Proposed Rules Under the Investment Advisers Act

SEC Proposes Rules to Implement Dodd-Frank Act Registration Requirements for Advisers to Private Funds; Registration Exemptions for Venture Capital Funds, Certain Private Fund Advisers and Foreign Private Advisers; and Reporting Requirements for Registered Advisers and Certain Exempted Advisers

SUMMARY
The SEC has proposed rules¹ to implement certain provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act regarding investment advisers to private funds, such as hedge funds and private equity funds. The proposals would:

- establish reporting requirements for private fund advisers that will be required by the Dodd-Frank Act to register under the Investment Advisers Act of 1940 and more limited reporting requirements for certain private fund advisers that will continue to be exempted from registration under the Advisers Act;
- increase the scope of disclosure required of all registered investment advisers on Form ADV;
- clarify the exemptions from Advisers Act registration available to advisers to venture capital funds and private funds with less than $150 million in assets under management in the United States, and foreign private advisers; and
- clarify the parameters of the prohibition from SEC registration applicable to “mid-sized” investment advisers with between $25 million and $100 million in assets under management.

The SEC requests comments on these proposals within 45 days after their publication in the Federal Register, which we expect to occur shortly. For further background on the Dodd-Frank Act provisions that the SEC’s proposed rules would implement, please see our memorandum entitled “Implications of Financial Services Reform for Hedge Funds and Private Equity Funds.”²
PROPOSED REPORTING REQUIREMENTS FOR CERTAIN ADVISERS TO PRIVATE FUNDS (INCLUDING HEDGE FUNDS AND PRIVATE EQUITY FUNDS) AND OTHER REGISTERED INVESTMENT ADVISERS

The Dodd-Frank Act eliminated the “private adviser” exemption from registration under the Advisers Act for investment advisers with fewer than 15 clients, thereby subjecting many previously exempt advisers, including advisers to hedge funds and private equity funds, to the regulatory regime of the Advisers Act (including registration, substantive regulation, disclosure requirements and SEC examination). The SEC has proposed specific reporting requirements for these advisers, and also proposes to modify Form ADV to require greater disclosure from all registered investment advisers about their operations.

REPORTING REQUIREMENTS FOR ADVISERS TO PRIVATE FUNDS

The proposed rules would implement disclosure requirements for advisers to private funds that are separate and distinct from those applicable to other registered advisers. Under the Dodd-Frank Act, a private fund is an issuer that would be an investment company (as defined in the Investment Company Act (the “ICA”)) but for an exemption under section 3(c)(1) or 3(c)(7) of the ICA. In general, private funds include hedge funds, private equity funds, liquidity funds, real estate funds and securitized asset funds.

Currently, Section 7.B of Schedule D to Form ADV requires advisers to complete the information required therein for any “investment-related limited partnership” that the adviser or a “related person” advises (where “related person” is defined as any advisory affiliate and any person that is under common control with the adviser’s firm). The proposed rules would modify this item to require completion of the information required therein only for a private fund that the adviser (and not a related person) advises.

This change would require advisers to report on pooled investment vehicles they advise regardless of whether the vehicles are organized as limited partnerships. To avoid multiple reporting, sub-advisers would be permitted to exclude private funds for which another adviser is reporting on Schedule D, and an adviser to a master-feeder fund arrangement would be permitted to submit a single Schedule D for the master fund and all of the feeder funds. Advisers with a principal office and place of business outside the United States would be permitted to omit a Schedule D for a private fund that is not organized in the United States and that is not offered to, or owned by, any U.S. person.

Currently, Section 7.B of Schedule D requires limited information about the “investment-related limited partnerships” advised by an adviser. The reporting requirements of Section 7.B would be expanded to require advisers to private funds to disclose basic organizational, operational and investment characteristics of each fund it advises. This would require private advisers to report, among other things:

- identifying information, including the name and identification number of the private fund, the state or country where the private fund is organized, and the name of its general partner, manager, directors, trustees or persons occupying similar positions;
- whether the fund qualifies for the 3(c)(1) or the 3(c)(7) exclusion under the ICA;
SULLIVAN & CROMWELL LLP

- the organization of the fund (e.g., whether the fund is a master fund, a feeder fund or fund of funds);
- whether the adviser is subject to a foreign financial regulatory authority;
- whether the fund relies on an exemption from registration of its securities under Regulation D of the Securities Act of 1933;
- the fund’s gross and net assets;
- the type of investment strategy employed by the adviser (i.e., hedge fund, liquidity fund, private equity fund, real estate fund, securitized asset fund, venture capital fund or other private fund);
- the assets held by the fund by class and categorization in the fair value hierarchy established under U.S. GAAP (i.e., Level 1, Level 2 and Level 3);
- the number and types of investors in the fund and minimum investment commitments required of fund investors;
- any characteristics of the fund that may present the fund adviser with conflicts of interest with fund investors (e.g., whether clients of the adviser are solicited to invest in the fund and what percentage of the other clients has invested in the fund); and
- identification of and basic information about service providers (or “gatekeepers”) in five areas deemed critical by the SEC: auditors, prime brokers, custodians, administrators and marketers.

NEW REPORTING REQUIREMENTS FOR REGISTERED INVESTMENT ADVISERS

The SEC also proposes to modify Form ADV to require greater disclosure by all registered investment advisers about their operations. The new disclosure requirements would include information about the following items:

- **Advisory Business.** The proposed rules would require additional information from advisers about their advisory activities, the types of clients they have and the number of their employees that are registered as investment adviser representatives or insurance agents.

- **Non-Advisory Activities.** The proposed rules would require expanded disclosure of any non-advisory activities that the adviser is actively engaged in, including business as a trust company, registered municipal advisor, registered security-based swap dealer, major security-based swap participant, accountant or lawyer. An adviser that is engaged in any of these activities under a different name would be required to list those other business names and the other lines of business in which the adviser engages using that name.

- **Potential Conflicts of Interest.** The proposed rules would require identifying information regarding sixteen types of related persons as listed in Item 7.A of Form ADV and information about the relationship with that related person. The proposed rules also include expanded disclosure regarding advisers and their business practices that may present significant conflicts of interest (such as the use of affiliated brokers, soft dollar arrangements, compensation for client referrals and financial industry affiliations), due to participation or interest in client transactions.

---

PROPOSED DEFINITIONS AND REPORTING REQUIREMENTS FOR VENTURE CAPITAL FUNDS, PRIVATE FUND ADVISERS AND FOREIGN PRIVATE ADVISERS

Although the Dodd-Frank Act eliminated the “private adviser” exemption from registration under the Advisers Act for investment advisers with fewer than 15 clients, it created new exemptions for (1) advisers solely to venture capital funds, (2) advisers solely to private funds with less than $150 million in assets
under management in the United States (the “private fund adviser exemption”) and (3) foreign private advisers. The proposed rules implement and clarify these statutory exemptions.

The proposing release states that subadvisers could rely on each of these new exemptions, provided that they satisfy all terms and conditions of the applicable exemption. The SEC requests comment on whether an adviser should be able to rely on any of these exemptions even if one of its affiliates engages in activity that would otherwise disqualify the adviser from the exemption.

**Venture Capital Fund Adviser Exemption.** Under the proposed definition, a “venture capital fund” is a private fund that: (1) invests only in equity securities of “qualifying portfolio companies,” cash, cash equivalents and U.S. Treasuries with a remaining maturity of 60 days or less;\(^3\) (2) has an arrangement under which it or its investment adviser offers to provide (and if accepted, does so provide) significant guidance and counsel concerning the management, operations or business objectives and policies of, or actually controls, the qualifying portfolio company; (3) does not borrow, issue debt obligations, provide guarantees or otherwise incur leverage in excess of 15 percent of the private fund’s aggregate capital contributions and uncalled committed capital, and any such borrowing, indebtedness, guarantee or leverage is for a non-renewable term of no longer than 120 calendar days; (4) does not offer its investors redemption or other similar liquidity rights except in extraordinary circumstances (but may entitle investors to receive distributions made to all investors pro rata); (5) represents itself as a venture capital fund to investors and potential investors; and (6) is not registered under the ICA and has not elected to be treated as a “business development company” (as defined in the ICA). The SEC states that this proposed definition was informed by language Congress previously used to describe venture capital funds in the context of exempting “business development companies” from various requirements of the ICA and the Advisers Act, which exemption was meant to support venture capital activity in capital formation for small businesses.

The SEC proposes to include the following provisions in connection with this exemption:

- **Qualifying Portfolio Companies.** Under the proposed rule, a “qualifying portfolio company” is any company that: (i) is not publicly traded (and does not control, and is not controlled by or under common control with, a publicly traded company) at the time of the venture capital fund’s investment; (ii) does not borrow or issue debt obligations, directly or indirectly, in connection with the venture capital fund’s investment; (iii) does not redeem, exchange or repurchase outstanding securities, or distribute to pre-existing security holders cash or other company assets, in connection with the venture capital fund’s investment; and (iv) is not itself an investment company, private fund or other pooled investment vehicle.

- **Grandfathering Provision.** The SEC proposes to “grandfather” certain preexisting venture capital funds into this exemption. The proposed definition of “venture capital fund,” for the purposes of the grandfathering provision, includes any private fund that: (i) has represented to investors at the time of the offering of the fund’s securities that it is a venture capital fund; (ii) has sold securities to one or more investors that are not related persons to the fund’s adviser prior to December 31, 2010; and (iii) does not sell any securities to (including accepting any committed capital from) any person after July 21, 2011.
The SEC seeks comment on the proposed definition of “venture capital fund” and whether a non-U.S. adviser should be able to rely on the exemption even if it advises clients other than venture capital funds, provided such clients are non-U.S. persons.

**Private fund adviser exemption.** In order to rely on the private fund adviser exemption, a U.S. adviser — i.e., an adviser with its principal office and place of business within the United States — would be permitted to act as an investment adviser solely to one or more “qualifying private funds” that have, in the aggregate, assets of less than $150 million. The proposed rule would deem all of the assets managed by an adviser to be “assets under management in the United States” (within the meaning of the Dodd-Frank Act) if the adviser’s principal office and place of business are in the United States.

A non-U.S. adviser — i.e., an adviser with its principal office and place of business outside the United States — could qualify for the exemption so long as all of the adviser’s clients that are U.S. persons (as defined under Regulation S) are “qualifying private funds” and all assets managed by the adviser from a place of business in the United States are solely attributable to private fund assets, the total value of which is less than $150 million. The proposed rule contemplates providing the exemption only to non-U.S. advisers that manage certain private fund assets from within the United States, the exemption seems unlikely to be available to non-U.S. advisers unless those advisers access U.S. investors only through private funds managed from within the United States. In determining which of its clients are U.S. persons, an adviser must include any discretionary or other fiduciary account that is held for the benefit of a U.S. person by a non-U.S. fiduciary who is a related person of the adviser.

Under the proposed rule, a “qualifying private fund” is a private fund that is not registered under the ICA and has not elected to be treated as a “business development company” under the ICA. The SEC proposes to define “assets under management” by reference to a proposed new Item 5.F of Form ADV. Under this definition, in addition to assets appearing on a private fund’s balance sheet, advisers would include uncalled capital commitments. This definition is described further below under “Reallocation of Regulatory Responsibility for ‘Mid-Sized’ Investment Advisers – Calculating Assets Under Management.” Each adviser would be required to determine the amount of its private fund assets quarterly, based on the fair value of the assets at the end of the quarter.

**Foreign private adviser.** Under the Advisers Act as amended by the Dodd-Frank Act, a “foreign private adviser” is any investment adviser that: (1) does not have a place of business in the United States; (2) has, in total, fewer than 15 clients and investors in the United States in private funds advised by the adviser; (3) has less than $25 million in aggregate assets under management (or such higher amount as the SEC may provide) from clients and private fund investors in the United States; and (4) does not hold itself out generally to the public in the United States as an investment adviser and does not act as an adviser to a registered investment company or business development company under the ICA.

The proposed rules include the following provisions in connection with this exemption:
Proposed Rules Under the Investment Advisers Act
November 24, 2010

• **Counting Clients.** The SEC proposes to adopt client counting rules for purposes of this exemption similar to those in Rule 203(b)(3)-1, as currently in effect.

• **Avoiding Double Counting of Clients.** However, as required by statute, foreign private advisers must count not only clients but also private fund investors for purposes of satisfying the exemption’s requirements. The proposed rule states that an adviser need not count a private fund as a client if the adviser counted any investor in that private fund for purposes of determining the availability of the exemption. An adviser also would be able to treat as a single investor any person who is an investor in two or more private funds advised by the investment adviser.

• **Private Fund Investors.** The SEC proposes to define “investor” for purposes of this exemption as any person who would be included in determining the number of beneficial owners of the outstanding securities of a private fund under section 3(c)(1) of the ICA or whether the outstanding securities of a private fund are owned exclusively by qualified purchasers under section 3(c)(7) of the ICA. Also included as an “investor” would be a beneficial owner (i) who is a “knowledgeable employee” with respect to the private fund or (ii) of “short-term paper” issued by the private fund (even though these persons are not counted as beneficial owners for purposes of section 3(c)(1) and knowledgeable employees are not required to be qualified purchasers under section 3(c)(7)).

• **In the United States.** The proposed rule generally refers to definitions of “U.S. person” and “United States” under Regulation S to assess whether a client or investor is “in the United States.” The proposal specifies that for purposes of this exemption, a person that is “in the United States” may be treated as not being “in the United States” if such person was not “in the United States” at the time of becoming a client or, in the case of an investor in a private fund, at the time the investor acquires the securities issued by the fund.

• **“Place of business.”** The proposed rule defines “place of business” to mean any office where the investment adviser regularly provides advisory services, solicits, meets with, or otherwise communicates with clients, and any location held out to the public as a place where the adviser conducts any such activities.

As with the private fund adviser exemption above, the SEC also proposes to define “assets under management” for purposes of this exemption by reference to a proposed new Item 5.F of Form ADV.

**REPORTING REQUIREMENTS FOR “EXEMPT REPORTING ADVISERS”**

As described above, although advisers solely to venture capital funds and advisers solely to private funds with less than $150 million in assets under management in the U.S. would be exempt from registration, they would not be exempt from recordkeeping, reporting and examination. The SEC’s release thus refers to these advisers as “exempt reporting advisers.” Exempt reporting advisers would be required to file and periodically update a subset of items on Form ADV through the Investment Adviser Registration Depository (“IARD”) using the same process as registered investment advisers. This subset of items includes information regarding basic identifying details about an exempt reporting adviser such as name, address, contact information, form of organization and ownership of the adviser, other business activities that the adviser and its affiliates are engaged in that pose conflicts of interest, the disciplinary history for the adviser and its employees and a comprehensive overview of private funds they advise. Exempt reporting advisers would not be required to prepare a client brochure (Part 2 of Form ADV).

This disclosure would be publicly available on the SEC’s website and, as with other filers, would be required to be updated at least annually, within 90 days of the end of the adviser’s fiscal year, and more frequently, if required by the instructions to Form ADV. The proposed rules would require an adviser to
update certain items, such as identification and disciplinary information, promptly if the disclosure becomes inaccurate during the course of the year. The initial report on Form ADV for exempt reporting advisers would be required to be filed by August 20, 2011.

**REALLOCATION OF REGULATORY RESPONSIBILITY FOR “MID-SIZED” INVESTMENT ADVISERS**

Under existing law, investment advisers generally may not register with the SEC unless they have at least $25 million in assets under management. The Dodd-Frank Act raises the threshold for SEC registration to $100 million by creating a new category of advisers called “mid-sized advisers.” As amended by the Dodd-Frank Act, the Advisers Act defines a mid-sized adviser as an adviser that:

- has between $25 million and $100 million in assets under management;
- is required to be registered in the state where it maintains its principal office and place of business; and
- would be subject to examination by that state, if registered.

A mid-sized adviser may not register with the SEC unless it is required to register in 15 or more states or falls under one of the exemptions to the prohibition on SEC registration outlined below. This provision is expected to require a significant number of advisers currently registered with the SEC to withdraw their registrations with the SEC and to switch to registration with one or more state securities authorities. Mid-sized advisers will be subject to state regulation and will continue to be subject to the Advisers Act’s general anti-fraud provisions.

**TRANSITIONING FROM SEC REGISTRATION**

The SEC proposes to require every investment adviser registered with it on July 21, 2011, the effective date of the relevant provisions of the Dodd-Frank Act, to file an amendment to its Form ADV no later than August 20, 2011 and to report the market value of its assets under management determined within 30 days of the filing. This amendment would require each investment adviser to determine whether it meets the revised eligibility criteria for SEC registration. Advisers no longer eligible for SEC registration would have to withdraw their SEC registration by filing Form ADV-W no later than October 19, 2011.

For an adviser that would otherwise need to register with the SEC for the first time on January 1, 2011 (because its assets under management have only recently risen above $30 million), the SEC states that it will not object if such adviser is not registered with it if, on or after January 1, 2011 until the end of the transition process (which would be October 19, 2011 under the proposed rule), the adviser reports on its Form ADV that it has between $30 million and $100 million of assets under management, provided that the adviser is registered as an investment adviser in the state in which it maintains its principal office and place of business and has a reasonable belief that it is required to be registered with, and is subject to examination as an investment adviser by, that state.
EXEMPTIONS TO THE PROHIBITION ON SEC REGISTRATION

Under current Advisers Act Rule 203A-2, an adviser with assets under management of less than $25 million may register with the SEC if it is (1) a nationally recognized statistical rating organization ("NRSRO"); (2) a pension consultant with a minimum value of plan assets of $50 million; (3) affiliated with an adviser registered with the SEC; (4) expecting to be eligible for SEC registration within 120 days after its registration becomes effective; (5) an investment adviser required to register in 30 or more states; or (6) an internet adviser. To better align these current exemptions with other amendments adopted by the Dodd-Frank Act, the SEC proposes to eliminate the exemption for NRSROs, increase the minimum value of plan assets in the pension consultant exemption to $200 million, and permit any investment adviser required to register as an investment adviser with 15 or more states to register with the SEC.

CALCULATING ASSETS UNDER MANAGEMENT

The SEC provided the current instructions to calculate assets under management in 1997 as part of the implementation of the $25 million assets under management threshold for SEC registration. Given the expanded use of the term after the Dodd-Frank Act, the SEC proposes to provide a “uniform method” of calculating assets under management for purposes of the Advisers Act. This method of calculation would be used to determine whether an adviser qualifies to register with the SEC rather than the states, as well as to determine eligibility for the private fund adviser and the foreign private adviser exemptions discussed above.

Under the proposed Form ADV instructions, advisers would include in their assets under management (which the proposed instruction refers to as “regulatory assets under management”) securities portfolios for which they provide continuous and regular supervisory or management services, regardless of whether these assets are proprietary assets, assets managed without receiving compensation or assets of non-U.S. clients (all of which an adviser may currently exclude). Moreover, advisers could not deduct outstanding indebtedness and other accrued but unpaid liabilities, such as accrued fees and expenses or the amount of any borrowing, that remain in a client’s account and are managed by the adviser.

Private funds. Form ADV currently provides no specific instructions regarding how to calculate assets under management for advisers to private funds. The SEC proposes to require in such calculations: (1) the value of any private fund over which the adviser exercises continuous and regular supervisory or management services, regardless of the nature of the assets held by the fund and (2) uncalled capital commitments to private funds. The proposed instructions also require advisers to use the fair value of private fund assets, as opposed to other measures, such as cost basis. The SEC recognizes that fair value methodologies may be difficult to apply when the fund holds illiquid assets or assets not traded on organized markets, but states in the proposing release that the benefits of consistent reporting and calculations outweigh any burdens. The SEC requests comment on the proposed valuation rules.

* * *

Proposed Rules Under the Investment Advisers Act
November 24, 2010
ENDNOTES


2 This memorandum, published on July 19, 2010, is available at https://www.sullcrom.com/files/upload/SC_Publication_Implications_Financial_Services_Reform_Hedge_Funds_Private_Equity_Funds.pdf

3 The proposed rule includes a requirement that at least 80 percent of each company’s securities owned by the venture capital fund were acquired directly from the qualifying portfolio company.

4 Pursuant to Section 203A(a)(1) of the Advisers Act, only investment advisers that have at least $25 million in assets under management or that advise a registered investment company may register with the SEC, and most state regulatory requirements are preempted with respect to SEC-registered advisers. The SEC has authority under Section 203A(a)(1) to increase this threshold by rule, and exercised this authority by promulgating Rule 203A-1(a), which raises the threshold for mandatory federal registration to $30 million in assets under management, as reported on an adviser’s Form ADV. This rule in effect makes federal registration optional for investment advisers having at least $25 million but less than $30 million in assets under management.
ABOUT SULLIVAN & CROMWELL LLP

Sullivan & Cromwell LLP is a global law firm that advises on major domestic and cross-border M&A, finance, corporate and real estate transactions, significant litigation and corporate investigations, and complex restructuring, regulatory, tax and estate planning matters. Founded in 1879, Sullivan & Cromwell LLP has more than 800 lawyers on four continents, with four offices in the United States, including its headquarters in New York, three offices in Europe, two in Australia and three in Asia.

CONTACTING SULLIVAN & CROMWELL LLP

This publication is provided by Sullivan & Cromwell LLP as a service to clients and colleagues. The information contained in this publication should not be construed as legal advice. Questions regarding the matters discussed in this publication may be directed to any of our lawyers listed below, or to any other Sullivan & Cromwell LLP lawyer with whom you have consulted in the past on similar matters. If you have not received this publication directly from us, you may obtain a copy of any past or future related publications from Jennifer Rish (+1-212-558-3715; rishj@sullcrom.com) or Alison Alifano (+1-212-558-4896; alifanoa@sullcrom.com) in our New York office.

CONTACTS

New York

<table>
<thead>
<tr>
<th>Name</th>
<th>Phone</th>
<th>Email</th>
</tr>
</thead>
<tbody>
<tr>
<td>John E. Baumgardner, Jr.</td>
<td>+1-212-558-3866</td>
<td><a href="mailto:baumgardnerj@sullcrom.com">baumgardnerj@sullcrom.com</a></td>
</tr>
<tr>
<td>Whitney A. Chatterjee</td>
<td>+1-212-558-4883</td>
<td><a href="mailto:chatterjeew@sullcrom.com">chatterjeew@sullcrom.com</a></td>
</tr>
<tr>
<td>Donald R. Crawshaw</td>
<td>+1-212-558-4016</td>
<td><a href="mailto:crawshawd@sullcrom.com">crawshawd@sullcrom.com</a></td>
</tr>
<tr>
<td>William G. Farrar</td>
<td>+1-212-558-4940</td>
<td><a href="mailto:farrarw@sullcrom.com">farrarw@sullcrom.com</a></td>
</tr>
<tr>
<td>Richard R. Howe</td>
<td>+1-212-558-3612</td>
<td><a href="mailto:hower@sullcrom.com">hower@sullcrom.com</a></td>
</tr>
<tr>
<td>Kenneth M. Raisler</td>
<td>+1-212-558-4675</td>
<td><a href="mailto:raislerk@sullcrom.com">raislerk@sullcrom.com</a></td>
</tr>
<tr>
<td>Frederick Wertheim</td>
<td>+1-212-558-4974</td>
<td><a href="mailto:wertheimf@sullcrom.com">wertheimf@sullcrom.com</a></td>
</tr>
</tbody>
</table>

Washington, D.C.

<table>
<thead>
<tr>
<th>Name</th>
<th>Phone</th>
<th>Email</th>
</tr>
</thead>
<tbody>
<tr>
<td>Eric J. Kadel, Jr.</td>
<td>+1-202-956-7640</td>
<td><a href="mailto:kadelej@sullcrom.com">kadelej@sullcrom.com</a></td>
</tr>
<tr>
<td>Paul J. McElroy</td>
<td>+1-202-956-7550</td>
<td><a href="mailto:mcelroyp@sullcrom.com">mcelroyp@sullcrom.com</a></td>
</tr>
</tbody>
</table>