line of no-action letters). There had been some concern that the staff's position in the Unibanco letters would be vacated because the letters were developed in the context of the private adviser exemption. The adopting release expressly states that nothing in the new rules is intended to withdraw the views expressed in the Unibanco letters.

- **Non-U.S. Advisers.** In contrast, under the rule, a non-U.S. adviser is required only to look at its clients managed from a U.S. place of business to determine whether it is eligible for the Private Fund Adviser Exemption.¹⁷ A non-U.S. adviser can rely on the exemption as long as all of the adviser's U.S. clients managed from a U.S. place of business are qualifying private funds and the Regulatory AUM of those private funds is less than \$150 million. A non-U.S. adviser seeking to rely on the Private Fund Adviser

¹³ This approach is different from the approach taken with respect to the Foreign Private Adviser Exemption, which looks at whether or not an adviser has a place of business in the United States and not whether assets are managed from the United States.

¹⁴ The SEC's long-standing position with respect to regulating the activities of non-U.S. advisers has been to follow a "territorial" approach that is based upon the agency's recognition that the non-U.S. activities of non-U.S. advisers are less likely to implicate U.S. regulatory interests and that non-U.S. advisers are less likely to participate in U.S. markets if it results in their global activities being subject to U.S. regulatory requirements. For instance, under the "private adviser exemption", only the United States clients of non-U.S. advisers with no U.S. place of business were counted for purposes of the client limit.

¹⁵ A "U.S. adviser" is an adviser with a principal office and place of business in the United States.

¹⁶ A "non-U.S. adviser" is an adviser with a principal office and place of business outside of the United States.

¹⁷ With respect to whether the activities of a non-U.S. adviser's U.S. office meet the "managed in the U.S." threshold, the adopting release cites to the definition of "continuous and regular supervisory or management services" that is found in the adopted new Form ADV: Instructions for Part 1A, Instruction 5.b(3). Under that definition, a non-U.S. adviser will be considered to be managing one or more funds or portfolios from the United States if its U.S. office (a) has discretionary authority over and provides ongoing supervisory or management services with respect to those funds or portfolios; or (b) does not have discretionary authority but has ongoing responsibility for selecting or making recommendations with respect to those funds or portfolios and is responsible for arranging or effecting the trades resulting from acceptance of those recommendations.

The Instructions indicate that the issue of whether continuous and regular supervisory or management services are being provided out of a particular location would be determined on a case-by-case basis, taking into account: (a) the terms of the relevant advisory agreement, i.e., is the U.S. office specifically mentioned and/or delegated certain functions; (b) the form of compensation, i.e., are U.S. office personnel compensated based on the performance of particular funds or portfolios; and (c) management practices, i.e., are there any funds or portfolios for which the personnel in the U.S. office perform the lion's share of the advisory work.

The adopting release notes that providing research or conducting due diligence at a U.S. place of business would not be viewed as continuous and regular supervisory or management services if a person outside of the United States makes independent investment decisions and implements those decisions.

Exemption could not advise any client from a U.S. place of business that is a U.S. person¹⁸ other than a private fund. Under the adopted rule, a client will not be considered a U.S. person so long as that person was not a U.S. person at the time of becoming a client of the adviser.

The business activities of a non-U.S. adviser outside of the United States have no bearing on the manager's ability to rely on the Private Fund Adviser Exemption. Specifically, non-U.S. advisers that manage U.S. private funds from non-U.S. locations are able to rely on the exemption, even if those U.S. private funds have \$150 million or more in assets. In addition, non-U.S. advisers may have non-U.S. managed account clients and/or non-U.S. managed fund clients that are not qualifying private funds and yet still qualify for the exemption because their non-U.S. activities are not taken into account for purposes of the exemption. Furthermore, a non-U.S. adviser does not need to manage one or more U.S. private funds to rely on this exemption.

- Timing of Regulatory AUM Calculation. While the proposed rule would have required managers to calculate whether they had crossed the \$150 million threshold on a quarterly basis, Rule 203(m)-1, as adopted, requires a manager to determine whether it has exceeded the \$150 million threshold on an annual basis. If the manager's Regulatory AUM managed from a place of business in the U.S. is \$150 million or more as reported on its Form ADV, the manager is no longer eligible for the Private Fund Adviser Exemption and will be required to register under the Advisers Act unless it qualifies for another exemption. Fluctuations in Regulatory AUM in between the filing of each annual updating amendment do not affect the availability of the Private Fund Adviser Exemption. An adviser could rely on the Private Fund Adviser Exemption if its Regulatory AUM fluctuates above the threshold during a year so long as its Regulatory AUM is less than \$150 million threshold at the time it is required to file its annual updating amendment.
- Timing of Registration. Advisers that have complied with their reporting requirements, which are discussed in detail below under "Reporting by Exempt Reporting Advisers," have up to 90 days after filing their annual updating amendment to apply for registration once the manager's Regulatory AUM is \$150 million or more as reported on its updated ADV. Accordingly, these managers will have up to 180 days after the end of the year that they cross the threshold to register.¹⁹ Managers that do not comply with their reporting requirements are not afforded this transition period. Additionally, an adviser that is no longer able to rely on the Private Fund Adviser Exemption by virtue of providing advice to clients other than qualifying private funds (e.g., managed accounts) is required to register prior to advising non-qualifying private fund clients.

Exemption for Advisers to Venture Capital Funds

Any investment adviser that acts solely as an adviser to venture capital funds is exempt from registration. Rule 203(l)-1 defines "venture capital fund" narrowly and was designed to distinguish venture capital funds from other types of private funds such as hedge funds and private equity funds.

- Definition of Venture Capital Fund. Specifically, a private fund will be considered a venture capital fund if all of the following criteria are met:
 - The fund represents itself as pursuing a venture capital strategy to investors and potential investors. The appropriate framework for analyzing whether a qualifying fund represents itself as pursuing a venture capital strategy depends on all of the relevant statements (and omissions) made by the fund to its investors and its prospective investors regarding its investment strategy.

¹⁸ The SEC defines "U.S. person" in this context by incorporating the definition of that term in Regulation S because "it would provide a well-developed body of law that would ... appropriately address many of the questions that will arise under Rule 203(m)-1." Under Regulation S, a discretionary account generally is treated as a U.S. person if the fiduciary (such as an adviser) is a U.S. person and as a non-U.S. person if the fiduciary is a non-U.S. person irrespective of the status of the account's owner. Regulation S generally looks to the residence of an individual to determine whether the individual is a U.S. person and in the case of entities, such as partnerships or corporations, looks to the country under whose laws the entity is organized or incorporated. In the case of a trust, Regulation S looks to the residence of the trustee. See *generally* 17 C.F.R. 230.902(k)(1) and (2).

¹⁹ Advisers must file their updating amendments within 90 days after the end of their fiscal year and then have another 90 days to register from the date of the filing of their updating amendment.

- The historical cost (or fair value) of the fund's non-qualifying investments (other than short-term holdings)²⁰ may not exceed 20 percent of the fund's capital commitments.²¹ Venture funds generally are required to pursue "qualifying investments,"²² which generally consist of equity securities issued by "qualifying portfolio companies."²³ A fund may use either historical cost or fair value to determine whether it satisfies the above limits for non-qualifying and qualifying investments, so long as the same method is applied to all investments of a qualifying fund in a consistent manner during the term of the fund. Only bona fide capital commitments may be included for the purposes of determining the 20 percent non-qualifying basket threshold.
- The fund does not utilize leverage except for limited short-term borrowing. The rule mandates that a venture capital fund must not borrow, issue debt obligations, provide guarantees or otherwise incur leverage in excess of 15 percent of its capital contributions and uncalled committed capital. Any borrowing, indebtedness, guarantee or leverage below this threshold must be for a non-renewable term of no longer than 120 calendar days. However, any guarantee by a fund of a qualifying portfolio company's obligations, up to the value of the fund's investment in the qualifying portfolio company, is not subject to the 120 calendar day limit.
- The fund provides investors with no liquidity rights, except in extraordinary circumstances. To qualify as a venture capital fund, a fund cannot permit investors to redeem or to withdraw securities, nor can it permit investors to require the repurchase of securities, except in "extraordinary circumstances," though pro rata distributions are permissible. The rule does not specifically define what constitutes "extraordinary circumstances," but, instead, provides several clarifying examples, and notes that whether or not a specific redemption or "opt out" right should be treated as "extraordinary" will depend on the particular facts and circumstances.²⁴
- The fund has not registered under or elected to be treated as a business development company pursuant to the Investment Company Act.
 - Grandfathering Provision. The rule contains a grandfathering provision that exempts from the definition of venture capital fund any private fund that: (i) represented itself to investors and potential investors as pursuing a venture capital strategy at the time the fund offered its securities; (ii) has sold securities to investors prior to Dec. 31, 2010; and (iii) does not sell any securities or accept additional capital commitments after July 21, 2011. Thus, a fund that

²⁰ "Short-term holdings" excluded from this 20 percent limit are cash and cash equivalents, U.S. Treasuries with a remaining maturity of 60 days or less and shares of registered money market funds that are regulated under Rule 2a-7 under the Investment Company Act.

²¹ The fund's compliance with the 20 percent limit is calculated at the time any non-qualifying investment is made and is based on the non-qualifying investments then held in the fund's portfolio and the fund's total capital commitments at the time the investment is made. A fund need only calculate the 20 percent limit when the fund acquires a new non-qualifying investment (other than short-term holdings). If a fund measures its 20 percent compliance based on the fair value of its non-qualifying investments, then it need not dispose of a non-qualifying investment simply because a change in value of investment puts it over the 20 percent threshold. However, such fund could not purchase additional non-qualifying investments until the value of its then-existing non-qualifying investments fell below 20 percent of the fund's committed capital.

²² "Qualifying investments" are generally equity securities that were acquired in one of three ways that suggest that the fund's capital is being used to finance the operations of the businesses rather than for trading in secondary markets. Rule 203(1)-1 defines a "qualifying investment" as: (i) any equity security issued by a qualifying portfolio company that is directly acquired by the private fund from the company ("directly acquired equity"); (ii) any equity security issued by a qualifying portfolio company in exchange for directly acquired equity issued by the same qualifying portfolio company; and (iii) any equity security issued by a company of which a qualifying portfolio company is a majority-owned subsidiary, or a predecessor, and that is acquired by the fund in exchange for directly acquired equity.

²³ A "qualifying portfolio company" is defined as any company that: (i) is not a reporting or foreign traded company and does not have a control relationship with a reporting or foreign traded 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 fund *in exchange for* the private fund investment; and (iii) is not itself a fund (i.e., is an operating company).

²⁴ Venture capital funds may provide extraordinary rights for an investor to withdraw from the fund under foreseeable but unexpected circumstances or to be excluded from particular investments due to regulatory or other legal requirements. These events may be "foreseeable" because they are circumstances that are known to occur (e.g., changes in law, corporate events such as mergers, etc.) but are unexpected in their timing or scope. Thus, withdrawal, exclusion or similar "opt-out" rights would be deemed "extraordinary circumstances" if they are triggered by a material change in the tax law after an investor invests in the fund, or the enactment of laws that may prohibit an investor's participation in the fund's investment in particular countries or industries. The trigger events for these rights are typically beyond the control of the adviser and fund investor (e.g., tax and regulatory changes).

commenced its offering by the end of 2010 and concluded such offering by July 21, 2011 may be exempt from registration even if it does not satisfy the elements of the new venture capital fund definition. This grandfathering provision affords pre-existing venture capital funds the benefit of exemption from SEC registration without requiring such funds to conform their investment strategies or fund terms to the standards set forth in the new definition.

- Non-U.S. Advisers. Under the rule, a non-U.S. adviser may rely on the venture capital exemption only if *all* of its clients, whether U.S. or non-U.S., are venture capital funds. Generally, only a fund that uses U.S. jurisdictional means in the offering of the securities it issues and that relies on Section 3(c)(1) or 3(c)(7) of the Investment Company Act qualifies as a private fund, and thus can be a venture capital fund if it meets the definition of a venture capital fund. However, under the rule, an adviser may treat as a “private fund” — and thus a venture capital fund, if it meets the rules’ other criteria — any non-U.S. fund that is not offered through the use of U.S. jurisdictional means but that would be a private fund if the issuer were to conduct a private offering in the United States. A non-U.S. fund that is treated as a private fund under these circumstances by an adviser relying on the venture capital exemption would also be treated as a private fund under the Advisers Act for all purposes, and thus would have to be reported in Item 7.B and Section 7.B of Schedule D of the adviser’s Form ADV, in accordance with the requirements for Exempt Reporting Advisers, which is discussed below under “Exempt Reporting Advisers.”
- Timing of Registration. An adviser that is no longer able rely on the Venture Capital Fund Exemption by virtue of providing advice to clients other than venture capital funds is required to register prior to advising those other funds unless another exemption is available.

Exemption for Foreign Private Advisers (the “Foreign Private Adviser Exemption”)

As noted above, the Act creates an exemption from SEC registration for foreign private advisers and defines “foreign private adviser,” as any investment adviser that:

- Has no place of business in the United States;
- Has, in total, fewer than 15 (a) clients in the United States and (b) investors in the United States in private funds managed by the adviser;
- Has less than \$25 million of Regulatory AUM attributable to (a) clients in the United States and (b) investors in the United States in private funds advised by the investment adviser;
- Does not hold itself out generally to the public in the United States as an investment adviser; and
- Does not act as an investment adviser to a registered investment company or a business development company.

Newly adopted Rule 202(a)(30)-1 clarifies the meaning and application of certain key terms in the Foreign Private Adviser Exemption.

- Counting Clients. The rule incorporates the safe harbor for counting clients currently in Rule 203(b)(3)-1, but modifies the rule to account for its use in the foreign private adviser context and eliminates the provision allowing advisers not to count those clients from which they receive no compensation. Under the new Foreign Private Adviser Exemption, a non-U.S. adviser can have a total of only 14 U.S. clients and U.S. investors in private funds managed by the adviser. The adviser can still have unlimited non-U.S. clients so long as the non-US clients that are private funds do not exceed the U.S. investor limitations.²⁵

²⁵ An adviser to a private fund would not be required to look through a non-U.S. entity investor and count U.S. persons that are equity holders of that non-U.S. entity towards the 15 investor threshold unless the non-U.S. entity was formed for the purpose of investing in

Like the former private adviser exemption, proposed Rule 202(a)(30)-1 allows a non-U.S. adviser to count as a single client (i) a natural person, its immediate family members and certain family-related and estate planning vehicles²⁶ and (ii) a vehicle to which the adviser provides investment advice based on its investment objectives.²⁷ To avoid double-counting, an adviser need not count a private fund as a client if the adviser counted one or more investors in that private fund as investors for purposes of the limit.

- In a significant departure from the former rule, the new rule eliminates the “special rule” that permitted advisers not to count as a client any person for whom the adviser provided investment advisory services without compensation. This is consistent with the inclusion of the assets of such clients in “regulatory assets under management.”
- Counting Private Fund Investors. As is noted above, new Advisers Act Section 202(a)(30) provides that, *inter alia*, in order to be exempt from SEC registration, a foreign private adviser cannot have more than 14 clients *and* investors in the United States in private funds advised by the adviser. The term “investor” was not previously defined in the Advisers Act or the underlying rules. New Rule 202(a)(30)-1 defines an investor in a private fund as including several different types of persons; knowledgeable employees are not included in the definition.²⁸
 - First, “investor” includes any person who would be included in determining the number of beneficial owners of the outstanding securities of a private fund under Section 3(c)(1) of the Investment Company Act, or who would be considered in determining whether the outstanding securities of a private fund are owned exclusively by “qualified purchasers” under Section 3(c)(7) of that Act. In order to avoid double-counting, an adviser would be permitted to treat as a single investor any person who is an investor in two or more private funds advised by it.
 - Second, an adviser must determine the number of investors in a private fund taking into account the prohibition in Section 208 of the Advisers Act against doing indirectly or through any other person, what it is unlawful to do directly. Thus, under certain circumstances, an adviser relying upon the exemption has to count as an investor a person who is not the nominal owner of the private fund’s securities. Such circumstances include the following:
 - In a master-feeder arrangement, the adviser to the master fund would treat as investors the holders of the units of any feeder fund formed to invest in the master fund;

the private fund. An adviser to a private fund with a non-U.S. fund of funds investor would count the fund of funds as a non-U.S. investor (regardless of the make-up of its equity holders) unless the fund of funds was formed for the purpose of investing in the private fund.

²⁶ Like the former Rule 203(b)(3)-1, new Rule 202(a)(30)-1 permits a non-U.S. adviser to treat as a single client a natural person and: (i) that person’s minor children (whether or not they share the natural person’s principal residence); (ii) any relative, spouse, or relative of the spouse of the natural person living at the same residence; (iii) all accounts of which the natural person and/or the person’s minor child or relative, spouse, or relative of the spouse who has the same principal residence are the only primary beneficiaries; and (iv) all trusts of which the natural person and/or the person’s minor child or relative, spouse, or relative of the spouse who has the same principal residence are the only primary beneficiaries.

²⁷ The new rule also retains the provisions of current Rule 203(b)(3)-1 that permit an adviser to treat as a single client (i) a corporation, general partnership, limited partnership, limited liability company, trust, or other legal organization to which the adviser provides investment advice based on the organization’s investment objectives; and (ii) two or more legal organizations that have identical shareholders, partners, limited partners, members, or beneficiaries. Rule 202(a)(30)-1(b)(1) - (3) also retains the current “special rules”: (1) an adviser must count a shareholder, limited partner, member or beneficiary (each, an “owner”) of a corporation, general partnership, limited partnership, limited liability company, trust or other legal organization, as a client if the adviser provides investment advisory services to the owner separate and apart from the legal organization; (2) an adviser is not required to count an owner as a client solely because the adviser, on behalf of the legal organization, offers, promotes, or sells interests in the legal organization to the owner, or reports periodically to the owners as a group solely with respect to the performance of or plans for the legal organization’s assets or similar matters; and (3) any general partner, managing member or other person acting as an investment adviser to a limited partnership or limited liability company must treat the partnership or limited liability company as a client.

²⁸ This is consistent with the pre-Dodd-Frank approach under which knowledgeable employees were not counted as beneficial owners of a fund for purposes of Section 3(c)(1), and are not required to be qualified purchasers under Section 3(c)(7).

- Any holder of an instrument, such as a total return swap, that effectively transfers the risk of investing in the private fund away from the nominal investor, would be counted as an investor for purposes of the Foreign Private Adviser Exemption.
 - Third, the new rule includes within the definition of investor those who own short term paper issued by the private fund and incorporates the broad definition of “short term paper” contained in Section 2(a)(38) of the Investment Company Act, which includes any note, draft, bill of exchange, or banker’s acceptance payable on demand or having a maturity at time of issuance not exceeding nine months. Under the Investment Company Act, such persons are not counted as beneficial owners for purposes of the exemption from registration under Section 3(c)(1) but are required to be qualified purchasers for purposes of the exemption under Section 3(c)(7).
- Meaning of “in the U.S.” The Foreign Private Adviser Exemption under Section 202(a)(30) of the Advisers Act employs the term “in the U.S.” in several contexts including: (a) limiting the number of, and Regulatory AUM attributable to, an adviser’s clients in the United States and investors in the United States in private funds advised by the adviser; (b) exempting only those advisers without a place of business in the United States and (c) exempting only those advisers that do not hold themselves out to the public in the United States as an investment adviser.²⁹
 - The SEC had added a note to paragraph (c)(2)(i) of new Rule 202(a)(30)-1 specifying that a person that is in the U. S. may be treated as not being in the U. S. if such person was not in the United States at the time of becoming a client or, in the case of an investor in a private fund, at the time the investor acquired the securities issued by the fund. This is intended to relieve non-U.S. advisers of the burden of having to monitor the location of clients and investors on an ongoing basis and possibly having to choose between registering with the SEC or terminating their relationships with any client or investor that moves to the United States.
- Meaning of “Place of Business.” A non-U.S. adviser seeking to utilize the Foreign Private Adviser Exemption cannot have a “place of business” in the United States. New Rule 203(a)(30)-1 defines “place of business” to mean any office where the 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. The SEC notes that a place of business in the United States would include: (i) any office from which an adviser communicates with clients; and (ii) an office or other location where an adviser regularly conducts research. The SEC also notes that, in contrast, an office where an adviser solely performs administrative services and back office activities would not be a “place of business” if such activities are not intrinsic to providing investment advisory services and do not involve communicating with clients. This is the definition that is used by both the SEC and state regulators for purposes of determining their regulatory jurisdiction pursuant to Section 222(d) of the Advisers Act, which states that a state may not require an adviser to register if the adviser does not have a place of business within, and has fewer than six clients resident in, the state.
- Calculation of Assets Under Management. Under the Foreign Private Adviser Exemption, a non-U.S. adviser must have less than \$25 million in Regulatory AUM attributable to clients in the United States and investors in the United States in private funds.³⁰
- Timing of Registration. An adviser that is no longer able to rely on the Foreign Private Adviser Exemption for any reason is required to register prior to becoming ineligible for the Foreign Private Adviser Exemption unless another exemption is available.

²⁹ The new rule defines “in the U.S.” in accordance with the established definitions under Regulation S with one significant exception: any discretionary account for the benefit of a U.S. person that is maintained outside of the United States is treated as if it were maintained in the United States if the non-U.S. adviser is a related person (i.e., an entity that is controlling, controlled by or under common control with) of the adviser claiming the Foreign Private Adviser Exemption. The SEC believes that this exception is necessary “in order to discourage non-U.S. advisers from creating such discretionary accounts with the goal of circumventing the exemption’s limitation with respect to persons in the U.S.” SEC Release at 117.

³⁰ See “Registration of Advisers to Private Funds—Regulatory Assets Under Management.” The definition does not permit the exclusion of accounts of clients who are not U.S. persons; however, this provision would have little or no impact on the \$25 million threshold under the Foreign Private Adviser Exemption, which applies only to clients in the United States.

Impact on Subadvisers and Affiliates

The rules state that subadvisers will be eligible to rely on the above exemptions to the extent that they satisfy their conditions with respect to the funds and/or managed accounts to which they provide advisory services. The SEC notes that advisers with advisory affiliates “will encounter interpretative issues” as to whether those affiliates’ activities need to be taken into account for purposes of determining the adviser’s compliance with the conditions of a particular exemption and states that such issues will be resolved under a facts and circumstances approach.³¹

In the past, the SEC staff stated that certain affiliates of a registered investment adviser may rely on the registered adviser’s status if the affiliate is subject to the adviser’s supervision and control and is subject to the requirements of the Advisers Act.³² It follows that a similar analysis would allow certain affiliates of exempt advisers to rely on the exempt adviser’s status with respect to the Advisers Act. Further interpretative guidance from the SEC may be forthcoming on this issue.

Optional Nature of Exemptions

None of the above exemptions are mandatory. Notwithstanding its qualification for one of the above exemptions, an adviser could elect to register (or remain registered) with the SEC if it has the requisite Regulatory AUM under Section 203A of the Advisers Act, which is generally \$100 million subject to certain exceptions. For non-U.S. advisers, Regulatory AUM for foreign clients count toward the minimum threshold.

Exempt Reporting Advisers

Examination and Recordkeeping Requirements

The SEC has created the new category of “Exempt Reporting Advisers,” which consists of advisers relying on the Private Fund Adviser Exemption and the Venture Capital Fund Exemption. Exempt Reporting Advisers have not been specifically exempted from the requirement to register under Section 203(b) of the Advisers Act. Accordingly, the SEC has authority to require them to maintain records and provide reports and examine their records under Section 204(a). The SEC does not anticipate that its staff will examine Exempt Reporting Advisers on a regular basis, but the staff will conduct “cause” examinations of Exempt Reporting Advisers prompted by tips, complaints and referrals. The new rules describe the initial reporting requirements for Exempt Reporting Advisers, but do not specify the records required to be kept for SEC examination purposes.³³ The SEC will address recordkeeping requirements for Exempt Reporting Advisers in future rulemaking.

Reporting Requirements

Rule 204-4 requires Exempt Reporting Advisers to file the SEC’s new Form ADV, Part 1A (“Uniform Application for Investment Adviser Registration and Report by Exempt Reporting Advisers”), which will be publicly available via the SEC’s website. However, unlike registering or registered advisers, Exempt Reporting Advisers only have to respond to the following items on Form ADV, Part 1A:

- Item 1 (Identifying Information);
- Item 2.B (SEC Reporting by Exempt Reporting Advisers);
- Item 3 (Form of Organization);

³¹ See above in the section “Exemptions From Registration — Exemption for Advisers with Less Than \$150 Million AUM in the United States — U.S. Advisers” regarding the Richard Ellis and Unibanco no action letters.

³² Letter from SEC staff to the ABA Subcommittee on Private Investments Dec. 8, 2005.

³³ Exempt reporting advisers also remain subject to examination under Section 206 of the Advisers Act, the antifraud provisions of the Advisers Act.

- Item 6 (Other Business Activities);
- Item 7 (Financial Industry Affiliations and Private Fund Reporting);
- Item 10 (Control Persons);
- Item 11 (Disciplinary Disclosure); and
- the corresponding sections of Schedules A, B, C and D.

Exempt Reporting Advisers do not have to complete the other Items in Part 1A or prepare a client brochure (Form ADV, Part 2). However, Item 7.B and its related Schedule D section have been expanded to require significantly more types of information regarding private funds advised by Exempt Reporting Advisers.³⁴ It is important to note that advisers whose principal office and place of business is outside of the United States are permitted to omit from Item 7.B information for any private fund that is not organized in the United States and that is not offered to or owned by U.S. persons (other than those funds that are treated as private funds for purposes of the Venture Capital Fund Exemption).

An Exempt Reporting Adviser is required to file its initial report on Form ADV by March 30, 2012. Advisers would need to update their Form ADV filings based on the same deadlines as registered advisers, which generally calls for an annual update with prompt updates to information in Items 1, 3 and 11 as it changes and to Item 10 if it becomes materially inaccurate.

The SEC Chairman indicated, in connection with the adoption of the new rules relating to Exempt Reporting Advisers, that the SEC will reconsider the reporting requirements of Exempt Reporting Advisers one year after the first reports are filed.

Adviser Reporting Requirements Regarding Private Funds

The SEC significantly amended Item 7.B and Section 7.B of Schedule D of Form ADV, Part 1A, the form that serves as the application for investment adviser registration. Under their current versions, these parts of the form require advisers to identify and provide certain information, such as assets under management for each “investment-related limited partnership” that the adviser or a related person advises. The amendment requires advisers to provide information on “private funds” and expands the amount of information required to be reported by adding basic organizational, operational and investment characteristics of each private fund, the nature of the investors in the fund, and the fund’s service providers. The amendment does not require advisers to report on private funds advised by related persons.³⁵

- As amended, Part A of Section 7.B requires:
 - Basic identifying information about the fund (including the name of the fund, the jurisdiction in which it was organized and the name(s) of the fund’s general partner, directors or persons serving in a similar capacity);
 - Operational and structural information (including the strategy of the fund and whether it is part of a master-feeder arrangement);
 - The Investment Company Act exemption on which it relies;
 - The name of any foreign regulatory authority with which the fund has registered;

³⁴ See “Adviser Reporting Requirements Regarding Private Funds” for a discussion of the changes to Item 7.B and its related Schedule D.

³⁵ To the extent that an adviser files on behalf of multiple related entities, information regarding the private funds advised by those entities will be incorporated into the response to Item 7.B.

- The type of private fund (hedge fund, liquidity fund, private equity fund, real estate fund, securitized asset fund, venture capital fund or other type of fund);
 - The gross asset value of the fund;
 - The minimum investment amount;
 - The approximate number of beneficial owners; and
 - The approximate percentage of the fund owned by the investment adviser or related persons, by fund of funds and by non-United States persons.
- As amended, Part B of Section 7.B requires identifying and other information on the fund's service providers, including auditors, prime brokers, custodians, administrators and marketers.

To avoid multiple reporting for certain private funds, the SEC will permit a sub-adviser to exclude private funds that are the subject of reporting by another adviser on Schedule D and will permit an adviser sponsoring a master-feeder arrangement to complete a single Schedule D for the master fund and its feeders if the information is substantially identical for all feeder funds (and if the feeder funds do not use a prime broker or custodian).

As amended, advisers must complete Section 7.B. of Schedule D for each private fund they (and not a related person) advise. If a private fund has issued two or more series (or classes) of equity interests whose values are determined with respect to separate portfolios of securities and other assets, then each series (or class) should be regarded as a separate private fund if the separate classes are managed as if they are separate funds.

Additional Changes to Form ADV

The SEC has made a number of changes to Form ADV, Part 1A in addition to the reporting requirements regarding private funds. The changes are intended to provide the Commission with additional information necessary to effectively run its regulatory program. The amendments are in addition to the previously adopted amendments to Part 2 of Form ADV.

The other amendments to Form ADV include the following changes.

- Advisers will be asked in Item 1.O. if they had \$1 billion or more in total assets as of the last day of its most recent fiscal year. The question specifically addresses the adviser's total assets and not the net asset value of clients advised by the adviser. This question has been added to Form ADV, Part 1A pursuant to Section 956 of the Dodd-Frank Act which requires oversight with respect to incentive compensation arrangements for certain firms, including investment advisers with \$1 billion or more in total assets.
- Advisers will be asked to provide contact information for their chief compliance officer in Item 1.J with the option to provide an additional contact in Item 1.K. An adviser also will have to disclose any of its control persons that are public reporting companies under the Exchange Act.
- Item 2, which requires each applicant to indicate its basis for registration, will be revised to reflect the new thresholds and other revisions resulting from the Act.
- The modifications to Item 5 of Part 1A expand the scope of the information the SEC collects from advisers regarding their business, types of services provided and types of clients. Advisers will be required to disclose exact numbers in response to questions regarding their employees (as opposed to checking of a range of numbers). The list of types of clients will be expanded to include business development companies, insurance companies, other investment advisers and pension and profit-sharing plans, and advisers will have to report the percentage (in 25 percent segments) of regulatory assets under management attributable to each type of client. The list of advisory activities in Item 5.G. will be expanded

to include “portfolio management for pooled investment vehicles, *other* than registered investment companies” to accurately capture alternative asset managers. Advisers will also be asked to select from a list the types of investments about which they provide advice, which will be similar to, but more expansive than, the list included in Item 3 of the old Form ADV, Part 2.

- The changes to Items 6 and 7 of Part 1A expand the types of businesses in which the adviser and its related persons may indicate they are actively engaged (e.g., accountant, lawyer, trust company, registered municipal advisor, registered security-based swap dealer, or major security-based swap participant). In addition the SEC will require additional reporting in the corresponding section of Schedule D including listing other names under which the adviser engages in non-advisory business and additional identifying information about related persons listed in Item 7.A. In contrast, the previous requirements only required identifying information about related persons that were investment advisers or broker dealers. An adviser may exclude certain related persons from Section 7.A of Schedule D if: (1) the adviser has no business dealings with the related person in connection with advisory services it provides to its clients; (2) the adviser does not conduct shared operations with the related person; (3) the adviser does not refer clients or business to the related person, and the related person does not refer prospective clients or business to the adviser; (4) the adviser does not share supervised persons or premises with the related person; and (5) the adviser has no reason to believe that its relationship with the related person otherwise creates a conflict of interest with its clients.
- The amendments to Item 8, which requires disclosure about an adviser’s participation in its client’s transactions, require an adviser to disclose whether the brokers or dealers it uses are related persons. Additionally, an adviser is required to report whether all of its soft dollar benefits qualify for the safe harbor under Section 28(e) of the Securities and Exchange Act of 1934 and whether it or a related person receives direct or indirect compensation for client referrals.
- Advisers will be asked to disclose the total number of persons that act as qualified custodians for their clients in Item 9.F.
- The SEC also made three technical changes to reporting of disciplinary events, including correcting a drafting error in connection with Item 3.D of Part 2B (the “Brochure Supplement”) to require disclosure of the revocation or suspension of a professional attainment, designation or license by the designating authority, as opposed to just revocations or suspensions by government authorities or self-regulatory organizations.

Summary of Exemptions to Registration

Exemption	ADV Part 1A Reporting Requirements	Subject to SEC Examination	Subject to SEC Pay-to-Play Rule
Private Fund Adviser	Yes	Yes	Yes
Venture Capital Fund	Yes	Yes	Yes
Foreign Private Adviser	No	No	Yes

Authored by [Paul N. Roth](#), [Josh Dambacher](#), [Ida Wurczinger Draim](#), [Marc E. Elovitz](#), [Jason S. Kaplan](#), [David K. Momborquette](#) and [Phyllis A. Schwartz](#).

If you have any questions concerning this *Memorandum*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

New York

Schulte Roth & Zabel LLP
919 Third Avenue
New York, NY 10022
+1 212.756.2000
+1 212.593.5955 fax

Washington, DC

Schulte Roth & Zabel LLP
1152 Fifteenth Street, NW, Suite 850
Washington, DC 20005
+1 202.729.7470
+1 202.730.4520 fax

London

Schulte Roth & Zabel International LLP
Heathcoat House, 20 Savile Row
London W1S 3PR
+44 (0) 20 7081 8000
+44 (0) 20 7081 8010 fax

www.srz.com

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