To Our Clients and Friends

Memorandum

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SEC Proposes Investment Advisers Act Rules to Implement Dodd-Frank Act

The Securities and Exchange Commission ("SEC") has proposed new rules and rule amendments under the Investment Advisers Act of 1940 (the "Advisers Act") to implement certain provisions of Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[1]

The Dodd-Frank Act repeals the "private adviser exemption" in section 203(b)(3) of the Advisers Act[2] and replaces it with narrower exemptions for foreign private advisers, venture capital fund advisers and private fund advisers with less than $150 million in assets under management. The Dodd-Frank Act authorizes the SEC to require registered and certain exempted investment advisers to submit reports as the SEC may require as "necessary or appropriate in the public interest," and reallocates responsibility for oversight of investment advisers by delegating responsibility for those investment advisers that have between $25 and $100 million in assets ("mid-sized advisers") to the states. These provisions of the Dodd-Frank Act will become effective on July 21, 2011.

The proposed new rules and rule amendments implement the foregoing provisions of the Dodd-Frank Act by, among other things: (i) requiring registered and "exempt reporting advisers" to disclose on Form ADV detailed information with respect to the hedge funds and private equity funds they advise; (ii) increasing the threshold of assets under management for registration with the SEC; and (iii) defining the terms "client," "venture capital fund," "United States person," "assets under management" and other relevant terms used in the Dodd-Frank Act. The proposed rule amendments address other changes to the Advisers Act affected by the Dodd-Frank Act, including amendments to the SEC's pay to play rule. Highlights of the new rules and rule amendments are summarized below.

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1 See http://sec.gov/rules/proposed/2010/ia-3110.pdf and Appendices A through G: http://sec.gov/rules/proposed/2010/ia-3110-appa.pdf; http://sec.gov/rules/proposed/2010/ia-3110-appb.pdf; http://sec.gov/rules/proposed/2010/ia-3110-appc.pdf; http://sec.gov/rules/proposed/2010/ia-3110-appd.pdf; http://sec.gov/rules/proposed/2010/ia-3110-appe.pdf; http://sec.gov/rules/proposed/2010/ia-3110-appf.pdf; http://sec.gov/rules/proposed/2010/ia-3110-appg.pdf. As to the proposed definitions of the new categories of exempt private advisers, see http://sec.gov/rules/proposed/2010/ia-3111.pdf.

2 Section 203(b)(3) currently provides an exemption from SEC registration for any investment adviser who during the course of the preceding 12 months has had fewer than 15 clients and who neither holds himself out generally to the public as an investment adviser nor acts as an investment adviser to any registered investment company or a business development company.

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New Exemptions from Registration as an Investment Adviser

Foreign Private Adviser Exemption

Under the Dodd-Frank Act, an adviser will be exempt from registration if the adviser: (i) has no place of business in the U.S.; (ii) has fewer than 15 clients and "investors" in the U.S. in "private funds" advised by the adviser; (iii) has aggregate assets under management attributable to clients "in the United States" and investors "in the United States" in private funds advised by the investment adviser of less than $25 million; and (iv) does not hold itself out generally to the public in the United States as an investment adviser or advise a registered investment company or a business development company.

The new rules would define "client" for this purpose in the same manner as the counting rules under the current private adviser exemption (Section 203(b)(3) of the Advisers Act), except that an adviser must count as clients any persons to whom it provides advisory services for no fees (e.g., employees and other affiliates), and an adviser need not count a private fund as a client if the adviser counts any one of its investors as its client. An "investor" is proposed to be defined as any person who would be deemed a beneficial owner of a 3(c)(1) fund for the purpose of counting the number of beneficial owners of a 3(c)(1) fund or a party that meets the definition of qualified purchaser to be eligible to invest in a 3(c)(7) fund. The adviser would also count "knowledgeable persons" (who do not count as beneficial owners of a 3(c)(1) fund and are not required to satisfy the qualified purchaser test in 3(c)(7) funds) as investors. The proposed rules do, however, permit an adviser to treat as a single investor any person that is an investor in multiple private funds advised by the adviser.

Venture Capital Fund Adviser Exemption

The proposed rules implement the Dodd-Frank Act's exemption from registration for advisers that solely advise "venture capital funds" and introduce a grandfathering provision for advisers to existing venture capital funds.[3] The proposed rule defines a "venture capital fund" as any "private fund" (defined under the Dodd-Frank Act to mean an issuer that relies on Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 (the "Investment Company Act")) that meets the following six conditions:

1. Represents to investors that it is a venture capital fund;
2. Owns solely (i) equity securities of certain "qualifying portfolio companies," at least 80% of which were acquired directly from the qualifying portfolio company; and (ii) cash or cash equivalents;
3. With respect to each qualifying portfolio company, either controls or provides significant guidance concerning the management or business objectives of the qualifying portfolio company;
4. Does not incur leverage in excess of 15 percent of its called and uncalled committed capital, and any such leverage is short term (e.g., term of no longer than 120 calendar days);
5. Does not provide investors with the ability, except in extraordinary circumstances, to withdraw, redeem or require the repurchase of such securities; and
6. Is not registered under the Investment Company Act and has not elected to be treated as a business development company.

[3] The proposed rules permit existing venture capital funds that meet the following three conditions to be treated as "venture capital funds" eligible for the exemption by their advisers: (i) the fund has represented to investors and potential investors at the time of the offering of its securities that it is a venture capital fund; (ii) prior to December 31, 2010, the fund has sold securities to one or more investors that are not related persons of any investment adviser of the private fund; and (iii) the fund does not sell any securities to (including accepting any committed capital from) any person after July 21, 2011.

Private Fund Adviser Exemption

A U.S. based adviser that manages only private funds and has less than $150 million in assets under management would be exempt from registration. An adviser based outside the U.S. would be exempt if it has no client that is a U.S. person except for one or more private funds and all assets managed from a place of business in the U.S. are solely attributable to private fund assets, with a total value of less than $150 million.

New Reporting Requirements for Registered Investment Advisers and Exempt Private Fund Advisers

Form ADV would be amended to require additional information from registered investment advisers concerning three areas of operation: (i) private funds they advise; (ii) their advisory business (including types of clients); and (iii) the advisers' non-advisory activities and their financial industry affiliations. Advisers that qualify for the venture capital fund adviser exemption or the private fund adviser exemption ("exempt reporting advisers") also would be required to provide certain information on Form ADV, which would become a reporting as well as registration form.[4] Advisers that qualify for the foreign private fund adviser exemption would not be subject to these reporting requirements. As proposed, the initial report would have to be filed by August 20, 2011. The information reported would be publicly available on the SEC's website.

Information Concerning Private Funds

Under the proposed reporting rule, both registered and exempt reporting advisers would have to provide:

- The name of the private fund;
- The state or country of organization and the name of its general partners, directors, trustees or persons holding similar positions;
- Information on the organization of the fund, including whether it is a master or feeder fund, the regulatory status of the fund and its adviser, including the exclusion from the Investment Company Act on which it relies and whether it relies on an exemption from the Securities Act of 1933;
- Whether the adviser is a subadviser to a private fund and the names and SEC file numbers of any other advisers to the fund;
- The size of the fund, including gross and net assets;
- The investment strategy of the fund;
- The breakdown of assets and liabilities of the fund by class and categorization in the fair value hierarchy established under GAAP;
- The number and types of investors in the fund;
- The minimum amount of investment; and
- Characteristics of the fund that may present the manager with conflicts of interest.

In addition, registered and exempt reporting advisers would have to provide information concerning five categories of "gatekeepers" that perform critical roles for advisers and the private funds they manage:

[4] Exempt reporting advisers also must complete certain other items concerning their operations on Form ADV including: (i) identifying information; (ii) SEC reporting information; (iii) form of organization; (iv) other business activities; (v) financial industry affiliations; (vi) names of control persons; and (vii) disclosure information on criminal and regulatory violations.

- **Auditors**. Whether they are independent, registered with the Public Company Accounting Oversight Board (PCAOB) and subject to its regular inspection and whether audited financial statements are distributed to fund investors.
- **Prime brokers**. Whether they are SEC registered and act as custodians for the private fund.
- **Custodians**. Whether they are related persons.
- **Administrators**. Whether they prepare and send to investors account statements and what percentage of the fund's assets are valued by the administrator or another person that is not related to the adviser.
- **Marketers**. Whether they are related to the adviser, their SEC file numbers (if any) and any website they use to market the fund.

Eligibility for Registration with the SEC

Section 203A of the Advisers Act currently prohibits, with some exceptions, an investment adviser from registering with the SEC if the adviser is regulated by the state in which its principal office and place of business is located if it has less than $25 million in assets under management. The Dodd-Frank Act creates a new category of "mid-sized adviser" which also is to be primarily regulated by the state where it has its principal office and place of business if it has between $25 and $100 million of assets under management. Such a mid-sized adviser will not be precluded from registration with the SEC if: (i) it is not required to be registered as an investment adviser in its home state; (ii) it is registered in its home state, but is not subject to examination by the state; or (iii) it is required to register in 15 or more states. Proposed new rule 203A-5 would require each investment adviser registered with the SEC on July 21, 2011 to file an amendment to its Form ADV no later than August 20, 2011 to report the market value of assets under management determined within 30 days of the filing of the amended form. Based on this information, an adviser no longer eligible for SEC registration would have to withdraw such registration by filing Form ADV-W no later than October 19, 2011.

Assets Under Management

In order to determine whether an adviser is eligible for SEC registration, the SEC proposes to revise the instructions for Form ADV for calculating assets under management. For this purpose, the Form ADV would refer to "regulatory assets under management," which would include all securities portfolios for which the adviser provides "continuous and regular supervisory or management services," regardless of the types of assets, and would eliminate the ability to opt into or out of state or federal regulation by including or excluding certain classes of assets (such as proprietary assets). For advisers to private funds, the value of the private funds' assets, including any uncalled capital commitments to the funds, would be included in regulatory assets under management.

Amendments to Pay to Play Rule

Rule 206(4)(5), adopted in July 2010, generally prohibits registered and certain unregistered advisers from engaging in certain pay to play practices in connection with providing advisory services to state and local governmental entities, including public pension funds.[5] The SEC has proposed expanding the rule to apply it to exempt reporting advisers and foreign private advisers. It also would expand the definition of "regulated person" to include "municipal advisors," a new category of registration created under the Dodd-Frank Act, to those persons excepted from the rule's prohibition of paying solicitors or payment agents to solicit governmental entities, provided they are registered with the SEC and subject to the pay to play rules of the Municipal Securities Rulemaking Board. Also, the rule's definition of "covered associate" of an adviser would be amended to include entities, in addition to natural persons.

5 See Fried, Frank, Harris, Shriver & Jacobson Client Alert *SEC Adopts Rule Banning Investment Advisers from Engaging in Pay-to-Play Practices,* July 13, 2010, http://www.friedfrank.com/index.cfm?pageID=25&itemID=6219.

If you have any questions about the contents of this memorandum, please call your regular Fried Frank contact or any of the attorneys listed below.

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