SEC ADOPTS NEW ADVISERS ACT RULES AND IMPLEMENTS REGISTRATION EXEMPTION

GOODWIN PROCTER CLIENT ALERT - JUNE 30, 2011

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GOODWIN PROCTER

1. SEC Adopts New Advisers Act Rules and Implements Registration Exemptions - Intro

Who Will Be Affected?

A wide range of U.S. and non-U.S. investment advisers, particularly managers of hedge, venture capital, private equity, real estate and other privately offered funds.[1]

When Do the New Rules Take Effect?

In general, obligations under the new rules take effect as of March 30, 2012, but advisers who are required to register with the SEC will need to file their registration paperwork no later than February 14, 2012. Until March 30, 2012, as a practical matter, there will be a registration exemption for any adviser with "fewer than 15 clients" that does not hold itself out to the public as an investment adviser or advise U.S. registered mutual funds or business development companies (i.e., similar to the current exemption). Mid-sized advisers that will be required to switch from federal to state registration will be required to withdraw at the federal level by June 28, 2012. Between January 1 and March 30, 2012 all advisers must file a Form ADV to determine their eligibility for SEC registration, and after January 1, 2012 all filings must be on Form ADV as amended in connection with the new rules. All advisers should pay careful attention to the effective dates and requirements during the upcoming transition period, as discussed below.

2. Executive Summary

On June 22, 2011, the Securities and Exchange Commission (the "**SEC**") adopted final rules under the Investment Advisers Act of 1940 (the "**Advisers Act**") relating to provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**"). These new rules implement and clarify the provisions of the Dodd-Frank Act that will require previously exempt advisers, including many advisers to private investment funds, to register as investment advisers or to become "exempt reporting advisers" ("**ERAs**"), and satisfy new compliance obligations. The new registration obligations result primarily from the Dodd-Frank Act's deletion of the "fewer than 15 clients" adviser registration exemption (Advisers Act Section 203(b)(3)). The SEC adopted the new rules in two rule releases that focused on defining and clarifying the Advisers Act registration exemptions adopted under the Dodd-Frank Act (the "Exemptive Release") and implementing those exemptions (the "Implementing Release").

For the most part, the new rules are similar to the rules proposed November 19, 2010, with four principal modifications: (1) as a practical matter, compliance generally has been delayed from July 21, 2011 to March 30, 2012; (2) venture capital funds will have more flexibility under the new rules, including an ability to make non-conforming investments, subject to a 20% basket; (3) non-U.S. firms that deal with U.S. clients or U.S. fund investors may benefit from the continuing ability to avoid integrating a registered U.S. adviser and an affiliated, unregistered non-U.S. adviser under the *Unibanco* line of no-action letters (discussed here), although the future application and interpretation of prior guidance under the new rules remains undetermined; and (4) the new rules

[1] Family offices may also be affected by separate new rules that were discussed in Goodwin Procter's June 23, 2011 Client Alert.

apply a more uniform test to measure "assets under management" both to make determinations regarding registration and to satisfy other regulatory requirements.

Key elements of the new rules are as follows:

- *Foreign Private Adviser Exemption.* For non-U.S. advisers, the new rules adopt key definitions and clarifications for the so-called "**Foreign Private Adviser Exemption**"; however, the exemption likely will be of limited benefit for most non-U.S. advisers dealing with U.S. clients or fund investors. The Foreign Private Adviser Exemption is only available to an adviser that has no place of business in the U.S. and that does not hold itself out to the public in the U.S. as an adviser. Moreover, the adviser must have *both* (1) fewer than 15 clients (or investors in "private funds"[2]) in the U.S. and (2) aggregate assets under management attributable to clients (or investors in private funds) in the U.S. of less than $25 million.

- *"Exempt Reporting Advisers" or "ERAs".* The new rules establish exemptions and key definitions (1) for advisers whose clients are all "venture capital funds" and (2) for certain "private fund advisers" with less than $150 million in assets under management in the U.S. While exempt from registration, these advisers will be ERAs and required to file portions of Part 1 of Form ADV. The SEC will have examination authority over ERAs (although the SEC indicated it does not intend to conduct routine examinations of them).

    - *Registration Exemption for "Venture Capital Fund" Advisers.* The "**Venture Capital Exemption**" applies to advisers whose only clients are "venture capital funds." The new rules generally seek to distinguish a venture capital fund from a hedge, private equity or fund-of-funds by imposing limits on a venture capital fund's structure (e.g., limits on redemption provisions and leverage), the type of investments it may make and the type of companies in which it may invest, subject to an overall "basket" for non-conforming investments capped at 20% of fund capital. The rules also require that a venture capital fund represent to current and prospective investors that it pursues a venture capital strategy. Broad "grandfather" relief is provided with respect to pre-existing funds that have made similar representations as to pursuit of a venture capital strategy. The new rules permit venture capital funds much greater flexibility than the proposed rules, with the result that many more advisers are expected to qualify for this exemption. Advisers relying on the Venture Capital Exemption will be ERAs.

    - *Registration Exemption for "Private Fund" Advisers.* U.S.-based advisers with less than $150 million in total assets under management in "private funds" (and no other clients) will be able to use the "**Private Fund Adviser Exemption.**" Non-U.S.-based advisers with less than $150 million in assets under management *in the U.S.* in private funds (and no other *U.S.* clients) will also be able to use the Private Fund Adviser Exemption. Accordingly, the exemption's primary beneficiaries will

[2] Under Advisers Act Section 202(a)(29), the term "private fund" means "an issuer that would be an investment company, as defined in section 3 of the [Investment Company Act of 1940], but for section 3(c)(1) or 3(c)(7) of that Act." As discussed elsewhere in this Alert, a fund organized outside the U.S. that does *not* use U.S. jurisdictional means to conduct an offering (and, in particular, does not offer interests to U.S. persons) generally would not be a "private fund" for this purpose, under the SEC's prior interpretation of the Investment Company Act of 1940. (See *Advisers Act Release No. IA-3222 FN 294*.)

likely be non-U.S. advisers that do not manage any assets at a U.S. place of business and whose only U.S. clients are "private funds." Advisers relying on the Private Fund Adviser Exemption will be ERAs.

- *Calculating "Assets Under Management" and Its Implications*. The SEC adopted a new methodology for calculating "assets under management" that applies to determine eligibility for the various exemptions and is the basis for certain disclosures under Form ADV. The methodology is based on the gross assets in "securities portfolios" for which the adviser provides "continuous and regular supervisory or management services," and includes both proprietary and non-fee bearing assets.

- *State vs. Federal Registration*. As advisers determine their obligations to file at the state vs. federal level, new transition rules, assets under management thresholds and other provisions apply. ERAs to venture capital and private funds with total assets under management under $100 million will likely not benefit from state law registration exemptions applicable to "federal covered advisers." Such ERAs may be subject to state adviser registration unless the applicable state law provides an alternative exemption. However, NASAA, the organization for state securities administrators, has proposed a model rule creating an exemption from state registration for certain of these ERAs.

- *Other Matters*. The SEC also: (1) updated Form ADV primarily to include "private fund" disclosures and "exempt reporting adviser" reporting obligations, which are marginally less detailed than originally proposed; (2) indicated that Form PF will be finalized later this year; and (3) revised the "pay to play" rule to cover ERAs and foreign private advisers, and to add certain municipal advisers as permitted solicitors.

3. Timing and Exemptions During the Next Year

Effective as of July 21, 2011, the Dodd-Frank Act eliminated Section 203(b)(3) of the Advisers Act (commonly referred to as the "private adviser" exemption), which provided a federal registration exemption for any adviser that: (1) had fewer than 15 clients over the prior 12 months; (2) did not hold itself out to the public as an investment adviser; and (3) did not act as an investment adviser to a registered investment company or a business development company. In place of the private adviser exemption, the Dodd-Frank Act created several new exemptions. Effecting and implementing those new exemptions required the new SEC rules that were adopted last week in the Exemptive and Interpretive Releases (the "**new rules**").

To provide advisers with additional time to comply with the new rules, the SEC adopted transition rules which generally provide that advisers have until March 30, 2012 to come into compliance with the revised Advisers Act registration and reporting requirements. Generally, these transition rules are most significant for: (1) advisers previously exempt from registration under the private adviser exemption that are no longer exempt under the new rules; (2) currently registered advisers ("**RIAs**") that have new reporting obligations (particularly with respect to "private funds"); (3) advisers who require a period of time to meet one of the new registration exemptions adopted under Dodd-Frank; and (4) advisers no longer eligible to remain registered with the SEC.

Previously Exempt Advisers. The transition rules permit an adviser relying on the legacy private adviser exemption on July 20, 2011, to delay registering with the SEC until March 30, 2012, so long as the adviser: (1) during the course of the preceding 12 months, had fewer than 15 "clients"; and (2) neither holds itself out generally to the public as an investment adviser, nor acts as an investment adviser to a registered investment company or a business development company. For these purposes, in accord with the 2006 decision in *Goldstein v. Securities and Exchange Commission*, each "private fund" is generally treated as a single "client."

Existing RIAs. As part of the transition process for the Dodd-Frank Act related changes to Advisers Act exemptions and the implementation of the new rules, all advisers registered on January 1, 2012, regardless of their fiscal year end, will be required to file an amendment to their Form ADV on revised Form ADV by March 30, 2012. After January 1, 2012, any adviser filing an amendment to Form ADV will be required to provide responses to revised Form ADV, which includes more detailed disclosures regarding private funds (as discussed here). After the online IARD registration system is updated to reflect the revised Form ADV (which is currently expected to occur in late 2011), all new registrants must complete the revised form.

Exempt Reporting Advisers or ERAs. ERAs are not required to register as investment advisers with the SEC, but are required to file certain parts of Form ADV Part 1 each year. ERAs must file their initial reports on Form ADV Part 1 through the online IARD system between January 1 and March 30, 2012. The Exemptive Rules are effective July 21, 2011, and ERAs may begin relying on them as of such date.

RIAs No Longer Eligible to Register with the SEC. Mid-sized RIAs (generally, RIAs with assets under management between $25 million and $100 million) must file their amendment to Form ADV no later than March 30, 2012 and, with certain limited exceptions, must withdraw their registration with the SEC by June 28, 2012 and transition their registration to the appropriate state securities authorities in accordance with applicable state laws.

4. Foreign Private Adviser Exemption

"Foreign private advisers" are exempt from registration under the Advisers Act. A "foreign private adviser" is an investment adviser that: (1) has no *place of business* in the U.S.; (2) has, in total, fewer than 15 *clients and investors in the U.S.* in private funds advised by the adviser; (3) has less than $25 million of aggregate assets under management attributable to such clients and investors;[3] and (4) neither holds itself out generally to the public in the U.S. as an investment adviser nor advises mutual funds or business development companies.

The new rules, which were adopted substantially as proposed, define or explain the following terms that are central to the definition of "foreign private adviser":

"Place of Business." The "place of business" of an investment adviser is defined as (1) an office at which the adviser regularly provides investment advisory services, solicits, meets with, or otherwise communicates with clients; and (2) any other location that is held out to the general public as a location at which the adviser conducts any such activities. This definition leverages an existing regulation but, in

[3] The Advisers Act authorizes the SEC to raise this $25 million threshold if it deems appropriate, and the SEC has indicated that it will evaluate whether it is appropriate to do so in the future.

response to comments, the SEC clarified that an office at which an adviser regularly communicates with its clients, whether U.S. or non-U.S., or an office where an adviser regularly conducts research, would qualify as a "place of business." However, an office at which the adviser solely provides administrative and back-office activities would not qualify as a "place of business," if such activities are not intrinsic to providing investment advisory services and do not involve communicating with clients. Accordingly, whether an investment adviser has a place of business in the U.S. is dependent on the relevant facts and circumstances, and not all offices will constitute a "place of business."

"Client." The new rules provide a safe harbor for purposes of counting clients of a foreign private adviser. A foreign private adviser may deem the following to constitute a single "client": (1) a natural person, together with such natural person's minor children (regardless of whether they share the same principal residence), relatives, spouse, spousal equivalent or relative of the spouse or spousal equivalent, in each case who has the same principal residence as such natural person, and accounts and trusts for which such natural person and/or the foregoing persons are the only primary beneficiaries; and (2) a partnership, limited liability company, corporation or other legal organization (or two organizations with identical ownership) to which the adviser provides advice based on the organization's investment objectives, rather than the individual objectives of the organization's owners.

An adviser is not permitted to disregard a person as a "client" because the adviser provides services for such person without compensation.

A general partner or managing member or similar person acting as an investment adviser to a partnership or limited liability company is required to count the partnership or limited liability company as a "client."

To avoid double counting: (1) an adviser is not required to count a private fund as a client if it counts an investor in the private fund as a client; (2) an adviser is not required to count a person as an investor in a private fund if it counts the private fund as a client; and (3) an adviser may count an investor in two private funds advised by the investment adviser as a single "investor."

The new rules are non-exclusive safe harbors, and there may be other situations in which multiple persons constitute a single "client."

"Investor." An "investor" of a private fund generally includes a classic "limited partner" or "shareholder" (of an offshore fund), as well as any other person who would be taken into account when determining whether the private fund came within the exclusions from the definition of "investment company" under Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act of 1940 (the "**1940 Act**"), except that holders of short-term paper[4] issued by a private fund count as "investors" (even if they are not counted for purposes of Section 3(c)(1) or Section 3(c)(7)). In a change from the proposed rules, knowledgeable employees of

[4] "Short-term paper" means "any note, draft, bill of exchange, or banker's acceptance payable on demand or having a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof payable on demand or having a maturity likewise limited; and such other classes of securities, of a commercial rather than an investment character, as the SEC may designate by rules and regulations."

an adviser do *not* count as investors. Accordingly, a foreign adviser with senior managers based in the U.S. who qualify as knowledgeable employees does not need to count such managers as investors, but should consider whether it may need to count holders of short-term paper as investors. Advisers should determine the number of investors in a private fund based on the facts and circumstances and in light of the general prohibition on doing indirectly what cannot be done directly. Accordingly, an adviser may be required to "look through" certain intermediate accounts through which investors invest in a private fund. By way of example, holders of interests in feeder entities within a master-feeder structure would be counted as investors in the master fund.

"In the U.S." A place of business is treated as being "in the U.S." if it is treated as located in the "United States" as defined in Regulation S. An investor or client generally is treated as being "in the U.S." if that investor or client is a "U.S. person" for purposes of Regulation S, except with respect to certain discretionary or similar accounts that are held for the benefit of U.S. persons by certain non-U.S. dealers or other non-U.S. professional fiduciaries. However, if a person was not actually in the U.S. at the time the person became an investor or client (including each time that an investor in a private fund acquires securities in such fund), that person may be treated for purposes of this rule as not being in the U.S. Under this exception, if subscriptions for private fund interests were submitted and accepted such that the applicable securities were acquired when the applicable investors were outside the U.S., those investors (and the related subscription amounts) would be excluded from the adviser's assets and investors attributable to the U.S. even if, for example, the investors subsequently relocated to the U.S. (although future subscriptions or future acquisitions of securities would be analyzed by reference to the location of the investors at the time such subscriptions were submitted and accepted). The SEC has indicated that if an adviser reasonably believes that an investor or client is not "in the U.S." at the time that they became an investor or client then the adviser can treat such investor or client as not being "in the U.S."

The chart available here summarizes certain registration and ERA reporting requirements that may be relevant to non-U.S. advisers.

5. "Exempt Reporting Advisers" or "ERAs"

Advisers who elect to be ERAs will not be required to register with the SEC, but they will be subject to reporting, recordkeeping and other obligations, such that their compliance obligations may be material and grow over time. In addition to compliance requirements that apply to advisers regardless of their registration status (e.g., Advisers Act anti-fraud provisions), ERAs must file a portion of Form ADV, have and enforce policies and procedures to prevent the misuse of material, nonpublic information, and comply with the Advisers Act "pay to play" rule, and may be subject to specific recordkeeping requirements. ERAs are subject the SEC's examination authority.

Form ADV Filing Obligation. The Implementing Release provides that ERAs must file their initial Form ADV between January 1, 2012 and March 30, 2012. After March 30, new ERAs must file within 60 days of relying upon the Venture Capital Exemption or the Private Fund Adviser Exemption. ERAs must file the same Form ADV as RIAs, although ERAs need only respond to certain specified items and questions. Notably, an ERA must attest that it qualifies for either the Venture Capital Exemption or the Private Fund Adviser Exemption. Furthermore, the SEC rejected suggestions by commentators that some or all of this information receive confidential treatment – for now at least, the information will be publicly available online.

- *Required Information*. Although ERAs will not file a full Form ADV, the required ADV filing will disclose significant information regarding the adviser and its business. ERAs will be required to complete Form ADV Items 1 (Identifying Information), 2.B (SEC Reporting by Exempt Reporting Advisers), 3 (Form of Organization), 6 (Other Business Activities), 7 (Financial Industry Affiliations and Private Fund Reporting), 10 (Control Persons) and 11 (Disclosure Information), along with the corresponding sections of Schedules A, B, C and D. Answers to these items will disclose basic information about the adviser, details about the private funds it advises (name, domicile, investment strategy, gross assets, etc.), other business interests of the adviser and its affiliates, and disciplinary history of the adviser and its employees. For more details on the specific disclosure that will be required please see: (1) the discussion below on Amendments to Form ADV; and (2) a version of the Form ADV that has been highlighted to show the provisions most relevant to ERAs, which is available here.

- *Public Availability of Reports*. In the Implementing Release, the SEC reiterated its decision that, under the Advisers Act, reports filed with the SEC must be made available to the public unless the SEC decides the disclosure of such information is "neither necessary nor appropriate in the public interest or for the protection of investors."[5] Therefore, all of the information filed by ERAs on Form ADV will be available to the public through IARD.

- *Updating Requirements*. An ERA will be required to update its Form ADV on the same timetable and for the same reasons as a registered investment adviser: at least annually within 90 days of the end of the adviser's fiscal year, and more frequently for material developments as required by the instructions to Form ADV.

- *Ongoing Reporting Obligations*. In Chairman Mary Schapiro's Opening Statement during last week's open meeting, she announced that she has directed the SEC staff to reconsider the information the SEC collects from ERAs after the SEC receives and assesses the first year's ERA filings (although this direction does not appear explicitly in last week's rule releases). During the same open meeting, a majority of the Commissioners voted in favor of the ERA reporting requirements, but the two dissenting Commissioners expressed concern about the extent of ERA reporting obligations and the possibility that, particularly over time, and in light of the SEC's examination authority over ERAs, there may be no meaningful distinction between ERA and RIA reporting obligations .

Recordkeeping Requirements. Section 204 of the Advisers Act requires investment advisers to make and keep such records and to make and disseminate such reports as the SEC may prescribe by rule. There is an express exemption for advisers exempt under Section 203(b) (such as foreign private advisers) but not for ERAs. Accordingly, ERAs could be subject to SEC recordkeeping requirements, and the SEC will have the authority to examine such records. Specific recordkeeping obligations, which could significantly increase ERAs' compliance costs, have not been established, but could be the subject of future SEC rulemaking.

[5] Please see the Implementing Release, page 49.

Policies Regarding Material Non-Public Information ("MNPI"). Section 204A of the Advisers Act includes a general requirement that all advisers subject to Section 204 (which now includes ERAs) "establish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of such investment adviser's business, to prevent the misuse in violation of this Act or the Securities Exchange Act of 1934, or the rules or regulations thereunder, of material, nonpublic information by such investment adviser or any person associated with such investment adviser." ERAs should consider the nature of their businesses and establish appropriate written policies designed to prevent the misuse of MNPI.

SEC Examination. The new rules do not *require* ERAs to undergo routine SEC compliance examinations. However, the Implementing Release reiterates the SEC's authority to examine ERAs' records, leaving the door open for more regular and robust non-cause examinations. The SEC expects to conduct cause examinations of ERAs when it believes there have been "indications of wrongdoing, e.g., those examinations prompted by tips, complaints, and referrals."

Transition Period. After March 30, 2012, an ERA relying on the Private Fund Adviser Exemption that has complied with all of its reporting obligations may continue to advise private funds for up to 90 days after filing its annual updating amendment stating that its assets under management in the U.S. equal or exceed $150 million before filing its application for registration. This transition period is not available to an ERA that relies on the Venture Capital Exemption, but anticipates losing the benefit of the exemption. For example, an ERA relying on the Venture Capital Exemption must register with the SEC before advising any client that is not a VC Fund (as defined below) or before making a non-qualifying investment in a VC fund that would cause the VC fund to exceed the 20% basket.

Additional Considerations. ERAs will have a newly created status for regulatory purposes that differs from a simple registration exemption. Accordingly, they may need to give special consideration to various contractual and operational matters. For example, they may wish to consider: (1) whether their existing insurance coverage is sufficient to cover increased regulatory compliance risks or should be upgraded; (2) whether to update undertakings previously made to investors, clients, lenders, landlords or others regarding the availability of registration exemptions; and (3) whether to modify any ongoing disclosure documents that describe such exemptions. They should also monitor regulatory developments under the laws of the states in which they may be doing business, and consider whether other regulations (*e.g.,* non-U.S. regulations and CFTC regulations) may entail different consequences for an ERA than they have for an RIA or an adviser that previously relied on the "fewer than 15 clients" private adviser exemption.

6. Registration Exemption for "Venture Capital Fund" Advisers

As noted above, beginning July 21, 2011 the Venture Capital Exemption is available to advisers that manage *only* venture capital funds. Thus, a single adviser that manages both venture capital funds and other types of funds cannot qualify for the Venture Capital Exemption (although certain firms with multiple advisory entities may be able to use different exemptions for a different entities, as discussed below). The new rules provide a detailed definition of "venture capital fund" for this purpose, although a less restrictive definition applies to existing funds that qualify for a "Grandfather Rule." Both definitions are described below.

Definition of "Venture Capital Fund." Except as provided in the Grandfather Rule, a "venture capital fund" (or "VC fund") is required to have *all* of the following attributes: (1) pursues a venture capital strategy; (2) makes qualifying investments; (3) limits leverage; (4) offers no broad redemption rights; (5) has not registered under the 1940 Act or elected to be a BDC[6]; and (6) is a "private fund."

Venture Capital Strategy. The VC fund must represent to its investors and potential investors that it pursues a venture capital strategy. As described in the Exemptive Release, the determination of whether a VC fund makes such a representation is based upon all of the statements (and omissions) made by the fund to its investors and prospective investors. This would include statements made in marketing materials (such as a private placement memorandum or pitch deck) and governing agreements (such as a limited partnership or subscription agreement). It is not necessary for the fund to include the term "venture capital" in its name. It may even be possible for a VC fund to properly represent itself as pursuing a venture capital strategy without ever using the term, although such an effort generally would seem to create unnecessary risk.

The new rules do not expressly state that a VC fund must represent that it pursues a venture capital strategy to the exclusion of all other strategies. However, the Exemptive Release does state that it would not be acceptable for a VC fund to represent itself as a "multi-strategy" fund. This suggests it would be acceptable for a fund to represent itself as pursuing "principally" or "primarily" a venture capital strategy, with some degree of flexibility to make a modest number of purely opportunistic investments that do not rise to the level of a bona fide "strategy."

Significantly, the Exemptive Release does not define the term "venture capital strategy," although it notes that certain investment strategies (e.g., investments in oil and gas leases and short-term investments) are not venture capital strategies. In the absence of a definition, it would be advisable for funds seeking to qualify as VC funds to affirmatively use the term "venture capital strategy" in their marketing materials and governing agreements. The Exemptive Release suggests it should be acceptable for VC funds to indicate that they pursue a specific type of venture capital strategy (e.g., seed-stage, growth-stage, international, cleantech, etc.).

Finally, the Exemptive Release notes that it may be a violation of the Advisers Act (as well as other applicable securities laws) for a fund to falsely represent itself as pursuing a venture capital strategy while actually pursuing a different strategy. Especially in light of the new rules' failure to define the term "venture capital strategy," the obligation of VC funds to represent that they pursue such a strategy may create a new source of risk for advisers whose strategy is difficult to characterize.

Qualifying Investments. As of the time immediately after a VC fund's acquisition of any asset other than a qualifying investment or short-term holding, not more than 20% of the fund's capital may consist of assets other than qualifying investments or short-term holdings. This 20% "basket" is intended to allow a VC fund flexibility to engage in a variety of investments and activities outside the new rules' strict notion of "venture capital" investing. The Exemptive Release expressly contemplates that, within this basket, qualifying VC funds may make investments more typically associated with hedge, private equity or other types of funds, as well as other investments that do not meet the strict "qualifying investment" tests for any reason.

[6] The VC fund must not be registered as an investment company under the 1940 Act (i.e., the fund must not be a mutual fund) or have elected to be a business development company under such Act.

20% of Capital. For this purpose, a VC fund's capital is deemed to consist of (1) capital contributed to the fund plus (2) uncalled capital commitments. This is not identical to the total capital commitments made by the fund's equityholders. Principally, the rule appears to exclude capital that has been called, but not yet contributed (e.g., in the case of a pending capital call or a capital call default). Moreover, the Exemptive Release states that uncalled capital commitments may be counted only if they are bona fide commitments (i.e., there must be no understanding that such commitments will not be called and the adviser must have a reasonable belief that investors will be able to satisfy calls when issued (e.g. the investor is not known to be suffering significant financial distress)). This will require care in performing the calculation and may create difficult questions regarding the capital commitments of investors that the adviser believes to be in financial distress or otherwise subject to burdens (such as regulatory limitations) that may interfere with satisfaction of capital calls.

Valuation of Non-Qualifying Assets. For purposes of applying the 20% test, non-qualifying assets may be valued at cost or fair value, provided that the fund must apply the same method to all non-qualifying assets in a consistent manner throughout the fund's term. Alternating between valuation methodologies is not permitted. Because the fair value of most VC fund assets is difficult to determine with precision, and can vary on a highly unpredictable basis, we anticipate that most funds will elect to value non-qualifying assets at cost for purposes of the 20% test.

Immediately After Acquisition of Any Asset. The 20% test is applied only immediately after the VC fund's acquisition of an asset (other than a qualifying investment or short-term holding). Thus, a subsequent change in the value of non-qualifying assets, or the amount of the VC fund's capital, will not result in failure to satisfy the 20% test (unless yet another such asset is acquired, in which case the 20% test must be reapplied). While the new rules state that the 20% test must be applied immediate after the fund's acquisition of *any asset* (other than a qualifying investment or short-term holding), the explanatory language in the Exemptive Release raises the possibility that the 20% test need *not* apply if the fund acquires an asset other than an investment asset (e.g., an interest in an escrow account upon the sale of a portfolio company, a debt security received pursuant to settlement of a dispute or an item of intellectual property received pursuant to the liquidation of a portfolio company). This reading would seem fair, since a fund should presumably not cease to be a VC fund simply because it received a non-qualifying asset outside the normal course of its investment activities. In any event, if a fund expects to acquire such a non-qualifying asset, it may be advisable to avoid acquisition by pre-selling the right to receive the asset or by other means.

Not a Percentage of Current Portfolio. Based on the rules described above, it is quite possible that a VC fund may, at multiple times during its term, hold a portfolio that consists substantially (or even entirely) of non-qualifying assets without violating the 20% test. For example, a VC fund's initial investment (at the start of its term) or last remaining investment (at the conclusion of its term) might be a non-qualifying asset. In either such case, the portfolio would, at a specific point in time, consist entirely of non-qualifying assets. So long as those assets do not exceed 20% of the VC fund's capital at the time of acquisition, the 20% test should be satisfied.

Short-Term Holdings. Short-term holdings generally include cash (including foreign currencies), cash equivalents (i.e., bank deposits, certificates of deposit, bankers acceptances and similar bank instruments held for investment purposes, as well as the net cash surrender value of an insurance policy), U.S. Treasury obligations with a remaining maturity of 60 days or less, and shares of a money market fund that is registered under the 1940 Act. As described in the Exemptive Release, short-term holdings do not include other common types of short-term investments such as U.S. Treasury obligations with longer maturities, debt issued by foreign governments, repurchase agreements and commercial paper.

Types of Qualifying Investments. In general, a "qualifying investment" is defined to mean: (1) an equity security issued by a qualifying portfolio company that has been acquired by the VC fund directly from such portfolio company (a "Directly Acquired Security"); (2) an equity security issued by a qualifying portfolio company in exchange for a Directly Acquired Security previously issued by the qualifying portfolio company (a "Recap Security"); and (3) an 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 VC fund in exchange for a Directly Acquired Security or a Recap Security (an "M&A Security").

> *Equity Security*. The term "equity security" is defined very broadly (by reference to the definition under Section 3(a)(11) of the Securities Exchange Act of 1934) and includes: "any stock or similar security, certificate of interest or participation in any profit sharing agreement, preorganization certificate or subscription, transferable share, voting trust certificate or certificate of deposit for an equity security, limited partnership interest, interest in a joint venture, or certificate of interest in a business trust; any security future on any such security; or any security convertible, with or without consideration into such a security, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right; or any put, call, straddle, or other option or privilege of buying such a security from or selling such a security to another without being bound to do so."
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> Within the context of common VC fund investments, the term "equity security" includes typical forms of common and preferred stock, convertible debt (such as bridge loans), warrants, options, and limited partnership interests. Limited liability company ("LLC") interests are not specifically addressed, although it seems likely that most typical LLC interests would be treated as equity securities for this purpose. The inclusion of preorganization certificates and subscriptions may be particularly helpful to seed-stage VC funds that acquire interests in companies which have not yet completed their formation process.
>
> The term "equity security" includes many typical forms of hedges (e.g., puts, calls and straddles relating to common or preferred stock). However, it also appears to exclude many typical forms of hedges (e.g., currency and interest rate swaps). As with other types of non-qualifying investments, a qualifying VC fund may enter into non-qualifying hedges within its 20% basket.
>
> *Qualifying Portfolio Company*. In general, a "qualifying portfolio company" is any company that: (1) at the time of the VC fund's investment, is not publicly traded and is not controlled, controlling or under common control with respect to a publicly traded company; (2) does not borrow and distribute the proceeds of such borrowing to the VC fund in exchange for the fund's investment; and (3) is not an investment company, investment fund or commodity pool.

In this context, publicly traded means subject to the reporting requirements of the Securities Exchange Act of 1934 or having a security listed or traded on any exchange or organized market operating in a foreign jurisdiction. This rule may be particularly problematic for VC funds that invest outside the U.S., where many companies become publicly traded while still in early stages of development.[7]

Because the publicly traded status of a portfolio company is determined only at the time of the VC fund's investment, an otherwise qualifying investment in a portfolio company will not cease to qualify when the company conducts an IPO or otherwise becomes publicly traded (although a new investment in the company after it has become publicly traded generally would not be a qualifying investment). The new rules are not explicit with respect to the status of equity securities acquired from a publicly traded portfolio company via the conversion or exercise of qualifying investments that consist of convertible debt, options or warrants acquired by the VC fund before the portfolio company became publicly traded, but it would be logically consistent with other parts of the new rules for such newly acquired securities to be treated as qualifying investments.

The limitation on borrowing and distribution of proceeds to the VC fund is quite narrow. The Exemptive Release clearly states that the limitation applies only to borrowings in which proceeds are actually distributed to the VC fund in exchange for the fund's investment. In essence, the limitation applies when, as part of an integrated transaction, a portfolio company borrows and then distributes proceeds in order to repay all or a portion of the fund's investment. Thus, a qualifying portfolio company may borrow for general business purposes and, it appears, may even borrow to redeem securities held by third parties. Moreover, the Exemptive Release states that subsequent distributions by the portfolio company to the VC fund solely in respect of the fund's status as an investor would not be subject to the limitation.

As described in the Exemptive Release, a qualifying portfolio company generally must be an operating company, rather than an investment company, investment fund or commodity pool. The Exemptive Release expressly allows a VC fund to hold the fund's investment in a qualifying portfolio company through a *wholly owned* intermediate holding company formed solely for tax, legal or regulatory reasons. However, the Exemptive Release does not expressly contemplate the use of a single holding company that is *jointly owned* by two or more affiliated VC funds (a structure that would seem quite consistent with the purposes of the new rules). If the new rules are interpreted to preclude the use of jointly owned holding companies, it would be particularly burdensome in the context of parallel fund structures. Often, in these structures, several parallel funds (e.g., a main VC fund, a "principals VC fund" for members of the General Partner and an "affiliates VC fund" for a broader group of strategic persons) have used jointly owned holding

[7] In practice, many multi-national venture firms have "siloed" their operations into different geographic regional organizations that function with significant independence. These firms may wish to consider whether each organization may be respected as a separate, non-integrated adviser for purposes of the Advisers Act based on the precedents discussed below.

companies to facilitate the periodic rebalancing of their ownership interests in portfolio companies without the need to formally transfer ownership of portfolio company shares.[8]

In general, VC funds cannot themselves be qualifying portfolio companies, with the result that funds-of-venture-capital-funds cannot qualify for the Venture Capital Exemption.

Directly Acquired and Recap Securities. Except in the context of an M&A transaction, a qualifying investment for a VC fund generally must be acquired directly from the issuer, which means that equity securities acquired on a secondary basis (e.g., from pre-existing investors directly or via a secondary market mechanism) cannot be qualifying investments. The Exemptive Release does not specifically address the treatment of equity securities issued by a company to a VC fund that was not previously an investor in connection with the company's redemption of equity securities from pre-existing investors (i.e., a transaction that might be considered an indirect secondary mediated by the company). In the context of a recapitalization, the Exemptive Release acknowledges that Recap Securities can be qualifying investments when "the [VC] fund, along with other existing security holders, [accepts] newly issued equity securities in exchange for previously issued equity securities." The Exemptive Release does not specifically address a recapitalization in which some stakeholders are redeemed or washed-out, but it would seem consistent with other provisions of the new rules, and common practice relating to recapitalizations, to conclude that such redemptions or wash-outs generally should not disqualify equity securities issued in the recapitalization.

M&A Securities. As stated in the Exemptive Release, a VC fund generally may "acquire securities in connection with the acquisition (or merger) of a qualifying portfolio company by another company, without jeopardizing the fund's ability to satisfy the definition of a venture capital fund."

Under the specific provisions of the new rules, a qualifying investment will include equity securities issued by an acquiror (even though the acquiror is not a qualifying portfolio company) in a transaction pursuant to which the target portfolio company becomes a majority-owned subsidiary of the acquiror, so long as the securities surrendered by the VC fund in the transaction were themselves a qualifying investment. The new rules specify the same result if the target portfolio company is a "predecessor" of the acquiror.

While these provisions would appear to cover most common M&A transactions involving acquirors that are not themselves qualifying portfolio companies, some types of transactions are not clearly addressed (e.g., an acquisition that is structured as an asset purchase). It would seem appropriate to provide the same treatment for those types of transactions, although additional guidance may be required to achieve clarity on this point.

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8 Note that jointly owned holding companies also may be problematic from an ERISA perspective if one or more of the funds seeks to qualify as a "venture capital operating company."

Limitation on Leverage. In general, the aggregate amount of a VC fund's borrowing, issued debt obligations, guarantees of third-party obligations and other leverage must not exceed 15% of the VC fund's capital (as defined above), and any such borrowing, obligations, guarantees and other leverage must have a non-renewable term of 120 days or less. However, the 120-day limit does not apply to the VC fund's guarantee of a qualifying portfolio company's obligations (but only up to the amount of the VC fund's investment in such qualifying portfolio company).

> *Recycling the 15% Limit; When and How Tested.* Although not expressly stated in the Exemptive Release, it appears that the 15% limit should be determined by reference to the amount of borrowing, obligations, guarantees and other leverage in effect at a specific time, rather than on a cumulative basis over the VC fund's term. In this regard, the Exemptive Release leaves a number of open questions, such as (1) whether the 15% test is applied only immediately after each new borrowing, obligation, guarantee or other leverage transaction is entered into, and (2) whether accrued interest must be taken into account when determining the amount of a VC fund's borrowing, obligations, guarantees and other leverage.
>
> *Changes to Common Borrowing Arrangements.*[9] Many VC funds establish lines of credit to bridge capital calls and provide for other short-term capital needs. Such lines of credit may still be used, but a number of previously common terms generally should be changed. For example, such lines of credit generally should no longer provide for terms longer than 120 days or for automatic renewals (although it is possible that such changes may not be required with regard to the use of lines of credit exclusively to bridge capital calls, so long as each draw-down to bridge a capital call is repaid within 120 days and each subsequent draw-down relates to a different capital call). It also would be advisable to carefully review loan agreements for cross-guarantee provisions. Many loan agreements require cross-guarantees by parallel or affiliated funds. Such cross-guarantees generally would count toward the 15% limit.
>
> *Traps for the Unwary.* VC funds often engage in activities that may be deemed a borrowing, issuance of a debt obligation or other form of leverage for purposes of the new rules. For example, a VC fund's General Partner may defer receipt of management fees in order to allow the fund to make additional investments. Unless properly structured, such a deferral may be deemed a borrowing or other use of leverage that counts toward the 15% limit. Similarly, many VC fund agreements provide for the redemption of an investor's interest in exchange for a long-maturity promissory note (with or without interest or recourse) if the investor defaults on a capital call, fails to provide information needed by the VC fund to comply with applicable law, or would (by its continued participation as an investor) impose upon the VC fund substantial legal, tax or other burdens. Because such notes may count toward the 15% limit, it often may be advisable to seek alternative remedies.
>
> *Loans vs. Guarantees.* Often, a guarantee of portfolio company indebtedness can be avoided by making a loan to the portfolio company. Loans to portfolio companies do not appear to count toward the 15% limit. In some circumstances, it may be possible to replace a guarantee with a commitment to make a loan upon the occurrence of certain events (although such an arrangement must be structured with care to prevent it from being deemed a *de facto* guarantee).

[9] This section was updated with additional information on November 1, 2011.

No Broad Redemption Rights. A VC fund must not issue securities that grant investors a right (except in extraordinary circumstances) to withdraw, redeem or require the repurchase of such securities, although investors may be entitled to receive *pro rata* distributions from the fund. As described in the Exemptive Release, this rule is based upon a principal distinction between VC funds and hedge funds – specifically, broad redemption rights.

> Most VC funds do not grant broad redemption rights because an investment strategy based upon investments in private companies makes it difficult, if not impossible, to generate the routine liquidity necessary to implement such rights.
>
> Notwithstanding that most venture capital funds do not grant broad redemption rights, it is fairly common for fund agreements to allow redemptions/withdrawals under specific, generally unlikely, circumstances. For example, many fund agreements allow investors regulated under ERISA or similar laws to withdraw if their continued participation would give rise to violation of such laws. The key issue is whether such circumstances rise to the level of "extraordinary circumstances." Unfortunately, the language of the Exemptive Release is not particularly helpful, implying in some places that circumstances may be extraordinary if they are known to occur (e.g., corporate events such as mergers) but are unexpected in their timing or scope and implying in other places that circumstances based upon a legal requirement may be extraordinary only if they result from an actual change in the law and that the trigger for extraordinary circumstances should be outside the control of the parties. Ultimately, it appears that the rule is based upon an intention to allow redemption rights of the type historically common within the venture capital industry.
>
> It is common for a hedge fund to prohibit redemptions and withdrawals during an initial two-year (or similar) lock-up period following investment in the fund. The Exemptive Release states that such initial period lock-ups do not rise to the level of extraordinary circumstances, and implies that other types of restrictions commonly imposed by hedge funds (e.g., caps on withdrawals that would represent too large a percentage of the fund's total capital or otherwise impose an undue burden on the fund) also would not be deemed extraordinary circumstances.
>
> The Exemptive Release expressly states that an adviser could not rely upon the Venture Capital Exemption if it created *de facto* redemption or transfer rights by, for example, regularly identifying potential investors on behalf of fund investors seeking to transfer or redeem fund interests.
>
> *Carried Interest*. The Exemptive Release indicates that the existence of a General Partner's carried interest in the VC fund is not inconsistent with the requirement that distributions generally be *pro rata* so long as the General Partner's carried interest in the VC fund is not a "security." While the Exemptive Release notes that the treatment of the General Partner's carried interest as a security must be based on the particular facts and circumstances, it is commonly believed that the typical carried interest is not a security.

No Registration/Election Under the Investment Company Act. The VC fund must not be registered as an investment company under the 1940 Act (i.e., the fund must not be a mutual fund) or have elected to be a business development company under such Act.

"Private Fund" Status; Special Rule. The VC fund must be a "private fund."[10] For this purpose, under the SEC's prior interpretations of the 1940 Act, a fund generally can be a private fund *only* if it avails itself of U.S. jurisdictional means when fundraising or engaging in certain other activities, but the Venture Capital Exemption includes an additional special rule.

> The special rule allows an adviser to treat certain funds as "private funds," but only if the adviser is willing to treat the funds as private funds for all purposes under the Advisers Act. As stated in the Exemptive Release, this special rule is "designed to ensure that an adviser relying on the venture capital exemption by operation of [this special rule] is subject to the same Advisers Act requirements as other advisers relying on the venture capital exemption without use of [this special rule]."[11]
>
> Under this special rule, a non-U.S. fund that does not use U.S. jurisdictional means to conduct an offering (in particular, does not offer interests to U.S. persons) could be considered a "private fund" and, assuming it otherwise met the VC fund definition, could be a VC fund.

Grandfather Rule. Under the Grandfather Rule, a fund will be deemed a VC fund, even if it does not satisfy the general definition, if it has ***all*** of the following attributes.

> *Venture Capital Strategy.* A grandfathered VC fund must represent, and have represented, to its investors and potential investors at the time of the offering of its securities that it pursues a venture capital strategy. In general, the considerations applicable to this requirement are identical to those described above regarding the general definition although, in most cases, nothing can be done to alter communications that have already occurred. In particular, many existing funds that otherwise would appear to qualify under the Grandfather Rule may have used very different language (e.g., "growth") to describe their strategy. This will place particular emphasis on carefully reviewing all of the fund's communications to determine whether, taken as a whole, those communications effectively describe the fund's pursuit of a venture capital strategy, regardless of the specific terminology used.
>
> *Initial Closing.* A grandfathered VC fund must have sold (i.e., issued) securities, prior to December 31, 2010, to one or more investors that are unrelated to the fund's adviser.
>
> *Final Closing.* A grandfathered VC fund must not sell (i.e., issue) securities to any person (including by means of accepting a capital commitment from such person) after July 21, 2011. The Exemptive Release confirms that calling capital after July 21, 2011 in respect of commitments existing on July 21, 2011 will not violate this requirement.
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> *Private Fund.* A grandfathered VC fund must be a "private fund," in the same manner as under the general VC definition.

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[10] Please see Footnote 2 above in this Alert.

[11] Please see the discussion below regarding segregating adviser operations for Advisers Act purposes.

7. Registration Exemption for "Private Fund" Advisers

U.S. Advisers. Under the new rules, an adviser with its *principal office and place of business* in the U.S. is exempt from Advisers Act registration under the Private Fund Adviser Exemption if it: (1) acts solely as an adviser to one or more "**Qualifying Private Funds**"[12]; and (2) manages *private fund* assets of less than $150 million. For these purposes, a "principal office and place of business" means "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."

Non-U.S. Advisers. An adviser with its principal office and place of business outside the U.S. (a "**non-U.S. adviser**") is exempt from Advisers Act registration under the Private Fund Adviser Exemption if: (1) all of its *clients* that are *U.S. persons* are Qualifying Private Funds; and (2) all assets it manages at any *place of business in the U.S.* are solely attributable to Qualifying Private Funds and have a total value of less than $150 million. For these purposes, a U.S. person is any person that is a "U.S. Person" as defined in Regulation S promulgated under the Securities Act of 1933 ("**Regulation S**"), except with respect to certain discretionary or similar accounts that are held for the benefit of U.S. persons by certain non-U.S. dealers or other non-U.S. professional fiduciaries. A "place of business" has the same definition as for a Foreign Private Adviser.

ERA Status. An adviser that relies upon the Private Fund Adviser Exemption is an ERA and, as such, is subject to the reporting and compliance requirements discussed above under "*'Exempt Reporting Advisers' or 'ERAs'*."

Interpretive Guidance. The new rules and the Releases provide guidance on the following concepts contained in the Private Fund Adviser Exemption:

> *Assets Managed in the U.S.* If an adviser has its principal office and place of business in the U.S., it is deemed to manage[13] within the U.S. all of its private fund assets, even if the adviser has offices outside of the U.S. Accordingly, for purposes of qualifying for the Private Fund Adviser Exemption, an adviser with its principal office and place of business in the U.S. is required to include all assets under management regardless of where they are managed (even if managed from outside of the U.S.). By contrast, an adviser with a principal office and place of business outside the U.S. is only required to consider assets that are managed at a place of business in the U.S. for purposes of the Private Fund Adviser Exemption and would not lose this exemption by virtue of: (1) managing from outside of the U.S. Qualifying Private Funds with an unlimited amount of investment from U.S. investors; (2) advising clients that are not U.S. persons and are not Qualifying Private Funds; or (3) relying on services that are not considered "management" and are provided by its own employees from within the U.S.

[12] Qualifying Private Funds means private funds that have not registered as investment companies under the 1940 Act or elected to be business development companies under that Act.

[13] "Manage" means to provide continuous and regular supervisory or management services as contemplated in the instructions to Item 5 of Form ADV Part 1A.

Whether an adviser is managing assets at a place of business in the U.S. is a facts and circumstances analysis. For example, while the SEC has indicated that providing research or conducting due diligence at a U.S. place of business may constitute "managing" assets at a place of business in the U.S. under certain circumstances, it would not if a person outside of the U.S. makes independent investment decisions and implements those decisions.

"Qualifying Private Fund" Status; Special Rule. As noted above, a Qualifying Private Fund includes an issuer that would be an "investment company" under the 1940 Act *but for* the exclusions from that definition provided in Sections 3(c)(1) or 3(c)(7) of that Act. However, under a special rule, an adviser to a fund qualifying for *another* definitional exclusion, such as a real estate fund that qualifies for Section 3(c)(5)(C), may elect to treat such fund as a "private fund" for purposes of the Private Fund Adviser Exemption, so long as the adviser treats such fund as a "private fund" for all other Advisers Act purposes.[14] Accordingly, an adviser to funds that can qualify for other definitional exclusions beyond 3(c)(1)/(7) is not precluded from relying on the Private Fund Adviser Exemption by virtue of this fact. In addition, similar to the flexibility provided under the Venture Capital Exemption (see above), an adviser could elect to treat a non-U.S. fund that has not made an offering to U.S. persons as a "private fund" for purposes of the Private Fund Adviser Exemption.

Combining Exemptions. Given the structure of the Venture Capital and Private Fund Adviser Exemptions, a single adviser generally may not combine the Private Fund Adviser Exemption with other exemptions. For example, a single adviser could not advise VC funds with assets under management in excess of $150 million and also seek to rely on the Private Fund Adviser Exemption for other funds with assets under management of less than $150 million.

Calculating the Value of Assets. Advisers must annually (rather than quarterly, as initially proposed) calculate the amount of private fund assets that they manage to determine whether they continue to be eligible for the Private Fund Adviser Exemption and must report the amount in their annual updating amendments to Form ADV. Changes in the amount of private fund assets between annual updating amendments will not affect the availability of the exemption. If an adviser reports on its annual updating amendment that its assets under management in the U.S. equal or exceed $150 million such that it is no longer eligible for the Private Fund Adviser Exemption, then it will have up to 90 days after filing such amendment to apply for registration (i.e., up to 180 days in total after the end of the adviser's fiscal year).

The value of private fund assets under management is required to be calculated in accordance with the instructions in Form ADV. As discussed in more detail below, the instructions to Form ADV require that the calculation of the value of private fund assets under management (1) be made on a gross basis; (2) be based on market value (or fair value where market value is unavailable); (3) include assets managed without compensation; (4) only include the portion of any "securities portfolio" for which the adviser provides "continuous and regular supervisory or management services;" and (5) include uncalled commitments.

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[14] Including the special rules for calculating private fund "assets under management", as discussed below.

Affiliated Advisers / Unibanco No-Action Letters. The SEC noted in the Implementing Release that an adviser cannot satisfy exemptions, such as the $150 million Private Fund Adviser Exemption, by simply reorganizing into two separate advisory entities to split the business so that each entity's assets under management are below various thresholds, which would violate the general prohibition on doing indirectly what cannot be done directly. The SEC reiterated that whether two affiliated advisers would be integrated is based on a facts and circumstances analysis of certain factors discussed in prior no-action letters issued by the staff of the Division of Investment Management of the SEC (the "**Staff**").[15]

Multi-national advisory structures with a registered investment adviser in the U.S. and an affiliated non-U.S. unregistered adviser have historically relied on the line of no-action letters issued by the Staff beginning with the *Unibanco* no-action letter.[16] Under this line of no-action letters, the Staff adopted a less stringent approach to integrating a registered U.S. adviser and an affiliated, unregistered non-U.S. adviser than was the case under the position in the *Richard Ellis* no-action letter, by permitting such a non-U.S. adviser to remain separate and unregistered despite sharing resources and personnel with its affiliated, registered U.S. adviser (provided that certain other conditions were met). As noted above, a non-U.S. adviser with its principal office and place of business outside of the U.S. is only required to consider assets that are managed from a place of business in the U.S. for purposes of the $150 million threshold under the Private Fund Adviser Exemption; accordingly, many multi-national advisers sought affirmation from the SEC that it would continue to apply the *Unibanco* position in determining the assets that are managed by a non-U.S. adviser from a place of business in the U.S.

While the SEC stated in the Exemptive Release that it was not intending to withdraw any prior statement or views under the *Unibanco* line of no-action letters, it did not specifically affirm positions taken under the *Unibanco* line of letters, despite acknowledging the request to do so by a number of commentators. Moreover, the SEC noted that "the Unibanco letters were developed by the staff in the context of the private [adviser] exemption, which Congress repealed….. We expect that the staff will provide guidance, as appropriate, based on the 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."

Given these statements made by the SEC and the nature of the new Foreign Private Adviser Exemption and Private Fund Adviser Exemption, which by their terms take a territorial approach that focuses on where assets are being managed, advisers should be cautious in relying on the *Unibanco* letters absent further guidance either generally or in respect of specific situations.

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[15] See, *e.g.*, Richard Ellis, Inc., SEC Staff No-Action Letter (Sept. 17, 1981) ("***Richard Ellis***").

[16] Uniao de Bancos de Brasileiros S.A., SEC Staff No-Action Letter (July 28, 1992) ("*Unibanco*"). Under this no-action letter, the Staff indicated that it would not recommend enforcement action for failure to register against an unregistered non-U.S. adviser that is separately organized from an affiliated, registered U.S. investment adviser if: (1) each is separately organized and staffed with personnel (located in the U.S. or abroad) who are capable of providing investment advice; (2) all personnel of the unregistered adviser involved in the U.S. advisory activities are deemed "associated persons" of the registered adviser; and (3) the SEC has adequate access to trading and other records of each such unregistered affiliate and to its personnel to the extent necessary to enable the SEC to identify conduct that may harm U.S. clients or markets.

Certain multi-national advisers to private funds have a business model in which investment activities are conducted with relative independence and through separate legal entities, particularly in non-U.S. jurisdictions where local presence, relationships and knowledge are essential. In some cases, these advisers may manage exclusively VC funds in the U.S., but may have a broader mandate in another jurisdiction where the local professionals manage funds that are not VC funds. Viewed as a whole, these advisers may be unable to qualify for the Venture Capital Exemption (because of their non-U.S. business) or for the Private Fund Adviser Exemption (because of their U.S. business), even if each business, when viewed separately, would allow the adviser to be an ERA. Pending further guidance on the *Unibanco* analysis, these advisers may wish to consider whether their operations do or can satisfy the criteria set forth in the *Richard Ellis* no-action letter.[17] Under appropriate facts and circumstances, it would not be necessary to integrate the business of affiliated entities for determining registration requirements and the availability of exemptions under the new rules.

8. Calculating "Assets Under Management" and Its Implications

The amount of an adviser's "assets under management" is critical to determining whether the adviser is permitted to register (or must register) with the SEC and whether the investment adviser qualifies for the Private Fund Adviser Exemption or the Foreign Private Adviser Exemption. The new rules adopt a consistent approach of defining assets under management for each of these purposes. Advisers Act Section 203A(a)(2) defines "assets under management"[18] as the "securities portfolios" with respect to which an adviser provides "continuous and regular supervisory or management services."[19] Form ADV's instructions contain the balance of the rules regarding the calculation of assets under management.

Securities Portfolios. Except in the case of "private funds," discussed below, the new instructions do not alter the existing rule for determining what constitutes a "securities portfolio." The instructions to Form ADV provide that an account is a securities portfolio if at least 50% of the total value of the account consists of securities.[20] For this

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[17] *Richard Ellis* involved an RIA and its non-U.S. affiliate that was seeking to avoid having its business integrated with the RIA, requiring the affiliate to be registered. The *Richard Ellis* letter conditioned relief for the affiliated entity of the RIA on the basis that the affiliate (1) is adequately capitalized; (2) has a buffer, such as a board of directors a majority of whose members are independent of the RIA; (3) has employees dedicated to the entity and not engaged in the advisory business of the RIA; (4) uses independent sources of investment information and itself makes the investment decisions; and (5) keeps its investment decisions and advice confidential until communicated to the client.

[18] Form ADV now refers to assets under management as "regulatory assets under management," to distinguish the term from the assets under management that must be disclosed in Part 2 of Form ADV. Assets under management need not be calculated in the same way for purposes of Part 2 (i.e., the "client brochure"). For example, the Implementing Release notes that an adviser may continue to disclose a *net* amount of assets under management in its client brochure.

[19] The definition of "continuous and regular supervisory or management services" appears in the instructions for Part 1A of Form ADV.

[20] "Securities" is broadly defined by the Advisers Act. Some examples of assets that would not constitute "securities" include, in most cases, fee title to real estate (held directly or indirectly through wholly owned, non-corporate subsidiaries), general partner interests or managing member interests, commodities and collectibles.

purpose, cash and cash equivalents "may" be treated as securities, suggesting that it is also permissible to treat cash and cash equivalents as *other than* securities. If an account is a securities portfolio, its entire value is included in calculating assets under management.

Until the amendment of Form ADV and its instructions by the Implementing Release, advisers had the option of including or excluding family or proprietary accounts, accounts managed without receiving compensation and accounts of foreign clients in calculating their "assets under management." The new rules require that all of these types of accounts be included when determining "assets under management". The objective of the revision is to avoid allowing advisers to opt in or out of regulation by calculating their assets under management in a manner designed to exceed or avoid exceeding a threshold.

Private Funds. An adviser that exercises continuous and regular supervisory or management services with respect to a "private fund" must include the value of *all* of the assets of the private fund, regardless of their nature, in its "regulatory assets under management" (i.e., the 50% rule described above that applies to securities portfolios does not apply to private funds). In addition, the amount of any uncalled capital commitments must be added to the value of the fund's assets. Private fund assets must be valued at market value, or fair value if market value is not available.

Calculating the Value of "Securities Portfolios"

- *Market Value and Fair Value*. For *non*-private fund assets, advisers should continue to value assets under management based upon the "market value" of those assets used to report to clients or to calculate fees.[21] Under the new rules, private fund assets must also be valued at "market value," or where market value is unavailable, at "fair value." The new rules do not specify the methodology for reporting fair value beyond requiring that investment advisers report consistently and in good faith, but noted that the use of appraisers, pricing services or other third parties is not required. The Implementing Release indicates that an adviser that calculates fair value for financial reporting purposes is expected to use the same basis for reporting for fair value to determine its regulatory assets under management, whether that basis is GAAP or something else. There is a limited exception to the requirement that assets be valued at fair value for real estate assets where fair valuing of real estate assets is not required for financial reporting purposes under accounting principles used by the private fund that otherwise require fair value for assets. If the exception applies, real estate assets may be valued for purpose of computing assets under management as the private fund does for financial reporting purposes.

- *Gross Assets*. The revised instructions to Form ADV direct an adviser to calculate its regulatory assets under management on a gross basis without deducting any outstanding indebtedness or other accrued but unpaid liabilities. The Implementing Release suggests that a gross assets calculation would help to ensure that leverage is not used to avoid registration and help to ensure that highly leveraged funds do not avoid systemic risk reporting. The Implementing Release also indicates that an adviser may choose to report net assets in Part 2 of Form ADV, which constitutes the brochure it provides to clients.

[21] See Form ADV: Instructions for Part 1A, instr. 5.b.(4).

- *Open Questions*. As expected, the new rules regarding calculating assets under management raise certain interpretive questions. For example, one question not specifically addressed by the new rules is how to treat subsidiary debt for purposes of calculating the gross value of a fund's assets. An approach consistent with other discussions in the Implementing Release would be to perform the calculation consistent with how the fund reports for financial reporting purposes (i.e., if the assets and debt of the subsidiaries are consolidated on the fund's balance sheet, the gross assets of the subsidiaries would be used for purposes of determining assets under management). Additional questions are likely to arise as advisers contemplate the facts and circumstances relating to their client portfolios.

Implications for Advisers

- *Private Fund Advisers*. The new rule for calculating the assets under management of private funds (i.e., include all assets regardless of their nature and include uncalled commitments) and the rules with respect to calculating assets under management (i.e., include gross value) narrows the group of advisers to private funds that will be able to qualify for the Private Fund Adviser Exemption available to advisers managing private fund assets of less than $150 million.

- *Other Fund Advisers*. An adviser with less than $25 million in assets under management is not permitted to register as an investment adviser with the SEC.[22] In addition, an adviser with between $25 million and $100 million in assets under management that is required to register as an investment adviser with the state in which it maintains its principal office and place of business and, if registered, is subject to examination as an investment adviser in that state, is not permitted to register as an investment adviser with the SEC.[23]

  Advisers to funds that do not qualify as "private funds" and that manage assets that are predominantly not "securities" may fall within one of these prohibitions. For example, a real estate fund manager who only manages funds and accounts that only acquire fee title to real property (directly or indirectly through wholly owned non-corporate subsidiaries) may qualify for one of these prohibitions and thus may be prohibited from registering as an investment adviser with the SEC. The critical questions in this analysis are whether the funds and accounts managed by the adviser qualify as "private funds" and if not, whether less than 50% of the total value of each fund or account that is not a private fund consists of "securities." If a non-private fund has less than 50% of its total value in "securities," then it is not a "securities portfolio" and therefore contributes $0 to the calculation of the adviser's assets under management. A portfolio that consists of approximately 50% "securities" with an aggregate value that may fluctuate above and below the 50% mark presents particular challenges under this "all or nothing" approach.

Determining whether funds or accounts managed by an adviser qualify as "private funds" will, in certain cases, involve complexity and uncertainty depending on the nature of the adviser's assets. Many advisers that may be

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[22] Section 203(a)(1) of the Advisers Act. The adviser must also be regulated or required to be regulated in the state in which it maintains its principal office and place of business. All states regulate investment advisers, except Wyoming.

[23] Section 203(a)(2) of the Advisers Act.

able to take the position that one or more of their funds or accounts is not a private fund have not previously undertaken this analysis because they have relied on the exclusions from the definition of "investment company" provided by either Section 3(c)(1) or 3(c)(7) of the 1940 Act. Determining whether an account or fund falls within the definition of "investment company" under the 1940 Act, or qualifies for a definitional exclusion outside of 3(c)(1)/(7)(thereby excluding the fund or account from the definition of "private fund") may require a detailed analysis of the investments held by the account or fund and the manner in which they are held. Similarly, where a fund invests in non-corporate private market investments, determining whether less than 50% of the total value of a fund that is not a private fund consists of "securities" can require a detailed analysis of the terms of the investments that may not yield a clear answer.

Advisers that fall within one of the prohibitions on registration with the SEC should also bear in mind that they must continually analyze whether their funds and accounts continue not to be "private funds, " and whether the allocations or values of investments of their non-private funds has changed sufficiently, such that the non-private fund has become a "securities portfolio." For example, a real estate fund adviser that increases its investment in debt securities in a fund may find that the fund no longer has less than 50% of its total value in securities.

The chart available here summarizes certain principles regarding how assets under management affect registration and ERA reporting requirements.

9. State vs. Federal Registration

Under a regime created by the National Securities Markets Improvement Act of 1996, certain investment advisers are required to register with the SEC, and other advisers are prohibited from registering with the SEC. Advisers that register with the SEC are exempt from state registration requirements, although the states may require notice filing and may license adviser representatives that exceed a specified threshold of involvement with clients that are natural persons.

Advisers that are prohibited from registering with the SEC may be required to register in the states where they have a place of business, depending on the registration exemptions available under the state's law. Advisers Act Section 222(d) prohibits states from requiring registration of advisers that do not have a place of business in the state and have had fewer than six clients residing in that state during the preceding 12-month period.[24]

Advisers with $25 million or less in assets under management ("small advisers") are, and under the new rules will continue to be, required to register in the states in which they do business unless: (1) they are exempt from registration; (2) they have their principal office and place of business in a state that does not regulate investment advisers;[25] or (3) they qualify for one of the exemptions in Rule 203A-2, which permits certain types of investment advisers to register with the SEC even though they have less than $25 million of assets under management. Federal registered advisers register with the SEC; no state may require them to register, although the states may require notice filing.

[24] See "Federal De Minimis Exemption from State Registration" below.

[25] Wyoming is the only state that does not regulate investment advisers.

Section 410 of the Dodd-Frank Act creates a new category of "mid-sized advisers," having assets under management between $25 million and $100 million, and places these advisers under the primary regulation of the states. Unlike a small adviser, a mid-sized adviser must register with the SEC if (1) the adviser is not required to be registered as an investment adviser in the state in which it maintains its principal office and place of business, or (2) if registered with that state, the adviser would not be subject to examination as an investment adviser by the state securities administrator. In the Implementing Release, the SEC notes that in addition to Wyoming, which does not require registration of investment advisers, the states of Minnesota and New York had not advised the SEC that advisers registered with them are subject to examination; however, the SEC has since advised that Minnesota will subject advisers registered with them to examination.

Consequently, mid-sized investment advisers located in Minnesota, Wyoming and New York must register with the SEC, unless they otherwise qualify for a registration exemption. Section 203A(c) of the Advisers Act permits the SEC to create exemptions from the prohibition on federal registration for mid-sized advisers as it does for small advisers. As discussed below in the section entitled "Exemptions from Prohibition on Federal Registration," the SEC is adopting amendments to two of the exemptions and eliminating the exemption for NRSROs. The five exemptions remaining after the amendments will apply to both mid-sized investment advisers and small investment advisers.

Transition Rules and Buffer. The SEC estimates that approximately 3,200 SEC-registered advisers will be required to withdraw their registrations and register with one or more state securities administrators. New Rule 203A-5 is intended to provide for an orderly transition to state registration for mid-sized advisers no longer eligible for SEC registration.

> *Existing Registrants*. Each adviser registered with the SEC on January 1, 2012 must file an amendment to its Form ADV no later than March 30, 2012 (regardless of its fiscal year end and annual filing deadline). These amendments will respond to new items in Form ADV (discussed below) which are intended to identify mid-sized advisers no longer eligible to remain registered with the SEC. Those advisers no longer eligible for SEC registration must withdraw from registration with the SEC by filing Form ADV-W by June 28, 2012. Mid-sized advisers that wish to continue operations after June 28, 2012 must register with the appropriate states. Mid-sized advisers registered with the SEC as of July 21, 2011 that will be required to switch to state registration may not withdraw from SEC registration before January 1, 2012.
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> *New Applicants*. Until July 21, 2011, advisers that qualify as mid-sized advisers and are not yet registered may register with either the SEC or the appropriate state securities administrator. Beginning July 21, all new advisers qualifying as mid-sized advisers must register with the appropriate states (unless otherwise exempt from doing so).
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> *New Form ADV Questions*. The new Form ADV that all advisers must file by March 30, 2012 will contain an amended Item 2.A to reflect the new statutory threshold for registration. Each registrant will be required to identify whether it is eligible to register with the SEC by indicating that the adviser:

- Is a large adviser that has $100 million or more of regulatory assets under management (or $90 million or more if the adviser is filing its most recent annual updating amendment and is already registered with the SEC);[26]

- Is a mid-sized adviser that does not meet the criteria for state registration or is not subject to examination;[27]

- Has its principal place of business in Wyoming (which does not register investment advisers) or outside of the U.S.;

- Meets the requirements for one or more of the revised new rules under Section 203A (discussed below in the section entitled "Exemptions from Prohibition on SEC Registration");

- Is an adviser (or sub-adviser) to a registered investment company;

- Is an adviser to a business development company and has at least $25 million of regulatory assets under management; or

- Received an order permitting the adviser to register with the SEC.

An adviser that does not qualify for continued registration with the SEC must indicate that status on its amended Form ADV filed by March 30, 2012.

"Buffer Zone" for Switching Between State and Federal Registration. To avoid the need for frequent switching between state and federal registration for advisers with assets under management near $100 million, the SEC has amended Rule 203A-1 to provide that an adviser may, but is not required to, register with the SEC if it has assets under management of at least $100 million but less than $110 million. Conversely, an SEC-registered adviser need not withdraw its registration unless it has less than $90 million of assets under management. The $20 million range between $90 million and $110 million is the "buffer zone" within which an adviser is not required to switch its registration.

In amending Rule 203A-1 to create a buffer zone for mid-size advisers around the $100 million threshold, the SEC eliminated the $5 million buffer zone around the $25 million threshold, because that threshold is no longer significant for most advisers. However, the $25 million threshold continues to be significant for some advisers, notably those whose principal office and place of business are in New York, which

[26] See the discussion below in the section entitled "Buffer Amount for Transition."

[27] The SEC notes that advisers in New York are not subject to examination and therefore that mid-sized advisers with their main office and principal place of business in those states must register with the SEC. Mid-sized advisers with their principal office and place of business in other states may be required to register with the SEC if they qualify for an exemption in the state not available under federal law – e.g., an exemption for advisers whose only clients in the state are institutional investors.

regulates investment advisers but does not conduct examinations of advisers that it regulates. Thus, an adviser in New York must register with the state if it has assets under management up to $25 million (and does not qualify for an exemption from the prohibition on SEC registration) and must register with the SEC if it has assets under management over $25 million.[28]

Exemptions from the Prohibition on SEC Registration. There are currently six exemptions from the prohibition on registration with the SEC. Under the new rules, one of the exemptions will be eliminated and two others amended. The following is a description of the exemptions under the new rules:

- *NRSROs*. The exemption for nationally recognized statistical rating organizations has been eliminated as no longer necessary. Since the exemption was first adopted, Congress has amended the Advisers Act to exclude certain NRSROs from the Act's definition of "investment adviser" and provided for a separate regulatory regime for NRSROs under the Exchange Act.

- *Pension Consultants*. The minimum value of plan assets required to rely on the exemption has been raised from $50 million to $200 million.

- *Investment Advisers Affiliated with an SEC-Registered Adviser*. No change.

- *Investment Advisers Expecting to Be Eligible for SEC Registration within 120 Days*. No change.

- *Multi-State Investment Advisers*. Section 410 of the Dodd-Frank Act provides that a mid-sized adviser that otherwise would be prohibited from SEC registration may register with the SEC if it would be required to register with 15 or more states. As a result, the SEC has lowered from 30 to 15 the number of states in which an adviser would have to be required to register to qualify for the exemption. However, the SEC has determined that, based on the Congressional intent to set the threshold at 15, there should not be a buffer number below 15, equivalent to the five-state buffer below 30 states available in the current rule.

- *Internet Advisers*. No change.

Proposed State Exemption for ERAs. As discussed above under "*Exempt Reporting Advisers*," ERAs that would otherwise be required to register as investment advisers will be exempt from registration with the SEC, subject to reporting and other obligations. ERAs will generally not be "federal covered advisers" under state laws – i.e., advisers exempt from state registration because they are required to be registered with the SEC. Therefore, ERAs may be required to register with one or more states in which they do business unless there is an exemption available under state law. (Because the venture capital and private fund exemptions are not mandatory, advisers that are otherwise eligible for federal registration may elect, instead of claiming the venture capital or private fund exemption, to remain or become registered with the SEC to avoid state registration in the absence of a state exemption.)

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[28] For more information about the transition of registration for mid-sized advisers, see the SEC's publication "Frequently Asked Questions Regarding Mid-Sized Advisers."

The North American Securities Administrators Association ("NASAA") has published a proposed model rule for reporting advisers exempt from SEC registration.[29] The model rule, which individual states would be free to adopt as written (or with revisions) or disregard, would provide an exemption for advisers to private funds if:

- Neither the private fund adviser nor any of its advisory affiliates is subject to a disqualification as described in Rule 262 of SEC Regulation A;
- The private fund adviser files with the state each report and amendment that an ERA is required to file with the SEC; and
- The private fund adviser pays the required state fees.

The proposed rule would include additional requirements for an adviser to one or more funds exempt under Section 3(c)(1) that are not "venture capital funds" under the definition discussed above:

- Each of the owners of the 3(c)(1) funds advised by the private fund adviser (other than VC funds) must meet the definition of qualified client in SEC Rule 205-3;
- The private fund adviser must make certain disclosures to every beneficial owner of a 3(c)(1) fund that is not a VC fund about the nature of the duties and responsibilities of the adviser to the beneficial owners, including the fact that the fund, rather than the individual beneficial owners, is the adviser's client; and
- The private fund adviser must obtain on an annual basis audited financial statements of each 3(c)(1) fund that is not a VC fund, and deliver a copy to each beneficial owner of the fund.

The proposed rule also contains transition and grandfathering provisions, as well as a corresponding exemption from registration as an investment adviser representative.

The deadline for comment to NASAA on the proposed model rule is July 13, 2011.

Federal De Minimis Exemption from State Registration. Advisers will still be able to qualify for the de minimis exemption from state registration provided by the Advisers Act. This exemption, Advisers Act Section 222(d), is available to advisers that do not have a place of business in a state and have had fewer than six clients residing in that state during the preceding 12-month period. "Client" is currently defined for purposes of Section 222(d) as it is in Rule 203(b)(3)-1, permitting hedge funds and other entities to be counted as one client. The SEC is replacing the definition of "client" in Rule 203(b)(3)-1, which will be repealed, with a new definition in Rule 202(a)(30)-1 which will continue to permit entities to be counted as one client for purposes of this exemption or the Foreign Private Adviser Exemption. Rule 222-2 under the federal de minimis standard will cross reference the new definition in Rule 202(a)(30)-1.

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29 The proposal was originally published in December 10, 2010, and amended in response to comments.

10. Other Matters

Amendments to Form ADV

As discussed above, the SEC adopted several amendments to Form ADV (the "**ADV Amendments**"). While the ADV Amendments focus to a significant extent on ERAs, the changes to Form ADV Part 1A also apply to registered investment advisers, and, significantly, set forth, new detailed reporting requirements regarding private funds managed by an adviser. A general description of the ADV Amendments, as well as more detailed information on private fund reporting requirements and ERAs' reporting obligations, follows. A more detailed description of all of the ADV Amendments is set forth in Goodwin Procter's June 28, 2011 Financial Services Alert.

As a general matter, the ADV Amendments are designed to provide the SEC with additional information about three areas of an adviser's operations. First, the ADV Amendments require advisers to provide additional information about the private funds that they advise. Second, the ADV Amendments require advisers to provide additional data regarding their advisory business (including data about the types of clients they advise, their employees and their advisory activities), as well as their business practices that may present significant conflicts of interest (such as the use of affiliated brokers, soft dollar arrangements and compensation for client referrals). Third, the ADV Amendments require advisers to report on certain non-advisory activities and their financial industry affiliates.

Private Fund Information

The ADV Amendments significantly increase the amount of information that an adviser is required to report on its private fund(s) under Item 7.B of Form ADV Part 1A. Under the ADV Amendments, both registered advisers and ERAs are required to complete Item 7.B and the related portions of Schedule D, which require an adviser to provide a separate Section 7.B of Schedule D for each private fund that it advises. A brief overview of certain of the information that an adviser will be required to provide about each private fund, including, as applicable, distinctions from the SEC's initial rule proposals and interpretive matters, follows:

- *The name and size of the fund, whether it is part of a master-feeder arrangement or is a fund of funds and the securities law exemptions on which it relies.* The ADV Amendments modify the proposed rules in certain respects. Specifically, under the proposed rules, an adviser would have been required to report both the gross and net asset values of each private fund and the assets and liabilities of each fund broken down by class and categorization in the fair value hierarchy established under GAAP. In light of commenters' concerns regarding, among other things, the disclosure of competitively sensitive information, under the ADV Amendments, an adviser is not required to report a private fund's "net" asset value or the breakdown of assets and liabilities by class and categorization.

- *The fund's investment strategy (selected from one of seven broad categories described in the ADV Amendments) and whether it invests in shares of registered investment companies.* The ADV Amendments include definitions, certain of which have been modified from the proposed rules to provide enhanced clarity as to the appropriate classification. In this regard, the ADV Amendments include, among other things, a clarification for categorizing securitized asset funds and funds that engage in short selling activities for hedging currency exposure or managing duration. While the ADV Amendments include some guidance on the appropriate classification, advisers may experience some level of uncertainty on the appropriate classification of a private fund, particularly when the fund's structure lends itself to more than one category.

- *The minimum amount that investors are required to invest, the approximate number of beneficial owners of the fund and the approximate percentage of the fund owned by the adviser and related persons and the extent to which clients of the advisers are solicited to invest, and have, invested in the fund.* The ADV Amendments remove the aspect of the Proposed Rules that would have required disclosure regarding the types of investors in the fund. Certain information needed to respond to these questions may not be readily available. For example, the ADV Amendments require an adviser to provide information regarding the percentage of the private fund beneficially owned by funds-of-funds. Many private fund advisers may not be able to answer this question without reaching out to their investors or using a reasonable estimation. The level of precision or due diligence required is not specified. In addition, as a general matter, the concept of "beneficial ownership" is somewhat ambiguous as it applies to private funds.

- *Information regarding the five specific types of service providers to the fund (auditors, prime brokers, custodians, administrators and marketers).*

In addition, under the ADV Amendments, the SEC will no longer require an adviser to report funds that are advised by affiliates, and will allow a sub-adviser to exclude private funds for which an adviser is already reporting on Schedule D to Form ADV Part 1A. An adviser sponsoring a master-feeder arrangement may submit information on an aggregate basis for the master fund and all of the feeder funds that would otherwise be submitting substantially identical data.

ERA Obligations under the Form ADV Amendments.

As discussed above, the SEC has imposed on ERAs certain reporting and other obligations. While an ERA will not be required to file a full Form ADV, it will be required to respond to certain items to allow the SEC to gather certain basic information about the adviser, details about the private funds it advises (see above), other business interests of the adviser and its affiliates and disciplinary history of the adviser and its employees.

As discussed above, the SEC staff will reconsider the information the SEC collects from ERAs after the SEC receives and assesses the information gathered during the first year's filings. During last week's SEC open meeting, Commissioners Troy Paredes and Kathleen Casey objected to the level of reporting required of ERAs and highlighted the critical importance of the SEC staff's analysis after the first year's filings. It will be important for ERAs to consider, as they go through the reporting process, which aspects were particularly burdensome or otherwise objectionable.

Changes to Pay-to-Play Rule

The SEC also amended the "pay-to-play" rule in response to changes made by the Dodd-Frank Act. These amendments broaden the scope of the rule to confirm that its requirements apply to both ERAs and foreign private advisers. In addition, the amendments add regulated municipal advisors to the list of "regulated persons" that advisers may pay to solicit government entities' advisory business. The amendments include additional guidance on qualifying as a "municipal advisor", noting that a solicitor must be registered under Section 15B of the Exchange Act and be subject to "pay-to-play" rules adopted by the MSRB. In this regard, the MSRB has issued a proposed draft of a "pay-to play" rule and requested comment. In the Proposed Rules, the SEC had proposed to limit the exception to the third-party solicitation ban to municipal advisors but, in response to certain comments, has retained the approach of the current rule permitting advisers to compensate persons that are "regulated persons" (which could also include FINRA registered broker-dealers). The SEC also extended the compliance date for the ban on third-party solicitation from September 13, 2011 to June 13, 2012 in order to allow for FINRA and MSRB to adopt "pay-to-play" rules and to allow for solicitors to come into compliance.

Form PF

The SEC has also proposed creating a new reporting form (Form PF) to be filed periodically by registered investment advisers who manage one or more private funds. The SEC indicated that Form PF will be finalized later this year.

11. Resources and Appendices

Form ADV (ERA Highlighted Version)

Form ADV Glossary (ERA Highlighted Version)

Form ADV Part 1A Instructions (ERA Highlighted Version)

Form ADV General Instructions (ERA Highlighted Version)

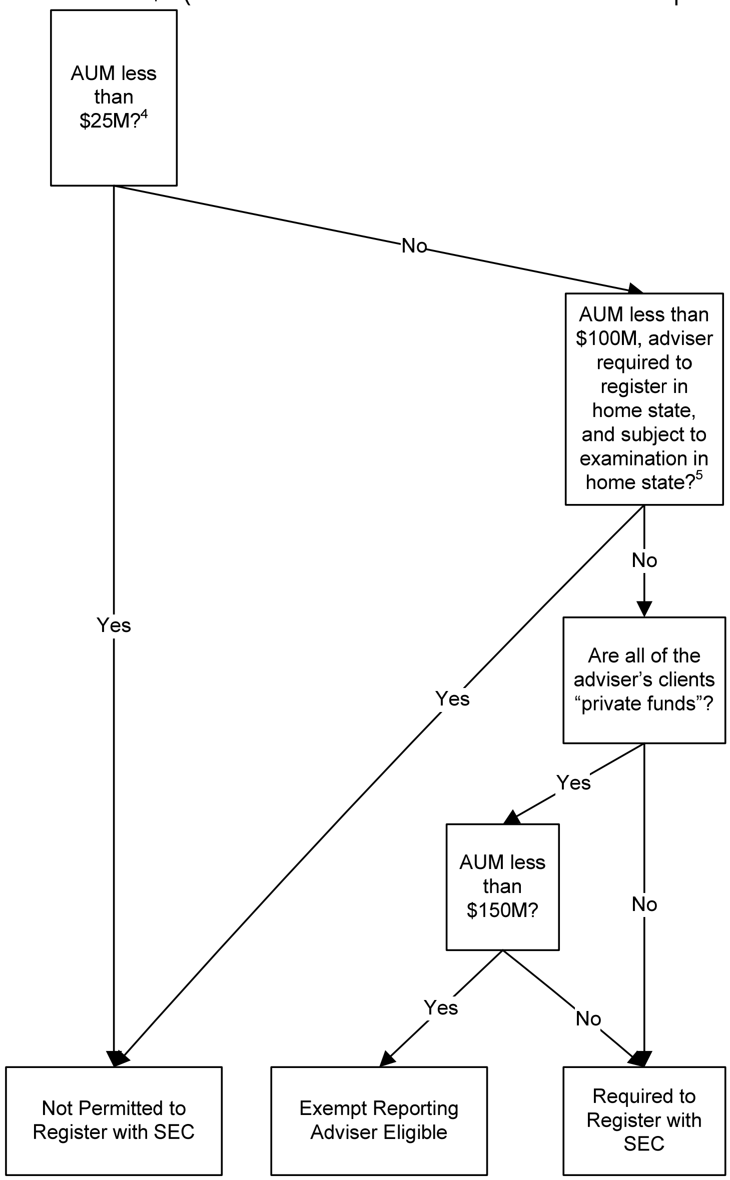
Calculating Assets Under Management

Principal Place of Business

Calculating Assets Under Management

Method #1: For Private Funds[2]: For each private fund, calculate assets under management ("AUM") by adding together the market value (and where market value is not available, the fair value), on a gross basis, of all assets of such private fund regardless of their nature, including assets that are not securities, plus uncalled commitments.

Method #2: For Other Funds and Accounts: For each fund or account that is not a private fund, determine whether 50% of more of the total market value of such fund or account consists of "securities."[3] If yes, apply same method as for private funds in Method #1 (but do not include uncalled commitments). If no, count AUM for each fund or account as $0 (because the fund/account is not a "securities portfolio").



1 The following analysis applies to investment advisers that have a principal office and place of business in the United States. Advisers with a principal office and place of business outside of the United States or no place of business in the United States should refer to the discussion of the Private Fund Adviser Exemption and the Foreign Private Adviser Exemption elsewhere in our Client Alert dated June 30, 2011. The analysis also assumes no other registration exemptions are available, such as the Venture Capital Exemption.

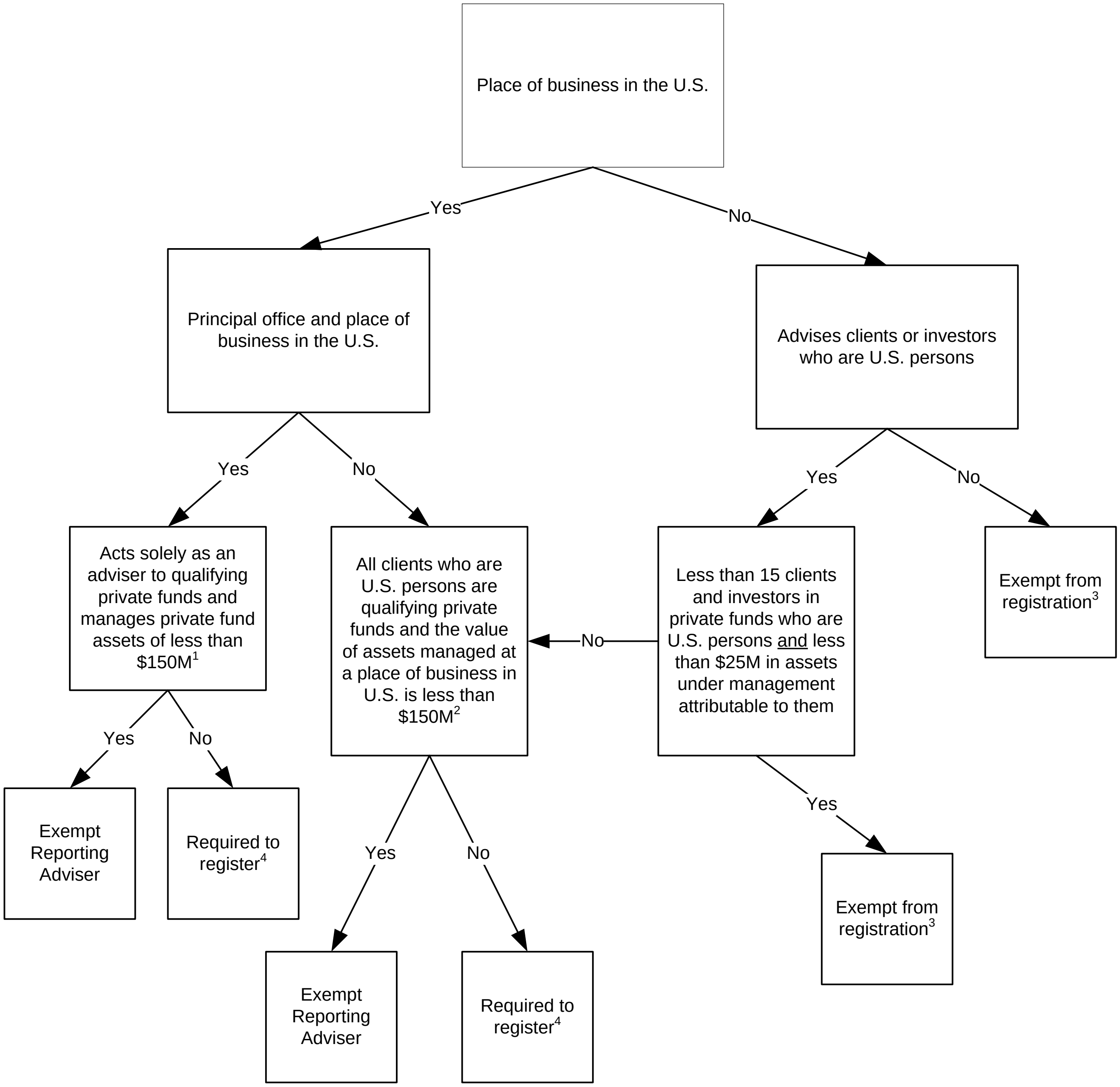
2 A "private fund" is an issuer that would be an investment company under the Investment Company Act of 1940 but for the exclusion provided in Section 3(c)(1) or 3(c)(7) of that Act. For purposes of the Private Fund Adviser Exemption, an adviser can elect to treat a client that does not otherwise meet this definition as a "private fund," if it treats such client as a private fund for all purposes of the Advisers Act. Examples of funds or accounts that are not "private funds" include funds or accounts that are not investment companies under Section 3(a)(1) of the Investment Company Act of 1940 or that qualify for an exclusion under the Act other than Sections 3(c)(1) or 3(c)(7), such as Sections 3(c)(5) or 3(c)(6).

3 "Securities" is broadly defined. Examples of interests that would generally not be "securities" are fee title to real estate (including through wholly owned non-corporate subsidiaries), general partner interests or managing member interests, commodities and collectibles. An adviser can elect whether to treat cash and cash equivalents as securities. Funds or accounts for which an adviser does not receive compensation must be included in the calculation of AUM.

4 The adviser must also be regulated or required to be regulated in the state in which it maintains its principal office and place of business. All states meet this requirement other than Wyoming.

5 The SEC advises that the State of New York does not subject advisers registered with it to examination.

Principal Place of Business



1 Count all private fund assets managed, including those managed from outside of the U.S.

2 Whether or not assets are managed at a place of business in the U.S. is inherently a factual question, however, if the adviser has *no* place of business in the U.S., one would expect that in most cases the adviser would be managing less than $150M of private fund assets from a place of business in the U.S.

3 Adviser must also not hold itself out generally to the public in the U.S. as an investment adviser nor advise mutual funds or business development companies.

4 Assumes no other exemption from registration is available (e.g. venture capital exemption).

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