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INVESTMENT MANAGEMENT

SEC Dodd-Frank Advisers Act Rulemaking: Part II

The Dodd-Frank Act eliminates the "private advisers" exemption in Section 203(b)(3) of the Investment Advisers Act of 1940. It also generally raises the floor for Advisers Act registration and creates additional exemptions. Part I of this article focused on the new assets under management floors and other implementing issues. Part II focuses on the new Advisers Act exemptions.

By Kenneth W. Muller

In June 2011, the Securites and Exchange Commission adopted rules implementing the venture capital, private funds and foreign private advisers exemptions as set forth in Section 203(l), 203(m), and 203(b)(3) of the Investment Advisers Act of 1940 (Advisers Act) as amended by The Dodd-Frank Act.[1] The Commission also adopted Rule 202(a)(11)(G)1 under the Advisers Act, which defines the term "family office" for purposes of the "family office" exemption.[2]

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Exemptions for Advisers to Venture Capital Funds, Certain Private Fund Advisers, and Foreign Private Advisers

The Venture Capital Fund Exemption

Section 203(l). Section 203(l) of the Advisers Act provides that "no investment adviser that acts as an investment adviser solely to one or more venture capital funds shall be subject to the registration requirements of [the Advisers Act] with respect to the provision of investment advice relating to a venture capital fund."[3]

Rule 203(l)-1. New Rule 203(l)-1 defines "venture capital funds" for purposes of the new exemption in Section 203(l). An adviser is eligible to rely on the venture capital exemption only if it solely advises venture capital funds that meet all of the elements of the definition or funds that have been grandfathered.

Definition of "Venture Capital Funds." In defining "venture capital funds," the Commission distinguished venture capital funds from other types of private funds, such as hedge funds and private equity funds, and addressed Congressional concerns about systemic risk.

Rule 203(l)-1(a) defines a venture capital fund as a "private fund"[4] that

1. represents itself to its investors and potential investors as pursuing a venture capital strategy;[5]

2. immediately after the acquisition of any asset (other than qualifying investments or short-term holdings[6]), holds no more than 20 percent[7] of the fund's aggregate capital contributions and uncalled capital commitments[8] in assets (other than short-term holdings) that are non-qualifying investments, valued at cost or fair value, consistently applied by the fund;[9]
3. does not borrow, issue debt obligations, provide guarantees or otherwise incur leverage,[10] other than limited short-term borrowings not in excess of 15 percent of the fund's 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, except that any guarantee by the private fund of a qualifying portfolio company's obligations up to the amount of the value of the private fund's investment in the qualifying portfolio company is not subject to the 120 calendar day limit;[11]
4. only issues securities the terms of which do not provide a holder with any right, except in extraordinary circumstances,[12] to withdraw, redeem or require the repurchase of such securities but may entitle holders to receive distributions made to all holders pro rata; and
5. is not registered under the Investment Company Act of 1940 (Investment Company Act) and has not elected to be treated as a business development company (BDC).

Under the final rule, "qualifying investments" generally are equity securities[13] that were acquired by the fund in one of three ways that suggest that the fund's capital is being used to finance the operations of businesses rather than for trading in secondary markets. Rule 203(l)-1(c)(3) defines a "qualifying investment" as:

1. any equity security issued by a qualifying portfolio company that is directly acquired by the private fund from the company ("directly acquired equity");
2. any equity security issued by a qualifying portfolio company in exchange for directly acquired equity issued by the same qualifying portfolio company;[14] or
3. any equity security issued by a company of which a qualifying portfolio company is a majority-owned subsidiary, as defined in Section 2(a)(24) of the Investment Company Act, or a predecessor, and that is acquired by the fund in exchange for directly acquired equity described above in clause (i) or (ii).[15]

Rule 203(l)-1(c)(4) defines a "qualifying portfolio company"[16] as any company that;

1. at the time of any investment by the private fund, is not a reporting or foreign traded company and does not control, is not controlled by or under common control with, a reporting or foreign traded company;[17]
2. does not borrow or issue debt obligations in connection with the private fund's investment in the company[18] *and* distribute to the private fund the proceeds of such borrowing or issuance *in exchange for*[19] the private fund's investment;[20] and
3. is not itself a private fund or other pooled investment vehicle[21] (*i.e.*, is an operating company).

Basket. Investments in the 20 percent "basket" can be outside the strict venture capital-oriented equity investment parameters imposed on the remaining 80 percent of the fund. The Commission stated that defining a venture capital fund to include funds engaged in some amount of non-qualifying investment activity provides advisers to venture capital funds with greater investment flexibility, while precluding an adviser relying on the exemption from altering the character of the fund's investments to such extent that the fund could no longer be viewed as a venture capital fund within the intended scope of the exemption.[22] While the definition limits the amount of non-qualifying investments, it allows the adviser to choose how to allocate those investments. Thus, one venture capital fund may take advantage of some opportunities to invest in non-convertible debt whereas others may seek limited opportunities in publicly offered securities, interests in other private funds or secondary market equity.

Grandfathering. Rule 203(l)-1(b) grandfathers any pre-existing venture capital fund as a venture capital fund if it satisfies certain criteria.

1. It has represented to investors and potential investors at the time the fund offered its securities that it pursues a venture capital strategy;
2. Prior to December 31, 2010, it has sold securities to one or more investors that are not related persons, as defined in Rule 206(4)-2(d)(7), of any investment adviser of the private fund; and
3. It does not sell any securities to (including accepting any capital commitments from) any person after July 21, 2011.

A fund that seeks to qualify under the grandfather provision should examine all of the statements and representations made to investors and prospective investors to determine whether the fund has satisfied the "holding out" criterion as it is incorporated into the grandfathering provision. The Commission stated that a fund that "represents" itself to investors as pursuing a venture capital strategy is typically one that discloses it pursues a venture capital strategy and identifies itself as such. The Commission does not expect that existing funds identifying themselves as pursuing a "private equity" or "hedge" fund strategy would be able to rely on this element of the grandfathering provision.

A grandfathered fund includes any fund that has accepted all capital commitments by July 21, 2011, even if none of the capital commitments has been called by such date. The Commission stated that the calling of capital after July 21, 2011 would be consistent with the grandfathering provision, as long as the investor became obligated by July 21, 2011 to make a future capital contribution.

Non-U.S. Advisers and Non-U.S. Activities. The Commission stated that a non-U.S. adviser may rely on the venture capital exemption provided that such adviser solely advises venture capital funds that satisfy all of the elements of the rule or satisfy the grandfathering provision. The Commission also noted that an investment adviser must take into consideration its non-U.S. activities in determining whether the investment adviser acts as an investment adviser solely to one or more venture capital funds. The Commission stated that this result stemmed from the fact that the exemption specifies the activities in which an adviser's clients may engage, and does not refer to activities in the U.S. By contrast, Section 203(m), the private funds exemption, discussed below, is based upon the location where the advisory activity is conducted.

Reporting Obligations. U.S. and non-U.S. advisers relying on the venture capital exemption would continue to be subject to the reporting obligations of exempt reporting advisers (as discussed in Part I of this article).

The Exemption for Advisers Solely to Private Funds with Less than $150 Million under Management

Section 203(m). Section 203(m) of the Advisers Act directs the Commission to exempt from the registration requirements of the Advisers Act any investment adviser that acts solely as an adviser to "private funds" and has assets under management in the U.S. of less than $150 million.[23]

Rule 203(m)-1. Rule 203(m)-1, which implements Section 203(m) of the Advisers Act, provides for the exemption and, in addition, addresses several interpretive questions.

Rule 203(m)-1(a) provides that, for purposes of Section 203(m), an investment adviser with its principal office and place of business in the U.S. is exempt from the requirement to register under the Advisers Act if the investment adviser (1) acts solely as an investment adviser to one or more "qualifying private funds," and (2) manages "private fund assets" of less than $150 million.

"Qualifying private fund" means any "private fund" that is not registered under Section 8 of the Investment Company Act and has not elected to be treated as a business development company.[24] Normally "private funds" only include Section 3(c)(1) and Section 3(c)(7) exempt funds, but Rule 203(m)-1(d)(5) contains a special provision that provides that with respect to the definition of "qualifying private fund," an investment adviser may treat as a private fund an issuer that qualifies for the exclusion from the definition of an "investment company," as defined in Section 3 of the Investment Company Act, in addition to those provided by Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act, provided that the adviser treats the issuer as a private fund under the Advisers Act and the rules thereunder for all purposes.[25] "Private fund assets" means the investment adviser's assets under management attributable to a qualifying private fund.[26]

Accordingly, an adviser that has one or more clients that are not "qualifying private funds" is not eligible for the exemption and must register under the Advisers Act unless another exemption is available. An adviser may advise an unlimited number of qualifying private funds, provided the aggregate value of the assets attributable to qualifying private funds is less than $150 million. The Commission noted, however, that, depending on the facts and circumstances, it may view two or more separately formed advisory entities that each has less than $150 million in private fund assets under management as a single adviser for purposes of assessing the availability of exemptions from registration.

The Commission expanded the scope of "private funds" by pivoting the Rule 203(m)-1 exemption around "qualifying private funds," which includes any fund that is exempt under Section 3 of the Investment Company Act, provided that the adviser treats the issuer as a private fund under the Advisers Act and the rules thereunder for all purposes. As originally proposed, the rule excluded only "private funds" as defined in the Dodd Frank Act (that is, only funds that would be investment companies but for the exemptions contained in Sections 3(c)(1) and 3(c)(7) of the Investment Company Act). Under the final rule, however, an investment adviser could rely upon the Section 203(m) exemption, for example, if it advised a real estate fund relying on the exemption contained in Section 3(c)(5)(C) of the Investment Company Act, provided that the adviser relying on this provision must treat the fund as a private fund under the Advisers Act and the rules thereunder for all purposes.

Some of the obligations that apply with respect to "private funds" are as follows. First, the SEC may require any registered investment adviser to be subject to record-keeping and reporting requirements in respect of "private funds."[27] Second, the Dodd-Frank Act requires the comptroller general of the U.S. to conduct a study of the feasibility of forming a self-regulatory organization (SRO) to oversee "private funds."[28] In addition, the Dodd-Frank Act requires the comptroller general to conduct a study of the appropriate criteria for determining the financial thresholds or other criteria needed to qualify for accredited investor status and eligibility to invest in "private funds."[29] As a result, it is likely there could be further regulation of "private funds." Third, the term "foreign private adviser" in Section 203(b)(3) means any investment adviser who, among other things, has, in total, fewer than 15 clients in the U.S. and investors in the

U.S. in "private funds" advised by the investment adviser. Treating a fund as a "private fund" would therefore subject foreign private advisers relying upon Section 203(b)(3) to limitations on the number of investors. Advisers that are not advisers to "private funds," when evaluating whether they should qualify as advisers to "qualifying private funds," must be aware of the implications of treating their funds as "private funds" to avoid unintended consequences.

Non-U.S. Investment Advisers. In the case of an adviser with a principal office and place of business[30] outside of the U.S., the exemption is available as long as *all* of the adviser's clients that are U.S. persons are qualifying private funds.[31] The Commission noted, however, that a non-U.S. adviser need not have one or more private fund clients that are U.S. persons in order to rely on the exemption. Under the rule, a non-U.S. adviser would not lose the private fund adviser exemption as a result of the size or nature of its advisory or other business activities outside of the U.S. However, all assets managed by the investment adviser at a place of business in the U.S. must be solely attributable to "private fund assets," the total value of which is less than $150 million.[32]

"U.S." has the same meaning as in Section 902(l) of Regulation S.[33] Rule 203(m)-1 defines a "U.S. person" generally by incorporating the definition of a "U.S. person" in Regulation S[34] under the Securities Act.[35] Rule 203(m)-1(d)(8) also contains a special rule that requires an adviser relying on the exemption to treat a discretionary or other fiduciary account as a U.S. person if the account is held for the benefit of a U.S. person by a non-U.S. fiduciary who is a related person[36] of the adviser. In contrast, under Regulation S, a discretionary account maintained by a non-U.S. fiduciary (such as an investment adviser) is not a "U.S. person" even if the account is owned by a U.S. person.[37] The Commission stated that it believed that the special rule was narrowly drawn and necessary to prevent advisers from purporting to rely on the exemption and establishing discretionary accounts for the benefit of U.S. clients with an offshore affiliate that would then delegate the actual management of the account back to the adviser. Finally, a note to Rule 203(m)-1(d)(8) provides that a client will not be considered a U.S. person if the client was not a U.S. person at the time of becoming a client.[38]

The Ability to Combine Exemptions. The Commission acknowledged that some commenters suggested that advisers should be permitted to combine other exemptions with the exemption provided by Rule 203(m)-1. For example, an adviser could advise venture capital funds with assets under management in excess of $150 in addition to other, non-venture capital private funds with less than $150 million in assets under management. The Commission declined to adopt this approach, stating that it would run contrary to the intent of the statute.[39]

Single Investor Funds. Some commenters asked the Commission to address whether a fund with a single investor could be a "private fund" for purposes of the exemption. The Commission responded that it depends on the facts and circumstances. The Commission noted that many attempts to create single-investor funds would be an illegal circumvention of Advisers Act registration requirements, but recognized that there are circumstances when it may be appropriate for an adviser to treat a single-investor fund as a private fund for purposes of Rule 203(m)-1. For example, a fund that seeks to raise capital from multiple investors but has only a single, initial investor for a period of time could be a private fund, as could a fund in which all but one of the investors have redeemed their interests. However, advisers could not convert managed accounts to single-investor funds in order to qualify for the exemption. An adviser also would not be eligible for the exemption if it advises what is nominally a "private fund" but that in fact operates as a means for providing individualized investment advice directly to the investors. In this case, the investors would be clients of the adviser.

Calculating AUM. The rules prescribe how to calculate assets under managements to determine whether an adviser qualifies for this exemption. Under Rule 203(m)-1, an adviser must aggregate the value of all "private fund assets" to determine if the adviser is below the $150 million threshold. "Private fund assets" means the investment adviser's assets under management attributable to a "qualifying private fund."[40] Rule 203m-1 requires advisers to calculate the value of "private fund assets" pursuant to the revised instructions in Form ADV, which provide a uniform method of calculating assets under management for regulatory purposes under the Advisers Act.[41]

As discussed in Part I of this article, Section 203A(a)(3) of the Advisers Act defines "regulatory assets under management" as the "securities portfolios" with respect to which an adviser provides "continuous and regular supervisory or management services." The revised instructions to Form ADV provide that advisers must include in their regulatory assets under management securities portfolios for which they provide continuous and regular supervisory or management services, regardless of whether these assets are family or proprietary assets,[42] assets managed without receiving compensation, assets of foreign clients, and in the case of private funds, uncalled capital commitments.[43] Second, the revised instructions to Form ADV clarify that an adviser must calculate its regulatory assets under management on a gross basis, that is, without deduction of "any outstanding indebtedness or other accrued but unpaid liabilities."[44] Third, an adviser must include in its calculation of regulatory assets under management the value of any private fund over which it exercises continuous and regular supervisory or management services, regardless of the nature of the assets held by the fund.[45] A sub-adviser to a private fund would include in its regulatory assets under management only that portion of the value of the portfolio for which it provides continuous and regular supervisory or management services. Fourth, advisers must use the market value of private fund assets, or the fair value of private fund assets where market value is unavailable, which would include illiquid assets.[46] The Commission stated that while many advisers will calculate fair value in accordance with GAAP or another international accounting standard, other advisers acting consistently and in good faith may use another fair valuation standard, which would permit the general partner to retain discretion over the determination of fair value.[47]

Advisers relying on the exemption provided by the Rule 203(m)-(1) exemption must annually calculate the amount of the "private fund assets" under management and report these amounts in annual amendments to Form ADV.[48] Advisers reporting $150 million or more of "private fund assets" under management no longer qualify for the private fund adviser exemption. Thus, advisers may be required to register under the Advisers Act if assets under management appreciate above the threshold at the end of the annual reporting period, but not between annual reporting periods. An adviser reporting $150 million or more of "private fund assets" under management may apply for registration with the Commission up to 90 days after filing the annual updating amendment,[49] and may continue to act as a private fund adviser, consistent with the requirements of Rule 203(m)-1, during this transition period. This 90-day transition period is not available to advisers that have failed to comply with all Commission reporting requirements applicable to an exempt reporting adviser or that have accepted a client that is not a private fund. These advisers therefore should plan to register before becoming ineligible for the exemption.

Under Rule 203(m)-1(a), all of the private fund assets of an adviser with a principal office and place of business[50] in the U.S., regardless of whether the assets are invested in the U.S., are considered to be "assets under management," even if the adviser has offices outside of the U.S. Under Rule 203(m)-1(b), a non-U.S. adviser, however, need only count private fund assets it manages at a place of business[51] in the U.S toward the $150 million assets under management limit under the exemption. Any assets managed at a U.S. place of business for clients other than "private funds" would make the exemption unavailable for non-U.S. advisers.

Reporting Obligations. U.S. and non-U.S. advisers relying on the private funds exemption would continue to be subject to reporting obligations of exempt reporting advisers (as discussed in Part I of this article).

Relationship to Venture Capital Exemption. Investment advisers that qualify for the "private funds" exemption and the "venture capital" exemption may prefer the "private funds" exemption due to the fact that it generally involves a less complicated securities analysis and less complicated ongoing compliance obligations. Other investment advisers may prefer the "private funds" exemption, since it is not limited only to "private funds," as is the case for the "venture capital" exemption. Foreign investment advisers may find the "private funds" exemption more favorable, since they are generally not required to take into account their non-U.S. activities when meeting the exemption.

The Foreign Private Advisers Exemption

Section 203(b)(3). Section 403 of the Dodd-Frank Act creates a "foreign private adviser" exemption, which replaces the old "private adviser" exemption in Section 203(b)(3).

Definition of "Foreign Private Adviser." Section 202(a)(30) of the Advisers Act now defines a "foreign private adviser" as any investment adviser that

1. has no place of business in the U.S.;
2. has, in total, fewer than 15 clients in the U.S. and investors in the U.S. in private funds advised by the investment adviser;
3. has aggregate assets under management attributable to clients in the U.S. and investors in the U.S. in private funds advised by the investment adviser of less than $25 million;[52] and
4. does not hold itself out generally to the public in the U.S. as an investment adviser, and does not act as an investment adviser to a registered investment company or to a company that has elected to be a business development company pursuant to Section 54 of the Investment Company Act.

Rule 202(a)(30)-1. The Commission adopted Rule 202(a)(30)-1, which defines certain terms in Section 202(a)(30) for purposes of the "foreign private adviser" exemption, including: (1) "investor"; (2) "in the U.S."; (3) "place of business"; and (4) "assets under management."[53] The Commission also included in Rule 202(a)(30)-1 the safe harbor and many of the client counting rules that appeared in old Rule 203(b)(3)-1.

Impact on Foreign Investment Advisers. Given the limited scope of the foreign private adviser exemption, it is unlikely that many non-U.S. advisers will rely on it. However, non-U.S. advisers will be able to consider relying upon any of the other new exemptions under the Advisers Act.

Clients. New Rule 202(a)(30)-1(a)(1) allows an adviser to treat as a single client a natural person and: (1) that person's minor children (whether or not they share the natural person's principal residence); (2) any relative, spouse, spousal equivalent,[54] or relative of the spouse or of the spousal equivalent of the natural person who has the same principal residence; (3) all accounts of which the natural person and/or the persons referred in paragraph (a)(1) are the only primary beneficiaries; and (4) all trusts of which the natural person and/or the persons referred in paragraph (a)(1) are the only primary beneficiaries. Rule 202(a)(30)-1(a)(2) also permits an adviser to treat as a single "client" (1) a corporation, general partnership, limited partnership, limited liability company, trust (other than a trust referred to in paragraph (a)(1)(iv), or other legal organization (each, a "legal organization") to which the adviser provides investment advice based on the legal organization's investment objectives rather than the investment objectives of its shareholders, partners, limited partners, members, or beneficiaries (each, an "owner"), and (2) two or more legal organizations referred to in paragraph (a)(2)(i) that have identical owners.

In addition, Rule 202(a)(30)-1(b)(1) through (3) contain the following related "special rules": (1) an adviser must count an owner as a client if the adviser provides investment advisory services to the owner separate and apart from the investment advisory services provided to the legal organization, provided, that the determination that an owner is a client will not affect the applicability of this section with regard to any other owner; (2) an adviser is not required to count an owner as a client solely because the adviser, on behalf of the legal organization, offers, promotes, or sells interests in the legal organization to the owner, or reports periodically to the owners as a group solely with respect to the performance of or plans for the legal organization's assets or similar matters; and (3) a limited partnership or limited liability company is a client of any general partner, managing member, or other person acting as an investment adviser to the limited partnership or limited liability company. As proposed, the Commission declined not to count as a client any person for whom the adviser provides investment advisory services without compensation.

The new rule includes two provisions that clarify that advisers need not double-count private funds and their investors under certain circumstances.[55] Rule 202(a)(30)-1(b)(4) specifies that an adviser need not count a private fund as a client if the adviser counted any investor, as defined in the rule, in that private fund as an investor in the U.S. in that private fund.[56] The Commission stated that this provision is applicable only for purposes of determining whether an adviser has fewer than 15 clients in the U.S. and investors in the U.S. in private funds it advises under Section 202(a)(30)(B) of the foreign private adviser exemption. It does not apply to the determination of the assets under management relevant for purposes of the exemption under Section 202(a)(30)(C). Rule 202(a)(30)-1(b)(5) clarifies that an adviser is not required to count a person as an investor in a private fund that such investment adviser advises if the adviser counts such person as a client in the U.S.[57]

The Commission stated that if a client relationship involving multiple persons does not fall within one of the provisions of the rule, whether the relationship may appropriately be treated as a single "client" depends on the facts and circumstances. Paragraphs (a) and (b) are a safe harbor and are not intended to specify the exclusive method for determining who may be deemed a single client for purposes of Section 202(a)(30).[58]

Investors. Rule 202(a)(30)-1(c)(2) defines an "investor," for purposes of Rule 202(a)(30)-1, 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 Investment Company Act, or in determining whether the outstanding securities of a private fund are owned exclusively by qualified purchasers under Section 3(c)(7) of that Act.[59] This approach defines "investor" by reference to the well-developed understanding of ownership under Sections 3(c)(1) and 3(c)(7). More importantly, the Commission stated that defining the term "investor" by reference to Sections 3(c)(1) and 3(c)(7) places appropriate limits on the ability of a non-U.S. adviser to avoid application of the registration provisions of the Advisers Act by setting up intermediate accounts through which investors may access a private fund and not be counted for purposes of the exemption. Advisers must "look through" nominee and similar arrangements to the underlying holders of private fund-issued securities to determine whether they have fewer than 15 clients and private fund investors in the U.S.[60] The Commission noted that holders of both equity and debt securities of a private fund must be counted as investors.[61] In addition, even though not counted for purposes of Section 3(c)(1) under the Investment Company Act, a beneficial owner of any outstanding short-term paper, as defined in Section 2(a)(38) of the Investment Company Act, issued by the private fund is an "investor."[62] Unless the extension of credit by a fund's broker-dealer or custodian bank results in the issuance of a security by the fund to its creditor, the creditor would not be considered an investor for purposes of the foreign private adviser exemption.[63] In order to avoid double-counting, a note to the rule clarifies that an adviser may treat as a single investor any person who is an investor in two or more private funds advised by the investment adviser.[64]

The final Rule 202(a)(30)-1, unlike the proposal, does not treat as investors beneficial owners who are "knowledgeable employees" with respect to the private fund, and certain other persons related to such employees.[65] The Commission determined that the same policy considerations that justify disregarding knowledgeable employees for purposes of other provisions provide a valid basis for excluding them from the definition of "investor" under the foreign private adviser exemption. Knowledgeable employees are likely to be in a position or have a level of knowledge and experience in financial matters sufficient to be able to evaluate the risks and take steps to protect themselves.

Under Rule 202(a)(30)-1, an adviser will determine the number of investors in a private fund based on the facts and circumstances and in light of the applicable prohibition not to do indirectly, or through or by any other person, what is unlawful to do directly.[66] Depending upon the facts and circumstances, persons other than the nominal holder of a security issued by a private fund may be counted as the beneficial owner under Section 3(c)(1), or be required to be a qualified purchaser under Section 3(c)(7). In addition, the Commission stated that the adviser to a master fund in a master-feeder arrangement would have to treat as investors the holders of the securities of any feeder fund formed or operated for the purpose of investing in the master fund. The Commission noted that it has taken the same approach in its rules that require a private fund to "look through" any investor that is formed or operated for the specific purpose of investing in a private fund, such as a "master-feeder" structure.[67]

In addition, an adviser would need to count as an investor an owner of a total return swap on the private fund because that arrangement effectively provides the risks and rewards of investing in the private fund to the swap owner.[68] The Commission stated that whether an owner of another type of instrument referencing a private fund would be counted as the beneficial owner under Section 3(c)(1), or be required to be a qualified purchaser under Section 3(c)(7), would depend on the facts and circumstances.

The Commission stated that an adviser may treat as an investor in the U.S. a person the adviser reasonably believes is the actual investor.[69] Similarly, if an adviser reasonably believes that an investor is not "in the U.S.," "the adviser may treat the investor as not being "in the U.S."

In the U.S. New Rule 202(a)(30)-1(c)(3) defines "in the U.S." generally by incorporating the definition of a "U.S. person" and "U.S." under Regulation S.[70] In particular, the Commission defined "in the U.S." in Rule 202(a)(30)-1(c)(3) to mean: (i) with respect to any client or investor, any person who is a "U.S. person" as defined in Rule 902(k) of Regulation S, except that any discretionary account or similar account that is held for the benefit of a person "in the U.S." by a non-U.S. dealer or other professional fiduciary is deemed "in the U.S." if the dealer or professional fiduciary is a related person, as defined in Rule 206(4)-2(d)(7) of the Advisers Act, of the investment adviser relying on the exemption;[71] (ii) with respect to any place of business, any such place that is located in the "U.S.," as defined in Rule 902(l) of Regulation S;[72] and (iii) with respect to the public, in the "U.S.," as defined in Rule 902(l) of Regulation S.[73]

The Commission included a note to paragraph (c)(3)(i) specifying that for purposes of that definition, a person who is "in the U.S." may be treated as not being "in the U.S." if the person was not "in the U.S." at the time of becoming a client or, in the case of an investor in a private fund, each time the investor acquires securities issued by the fund.[74] The Commission stated that the note is designed to reduce the burden of having to monitor the location of clients and investors on an ongoing basis, and to avoid placing an adviser in a position whereby it might have to choose between registering with the Commission or terminating the relationship with any client that moved to the U.S., or redeeming the interest in the private fund of any investor that moved to the U.S.[75]

The Commission decided to treat as persons "in the U.S." for purposes of the foreign private adviser exemption certain persons that would not be considered "U.S. persons" under Regulation S. For example, it inclued any discretionary account owned by a U.S. person and managed by a non-U.S. affiliate of the adviser in order to discourage circumventing the exemption's limitation with respect to advising assets of persons in the U.S.[76]

The Commission agreed to allow non-U.S. advisers not to count persons (and their assets) who invest in a foreign private fund through certain Canadian retirement accounts (Participants) after having moved to the U.S. if the fund is in compliance with Rule 7d-2 under the Investment Company Act.[77]

Place of Business. New Rule 202(a)(30)-1(c)(4), by reference to Rule 222-1(a) of the Advisers Act, defines "place of business" to mean (1) an office where the investment adviser regularly provides advisory services, solicits, meets with, or otherwise communicates with clients, (whether U.S. or non-U.S.)[78] and (2) any other location held out to the general public as a location where the adviser conducts any such activities. Under Rule 202(a)(30)-1, an adviser must determine whether it has a place of business in the U.S. in light of the relevant facts and circumstances.[79] For example, any office from which an adviser regularly communicates with its clients, whether U.S. or non-U.S., would be a place of business. In addition, an office or other location where an adviser regularly conducts research would be a place of business because research is intrinsic to the provision of investment advisory services. A place of business would not, however, include an office where an adviser solely performs administrative services and back-office activities if they are not activities intrinsic to providing investment advisory services and do not involve communicating with clients.[80]

The Commission stated that there is no presumption that a non-U.S. adviser has a place of business in the U.S. solely because it is affiliated with a U.S. adviser. A non-U.S. adviser might be deemed to have a place of business in the U.S., however, if the non-U.S. adviser's personnel regularly conduct activities at an affiliate's place of business in the U.S.[81]

The Commission has provided guidance as to whether certain activities would result in an investment adviser representative having a place of business as defined in Rule 203A-3(b). Such guidance also is applicable to an adviser's determination as to whether it has a U.S. place of business under Rule 222-1. The Commission explained that the definition in Rule 203A-3(b) "encompasses permanent and temporary offices as well as other locations at which an adviser representative may provide advisory services, such as a hotel or auditorium."[82] It further explained that whether a temporary office or location is a place of business "will turn on whether the adviser representative has let it be known generally that he or she will conduct advisory business at the location, rather than on the frequency with which the adviser representative conducts advisory business there."[83]

Assets under Management. For purposes of Rule 202(a)(30)-1 the Commission defined "assets under management," by reference to the calculation of "regulatory assets under management" in Item 5.F of Form ADV.[84]

Holding Out. Rule 202(a)(30)-1(d) provides that if the adviser is relying on the "foreign private adviser" exemption, it shall not be deemed to be holding itself out generally to the public in the U.S. as an investment adviser solely because it participates in a non-public offering in the U.S. of securities issued by a private fund under the Securities Act. The release does not explain in detail what would constitute holding oneself out as an investment adviser. Most likely, this would be interpreted consistent with the "holding out" provision of Section 203(b)(3) as it existed prior to enactment of the Dodd-Frank Act. While no clear guidelines existed, the Commission often interpreted "holding out" broadly to include the following: (1) advertising related to investment advisory services; (2) maintaining a list as an investment adviser in a telephone or building directory; (3) letting it be known by word of mouth or otherwise that the person will accept new investment advisory clients; (4) using letterhead or business cards referring to investment advisory activities; or (5) participation in a "mini-account" or similar investment advisory programs.[85] In order to have an argument that it is not holding itself out, a foreign private adviser that uses the Internet should consider having procedures reasonably designed to guard against directing information about the adviser's advisory services to U.S. persons, such as using password protected Web sites and disclaimers that it does not offer services to the general public in the U.S.[86]

Family Offices

The Dodd-Frank Act adds an exclusion from the definition of "investment adviser" in Section 202(a)(11) for any "family office," as defined by rule, regulation or order of the Commission.[87] In Release No. IA-3220, the Commission adopted Rule 202(a)(11)(G)1 under the Advisers Act, which defines the term "family office."[88] Investment advisers that fall within the new definition of family office will not be subject to most provisions of the Advisers Act. The policy rationale for this decision is that disputes among family members concerning the operation of the family office could be resolved within the family unit or, if necessary, through state courts under laws designed to govern family disputes. The family office rule became effective on August 29, 2011.

General Requirements. Rule 202(a)(11)(G)-1(a) provides that a "family office" shall not be considered to be an investment adviser for purposes of the Advisers Act. Under new Rule 202(a)(11)(G)-1(b), to qualify for the "family office" exemption, a company (including its directors, partners, members, managers, trustees, and employees acting within the scope of their position or employment) must: (1) have no clients other than "family clients"; (2) be wholly owned by family clients and exclusively controlled (directly or indirectly) by one or more family members and/or family entities; and (3) not hold itself out as an investment adviser. The failure of a family office to be able to meet the conditions of the rule will not preclude the office from providing advisory services to family members either collectively or individually. Rather, the family office will need to register under the Advisers Act (unless another exemption is available) or seek an exemptive order from the Commission.

Involuntary Transfers. The Commission recognized that a transfer as a result of the death of a family member or key employee or other involuntary transfer from a family member or key employee to a person who is not a "family client" could jeopardize a family office's exclusion from the definition of investment adviser. As a result, Rule 202(a)(11)(G)-1(b)(1) permits the family office to continue to advise such an involuntary client for a one year transition period following the completion of the transfer of legal title to the assets resulting from the involuntary event. This grace period should allow family offices to seek exemptive relief, to ensure an orderly transition of that client's assets to another investment adviser, or otherwise to restructure its activities to comply with the Advisers Act.

Definition of "Family Clients." 202(a)(11)(G)-1(d) provides that "family clients" include current and former family members, key employees of the family office (and, under certain circumstances, former employees), charities funded exclusively by family clients, estates of current and former family members or key employees (and, under certain circumstances, of former key employees), irrevocable trusts existing for the sole current benefit of family clients or, if both family clients and charitable and non-profit organizations are the sole current beneficiaries, irrevocable trusts funded solely by family clients, revocable trusts funded solely by family clients, certain key employee trusts, and companies wholly owned (directly or indirectly) exclusively by, and operated for the sole benefit of, family clients (with certain exceptions). The different types of "family clients" are discussed in more detail below.

Family Members and Former Family Members. "Family members" under Rule 202(a)(11)(G)-1(d)(6) include all lineal descendants of a common ancestor (who may be living or deceased), as well as current and former spouses or spousal equivalents[89] of those descendants, provided that the common ancestor is no more than 10 generations removed from the youngest generation of family members. All children by adoption and current and former stepchildren also are considered family members. Also included are foster children and persons who were minors when another family member became their legal guardian. "Former family members" under Rule 202(a)(11)(G)-1(d)(7) include former spouses, spousal equivalents, and stepchildren that are no longer a family member due to a divorce or other similar event.

In determining the degree of lineal kinship to the designated relative, the family office will be able to choose the common ancestor (who may be deceased) and may change that designation over time such that the family office clientele is able to shift over time along with the family members served by the family office.[90] A family office exempt under the rule with a common ancestor several generations up from current family members will be able to serve a greater number of current collateral family members but fewer future lineal members, since the common ancestor must be no more than 10 generations removed from the youngest generation of family members.

Irrevocable Trusts. Rule 202(a)(11)(G)-1(d)(4)(vii) treats as a family client any irrevocable trust in which one or more family clients are the only current beneficiaries. The rule disregards contingent beneficiaries of trusts, since contingent beneficiaries are often named in the event all family members are deceased to prevent the trust from distributing assets to distant relatives or escheating to the state.[91] Rule 202(a)(11)(G)-1(d)(4)(viii) permits the family office to advise irrevocable trusts funded exclusively by one or more other family clients in which the only current beneficiaries, in addition to other family clients, are non-profit organizations, charitable foundations, charitable trusts, or other charitable organizations.

Revocable Trusts. Rule 202(a)(11)(G)-1(d)(4)(ix) treats as a family client a revocable trust of which one or more family clients are the sole grantor. Accordingly, a revocable trust may be advised by a family office relying on the rule regardless of whether the beneficiaries of the trust are family members. In the case of a revocable trust, the contingent nature of any beneficiary's expectation that it will benefit from the trust's assets supports disregarding a revocable trust's beneficiaries under the exclusion.

Estates. Rule 202(a)(11)(G)-1(d)(4)(vi) treats as a family client an estate of a family member, former family member, key employee or, subject to the condition contained in Rule 202(a)(11)(G)-1(d)(4)(iv) (discussed below), former key employee. This provision permits a family office to advise the executor of a family member's estate even if that estate will be distributed to (and thus be for the benefit of) non-family members.[92]

Non-Profit and Charitable Organizations. Rule 202(a)(11)(G)-1(d)(4)(v) treats as a family client any non-profit organization, charitable foundation, charitable trust (including charitable lead trusts[93] and charitable remainder trusts[94] whose only current beneficiaries are other family clients and charitable or non-profit organizations), or other charitable organization, in each case funded exclusively by one or more other family clients.[95] The Commission allowed these entities to be funded by family clients, as opposed only to permitting them to be funded by family members. This decision reflects the reality that family charities are often established and funded by family trusts, corporations or estates, and not exclusively by family members.

Some family offices currently advise charitable or non-profit organizations that have accepted funding from non-family clients. So that these family offices have sufficient time to transition such advisory arrangements or restructure the charitable or non-profit organization, Rule 202(a)(11)(G)-1(e)(1) included a transition period until December 31, 2013, before companies existing on July 21, 2011, that would otherwise qualify as a family office have to comply with this aspect of the exclusion.

Other Family Entities. To allow the family office to structure its activities through typical investment structures, Rule 202(a)(11)(G)-1(d)(4)(xi) treats as a family client any company, including a pooled investment vehicle that is excepted from the definition of "investment company" under the Investment Company Act, that is wholly owned, directly or indirectly, exclusively by, and operated for the sole benefit of, one or more other family clients. As long as the entity is wholly owned by and for the sole benefit of family clients, the Commission stated that, as with family trusts and family charitable organizations, the entity having non-family client control does not change that family clients are the ultimate beneficiaries of the investment advice, and thus the Commission eliminated the requirement for control by family clients in the proposal.[96]

Key Employees. The final rule treats certain key employees of the family office as family clients so that they may receive investment advice from, and participate in investment opportunities provided by, the family office. More specifically, Rule 202(a)(11)(G)-1(d)(8) provides that "key employee" means any natural person (including any key employee's spouse or spousal equivalent who holds a joint, community property or other similar shared ownership interest with that key employee) who is (1) an executive officer, director, trustee, general partner, or person serving in a similar capacity at the family office or its affiliated family office or (2) any other employee of the family office or its affiliated family office (other than an employee performing solely clerical, secretarial, or administrative functions with regard to the family office) who, in connection with his or her regular functions or duties, participates in the investment activities of the family office or affiliated family office, provided that such employee has been performing such functions or duties for or on behalf of the family office or affiliated family office, or substantially similar functions or duties for or on behalf of another company, for at least 12 months. The policy for extending Rule 202(a)(11)(G)-1 to key employees is that permitting investment participation by key employees of family offices would align their interests with those of family members and enable family offices to attract highly skilled investment professionals who may not otherwise be attracted to work at a family office.[97]

The Commission declined to include key employees of "family entities" as family clients.

"Family entities" include any of the trusts, estates, companies, or other entities set forth in paragraphs (v), (vi), (vii), (viii), (ix), or (xi) of Rule 202(a)(11)(G)-1(d)(4), but excluding key employees and their trusts from the definition of family client solely for purposes of this definition. The Commission stated that many family entities advised by the family office are not involved in providing investment advisory services to the family office or its clients and rather have principal business activities in a variety of industries unrelated to investment management.[98] There is no reason to expect that their key employees have a level of knowledge and experience in financial matters sufficient to protect themselves without the protections afforded by the Advisers Act. However, the Commission agreed in Rule 202(a)(11)(G)-1(d)(8) to include knowledgeable employees of an "affiliated family office"[99] in the definition of key employee.

The Commission included a definition of "executive officer," which is the substantially the same as the definition of the same term used in Rule 205-3 of the Advisers Act and Rule 3c-5 of the Investment Company Act. Rule 202(a)(11)(G)-1(d)(3) defines "executive officer" as "the president, any vice president in charge of a principal business unit, division or function (such as administration or finance), any other officer who performs a policy-making function, or any other person who performs similar policy-making functions, for the family office." The definition delineates executive officers that should have enough financial experience and sophistication to invest without the protection of the Advisers Act.

Rule 202(a)(11)(G)-1(d)(4)(x) clarifies that family clients include any trust of which (A) each trustee or other person authorized to make decisions with respect to the trust is a key employee; and (B) each settlor or other person who has contributed assets to the trust is a key employee or the key employee's current and/or former spouse or spousal equivalent who, at the time of contribution, holds a joint, community property, or other similar shared ownership interest with the key employee.

Finally, Rule 202(a)(11)(G)-1(d)(4)(iv) prohibits key employees (including their trusts and controlled entities) from making additional investments through the family office upon the end of their employment by the family office, but will not require former key employees to liquidate or transfer investments held through the family office to avoid imposing possible adverse tax or investment consequences that might otherwise result. Rule 202(a)(11)(G)-1(d)(4)(iv) specifically provides that the former key employee shall not receive investment advice from the family office (or invest additional assets with a family office-advised trust, foundation or entity) other than with respect to assets advised (directly or indirectly) by the family office immediately prior to the end of such individual's employment, except that a former key employee shall be permitted to receive investment advice from the family office with respect to additional investments that the former key employee was contractually obligated to make, and that relate to a family-office advised investment existing prior to the time the person became a former key employee.

Ownership and Control. Rule 202(a)(11)(G)-1(b)(2) requires that, to qualify for the exclusion from regulation under the Advisers Act, the family office must be wholly owned by family clients and exclusively controlled, directly or indirectly, by one or more family members or family entities. The rule expands who may own the family office from "family members," as proposed, to "family clients." While family clients may own the family office, family members and family entities must control, directly or indirectly, the family office. This is based on the core policy rationale that a family office is essentially a family managing its own wealth, so the family should control the family office.

Rule 202(a)(11)(G)-1(d)(2) defines "control" as "the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of being an officer of such company."

***Holding Out*.** Under Rule 202(a)(11)(G)-1(b)(2), a family office will not qualify for exclusion from the definition of investment adviser if it holds itself out to the public as an investment adviser. The release does not explain in detail what would constitute holding oneself out as an investment adviser. Most likely, this would be interpreted consistent with the "holding out" provision of Section 203(b)(3) as it existed prior to enactment of the Dodd-Frank Act. While no clear guidelines existed, the Commission often interpreted "holding out" broadly to include the following: (1) advertising related to investment advisory services; (2) maintaining a list as an investment adviser in a telephone or building directory; (3) letting it be known by word of mouth or otherwise that the person will accept new investment advisory clients; (4) using letterhead or business cards referring to investment advisory activities; or (5) participation in a "mini-account" or similar investment advisory programs.[100] To the extent an adviser to a family office uses the Internet to provide information about services, it should consider procedures reasonably designed to guard against directing information about the adviser's advisory services to the general public, such as using password protected websites and disclaimers that it does not offer services to the general public.[101]

Multifamily Offices. The exclusion the Commission adopted does not extend to family offices serving multiple families, as urged by several commenters.[102] The policy rationale for this is that in a multifamily office, the clients would neither have the protections of the Advisers Act nor family relationships for preventing or handling any discriminatory or fraudulent treatment of different families.

Grandfather Provisions. The Dodd-Frank Act and Rule 202(a)(11)(G)-1(c) prohibit the Commission from excluding from its definition of family office persons not registered or required to be registered under the Advisers Act on January 1, 2010, solely because such person provides investment advice to, and was engaged before January 1, 2010 in providing investment advice to:

1. Natural persons who, at the time of their applicable investment, are officers, directors, or employees of the family office who have invested with the family office before January 1, 2010, and are accredited investors, as defined in Regulation D under the Securities Act;
2. Any company owned exclusively and controlled by one or more family members; or
3. Any investment adviser registered under the Advisers Act that provides investment advice to the family office and who identifies investment opportunities to the family office, and invests in such transactions on substantially the same terms as the family office invests, but does not invest in other funds advised by the family office, and whose assets as to which the family office directly or indirectly provides investment advice represents, in the aggregate, not more than 5 percent of the value of the total assets as to which the family office provides investment advice; provided that a family office that would not be a family office but for the grandfathering provision shall be deemed to be an investment adviser for purposes of paragraphs (1), (2), and (4) of Section 206 of the Advisers Act.

Transition Periods. As discussed above, Rule 202(a)(11)(G)-1(e)(1) provides that any company existing on July 21, 2011, that would qualify as a family office under this section but for it having as a client one or more non-profit organizations, charitable foundations, charitable trusts, or other charitable organizations that have received funding from one or more individuals or companies that are not family clients shall be deemed to be a "family office" until December 31, 2013, provided that such non-profit or charitable organization(s) do not accept any additional funding from any non-family client after August 31, 2011 (other than funding received prior to December 31, 2013, and provided in fulfillment of any pledge made prior to August 31, 2011).

Rule 202(a)(11)(G)-1(e)(2) also provides that any company engaged in the business of providing investment advice, directly or indirectly, primarily to members of a single family on July 21, 2011, and that is exempt from registration under the Advisers Act in reliance on the "private adviser" exemption in Section 203(b)(3) on July 20, 2011, is exempt from registration with the Commission as an investment adviser until March 30, 2012, provided that the company (1) during the course of the preceding 12 months, has 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 any investment company registered under the Investment Company Act, or a company which has elected to be a business development company pursuant to Section 54 of the Investment Company Act.[103]

Effect of Proposed Rule on Prior Exemptive Orders. In the past, the Commission has issued orders under Section 202(a)(11)(G) of the Advisers Act to certain family offices declaring them and their employees acting within the scope of their employment to not be investment advisers within the intent of the Act.[104] The Commission noted that it was not rescinding prior exemptive orders issued to family offices.[105] In some areas, the exemptive orders may be broader than the rule, while in other areas they may be narrower. Family offices currently operating under these orders may therefore continue to rely on them, or, if they meet the conditions described above, may rely on the rule instead. Family offices may need to incur one-time learning costs to determine the differences between their orders and the rule. The Commission estimated that such costs will be no more than $5,000 on average for a family office if it hires an external consulting firm or law firm to assist in determining the differences.[106]

Subadvisory Relationships and Affiliates

The Commission interprets the definition of "investment adviser" in Section 202(a)(11) generally to include both investment advisers and subadvisers.[107] The Commission stated that subadvisers may rely on each of the new exemptions, provided that they satisfy all applicable terms and conditions of the applicable rule.[108] The Commission noted that in many subadvisory relationships a subadviser has contractual privity with a private fund's primary adviser rather than the private fund itself, but that the Commission would consider a subadviser eligible to rely on Rule 203(m)-1 if the subadviser's services to the primary adviser relate solely to private funds and the other conditions of the rule are met. Similarly, a subadviser may be eligible to rely on Section 203(l) if the subadviser's services to the primary adviser relate solely to venture capital funds and the other conditions of the rule are met.

The Commission considered whether its rules should provide that an adviser must take into account the activities of its advisory affiliates when determining eligibility for an exemption, by having the rule, for example, specify that the exemption is not available to an affiliate of a registered investment adviser. The Commission declined automatically to treat each advisory entity separately without regard to the activities of, or relationship with, its affiliates, but the Commission stated that it will treat as a single adviser two or more affiliated advisers that are separately organized but operationally integrated, which could result in a requirement for one or both advisers to register.[109] Generally, a separately formed advisory entity that operates independently of an affiliate may be eligible for an exemption if it meets all of the criteria set forth in the relevant rule. However, the existence of separate legal entities may not by itself be sufficient to avoid integration of the affiliated entities. The determination of whether the advisory businesses of two separately formed affiliates may be required to be integrated is based on the facts and circumstances.[110]

Conclusion

The new rules substantially change the registration regime under the Advisers Act. Investment advisers that previously were exempt from registration may now have to register, while investment advisers that previously registered may now be unable to register. Many non-U.S. investment advisers that previously were exempt may now have to register as well.

Investment advisers that register with the Commission will not be subject to state registration requirements.[111] "Investment advisers" that do not register under the Advisers Act as a result of falling short of the applicable floor may have to register under applicable state law instead. If an investment adviser does not register with the Commission on the basis of an exemption, it also may be required to register as an investment adviser under applicable state law, but some states provide exemptions for investment advisers that are exempt under the Advisers Act. California, for example, currently is considering granting an analogous exemption with respect to the private funds Section 203(m) exemption if the investment adviser has more than $100 million in assets under management, and an analogous exemption with respect to the venture capital Section 203(l) exemption regardless of assets under management. In the event a state does not grant such an exemption, if an investment adviser is eligible for Commission registration (but Commission registration is not required), many investment advisers will choose to register with the Commission rather than register with the applicable state authorities because state registration can be more onerous. It may require registration in multiple states and compliance with applicable state rules regarding investment advisers and investment adviser representatives.

An investment adviser that is required to register, that is not otherwise exempt (and that previously relied on the "private adviser" exemption in Section 203(b)(3) on July 20, 2011), may delay registering with the Commission until March 30, 2012.[112] Initial applications for registration can take up to 45 days to be approved. Thus, advisers relying on this transition provision to remain unregistered until March 30, 2012, should file a complete application, both Part 1 and a brochure(s) meeting the requirements of Part 2 of Form ADV at least by February 14, 2012.

Registration and exemption issues will affect compliance obligations. Such obligations will vary depending upon whether the investment adviser is unregistered, a foreign private adviser, a Section 203(l) or Section 203(m) exempt reporting adviser, or a registered investment adviser.

Unregistered investment advisers, as was previously the case, generally will be subject to Section 206, the anti-fraud provision of the Advisers Act, and Section 203(e)(6), the supervision provision of the Advisers Act. "Foreign private advisers" exempt under Section 203(b)(3) will be subject, in addition to the obligations of unregistered investment advisers, to the Commission's "pay to play" rules.

Section 203(l) and Section 203(m) exempt reporting advisers, in addition to being subject to the obligations of unregistered investment advisers, will be required to file a limited Form ADV, and to submitting to the Commission's "pay to play" rules. The Commission indicated that it does not anticipate that the staff will conduct compliance examinations of exempt reporting advisers on a regular basis. Nonetheless, the Commission has the authority under Section 204(a) of the Advisers Act to examine records of exempt reporting advisers and will do so if it receives indications of wrongdoing, *e.g.,* those examinations prompted by tips, complaints, and referrals.

To the extent an investment adviser registers with the Commission, it will become subject to the full scope of the Advisers Act (including, without limitation, the obligations of unregistered investment advisers). A brief summary of these obligations include, without limitation: (1) filing current disclosures on Form ADV; (2) record keeping requirements; (3) examinations by Commission's Office of compliance Inspections and Examinations; (4) establishing, maintaining and implementing compliance programs; (5) establishing, maintaining and implementing a code of ethics; (6) custody requirements; (7) restrictions on principal transactions; (8) complying with advertising rules; (9) restrictions on performance fees; and (10) compliance with "pay to play" rules. Certain parts of many non-U.S. investment adviser's compliance obligations will not apply with respect to non-U.S. clients, even if an investment adviser is registered under the Advisers Act.[113] Compliance is complex and registered investment advisers are advised to consult with counsel familiar with these issues.

Compliance Dates for Adviser Registration

July 21, 2011—Title IV of the Dodd-Frank Act generally became effective on July 21, 2011.

September 17, 2011 (60 days after publication of Release No. IA-3221 in the Federal Register)—Advisers may begin relying on the Commission's covered mid-sized investment adviser buffer in Rule 203A-1. Advisers may also begin relying on the Commission's amendments to the exemptions in Rule 203A-2 from the prohibitions on adviser registration. The Commission's new Form ADV amendments discussed in Release No. IA-3221 will become effective on such date.

January 1, 2012—Mid-sized advisers registered with the Commission as of July 21, 2011, must remain registered with the Commission (unless an exemption from Commission registration is available) until January 1, 2012. Sections 203(l) and 203(m) exempt reporting advisers may begin filing their first reports on Form ADV through the IARD on January 1, 2012.

February 14, 2012—Because initial applications for registration can take up to 45 days to be approved, advisers relying on the "private adviser" exemption transition provision to remain unregistered until March 30, 2012, should file a complete application, both Part 1 and a brochure(s) meeting the requirements of Part 2 of Form ADV at least by February 14, 2012.

March 30, 2012—Registered advisers registered with the Commission on January 1, 2012, must file an amended Form ADV by March 30, 2012. Sections 203(l) and Section 203(m) exempt reporting advisers must file their first reports on Form ADV through the IARD by March 30, 2012.

June 13, 2012—Registered advisers, Sections 203(l) and 203(m) exempt reporting advisers and foreign private advisers must comply with the ban on third-party solicitation in the "pay to play" rule by June 13, 2012.

June 28, 2012—Mid-sized advisers that are no longer eligible for Commission registration under Section 203A(a)(2) of the Advisers Act, and are not otherwise exempted by Rule 203A-2 from such prohibition, must withdraw their registrations with the Commission after filing their Form ADV amendments by filing Form ADV-W no later than June 28, 2012.

Notes

1. Release No. IA-3222, Exemptions for Advisers to Venture Capital funds, Private Fund Advisers with Less than $150 million in Assets under Management, and Foreign Private Advisers.
2. Release No. IA-3220, Family Offices.
3. Dodd-Frank Act, Section 407.
4. "Private fund" is defined by the Dodd-Frank Act as an investment fund that would be an investment company but for the exemptions in Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act of 1940. The Commission clarified that an investment adviser could treat as a "private fund"—and thus a venture capital fund, if it meets the rule's other criteria—any non-U.S. fund that has not offered or sold its securities in the U.S. or to U.S. persons but that would be a private fund if the issuer were to conduct a private offering in the U.S. *See* Rule 203(l)-1(c), note to subparagraph (c). Otherwise, a non-U.S. fund that has not offered or sold its securities in the U.S. or to U.S. persons would not be a private fund and therefore could not qualify as a venture capital fund, even if it operated as a venture capital fund in a manner that would otherwise meet the criteria under the Commission's definition.
5. This representation reflects the view that only funds that do not significantly differ from the common understanding of what a venture capital fund is, and that are actually offered to investors as funds that pursue a venture capital strategy, should qualify for the exemption. The Commission stated that as a result, for example, an adviser to a venture capital fund that is otherwise relying on the exemption could not (1) identify the fund as a hedge fund or multi-strategy fund (*i.e.*, venture capital is one of several strategies used to manage the fund) or (2) include the fund in a hedge fund database or hedge fund index. Note that the Commission stated that it is not necessary (nor indeed sufficient) for a qualifying fund to name itself as a "venture capital fund" in order for its adviser to rely on the venture capital exemption. Whether or not a fund represents itself as pursuing a venture capital strategy will depend on the particular facts and circumstances. The Commission stated that statements made by a fund to its investors and prospective investors, not just what the fund calls itself, are important to an investor's understanding of the fund and its investment strategy. The appropriate framework for analyzing whether a qualifying fund has satisfied the holding out criterion depends on all of the statements (and omissions) made by the fund to its investors and prospective investors. While this includes the fund name, it is only part of the analysis.
6. Short-term holdings include cash and cash equivalents (by reference to Rule 2a51-1(b)(7)(i) under the Investment Company Act), U.S. Treasuries with a remaining maturity of 60 days or less and shares of registered money market funds. *See* Rule 203(l)-1(c)(6).
7. The 20 percent basket need only be calculated when the fund acquires a non-qualifying investment (other than short-term holdings); after the acquisition, the fund need not dispose of a non-qualifying investment simply because of a change in the value of that investment. A qualifying fund need not include its investments in cash, cash equivalents, U.S. Treasuries with a remaining maturity of 60 days or less and shares of registered money market funds when determining whether it satisfies the 20 percent basket. Rule 203(l)-1(a)(2).
8. The capital commitments will often remain relatively constant throughout a fund's term, thereby giving rise to predictability when calculating the basket. The Commission stated that only bona fide capital commitments could be included in the calculation, as opposed to commitments made for the purpose of increasing the 20 percent basket, thus preventing funds from inflating their amount of non-qualifying investments. The Commission also stated that if a fund's initial capital call were invested in non-qualifying investments, the adviser would risk violating its representation that it pursues a venture capital strategy, thereby violating the antifraud provisions of the Advisers Act.
9. To determine if a fund satisfies the 20 percent limit for non-qualifying investments, the fund may use either historical cost or fair value, as long as the same method is applied to all investments of a qualifying fund in a consistent manner during the term of the fund. *See* Rule 203(l)-1(a)(2).
10. The Commission declined to carve-out from the limitation on leverage certain types of leverage, such as subscription facilities or borrowings by a venture capital fund in order to meet fee and expense obligations.

11. Rule 203(l)-1(a)(3).

12. The Commission stated that whether or not specific redemption or "opt out" rights for certain categories of investors under certain circumstances should be treated as "extraordinary" will depend on the particular facts and circumstances. It stated that these events may be "foreseeable," in that circumstances are known to occur, but are unexpected in their timing or scope. Withdrawal, exclusion or similar "opt-out" rights would be deemed "extraordinary circumstances" if they are triggered by a material change in the tax law after an investor invests in the fund, or the enactment of laws that may prohibit an investor's participation in the fund's investment in particular countries or industries. In practice, if the general partner typically permits investors to redeem their otherwise non-redeemable interests on a periodic basis, then the fund would not be considered to have issued securities that "do not provide a holder with any right, except in extraordinary circumstances, to withdraw." The Commission also discussed de facto transfer rights, which occur where a private fund's governing documents might provide that investors do not have any right to transfer without the consent of the general partner. The Commission stated that consents to transfer do not raise the same level of concern as de facto redemption rights, but noted that the adviser and its related persons could not regularly identify potential investors on behalf of fund investors that seek to transfer or redeem fund interests.

13. "Equity securities" is defined by reference to Section 3(a)(11) of the Securities Exchange Act of 1934 (Exchange Act) and Rule 3a11-1 thereunder. *See* Rule 203(l)-1(c)(2).

14. This provision enables a qualifying fund to participate in the reorganization of the capital structure of a portfolio company.

15. This provision enables a qualifying fund to 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 venture capital fund. It is therefore possible under this prong that a venture capital fund could hold equity securities of a company subject to reporting under the Exchange Act, which generally would not fall within qualifying investments in the case of prong (i) and prong (ii). The Commission also noted in connection with this prong that a security received as a dividend by virtue of the fund's holding of a qualifying investment would be also a qualifying investment.

16. The Commission stated that it believed its criteria for qualifying portfolio companies would exclude most private equity funds and hedge funds from the definition of venture capital funds.

17. Under the definition, a venture capital fund may continue to treat as a qualifying investment any previously directly acquired equity security of a portfolio company that subsequently becomes a reporting company. A control relationship with a reporting company is also measured at the time of acquisition of the investment. *See* Rule 203(l)-1(c)(4)(i).

18. The Commission noted that under the rule, a venture capital fund could provide financing or loans to a portfolio company, provided that the financing meets the definition of equity security or is made subject to the 20 percent limit for non-qualifying investments.

19. The Commission stated that this prong specifically delineates the types of leveraged transactions involving a qualifying fund (*i.e.*, a company's distribution of proceeds received in a debt offering to the qualifying fund) that would result in the company being excluded from the definition of a qualifying portfolio company. The approach is designed to distinguish leveraged buyout funds from venture capital funds. This definition of qualifying portfolio company would only exclude companies that borrow in connection with a venture capital fund's investment and distribute such borrowing proceeds to the venture capital fund in exchange for the investment, but would not exclude companies that borrow in the ordinary course of their business (*e.g.*, to finance inventory or capital equipment, manage cash flows, meet payroll, etc.). The Commission also stated that subsequent distributions of financing proceeds to the venture capital fund solely because it is an existing investor would not fall within the prohibition.

20. As a result, certain types of funds that use leverage or finance their investments in portfolio companies or the buyout of existing investors with borrowed money (*e.g.*, leveraged buyout funds, which are a different subset of private equity funds) would not meet the rule's definition of a venture capital fund.

21. For this purpose, pooled investment vehicles include investment companies, issuers relying on Rule 3a-7 under the Investment Company Act and commodity pools. The Commission stated that pooled investment vehicles would include venture capital fund of funds. The Commission, however, stated that a fund may disregard a wholly owned intermediate holding company formed solely for tax, legal, or regulatory reasons to hold the fund's investment in a qualifying portfolio company.

22. Release No. IA-3222, Exemptions for Advisers to Venture Capital funds, Private Fund Advisers with Less than $150 million in Assets under Management, and Foreign Private Advisers.

23. Dodd-Frank Act, Section 408.

24. Rule 203(m)-1(d)(5).

25. Rule 203(m)-1(d)(5).

26. Rule 203(m)-1(d)(4).

27. Dodd-Frank Act, Section 404.

28. Dodd-Frank Act, Section 416.

29. Dodd-Frank Act, Section 415.

30. "Principal office and place of business" of an investment adviser 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, regardless of the location where some of the advisory activities might occur. Rule 203(m)-1(d)(3). The Commission stated that this is the location where the adviser controls, or has ultimate responsibility for, the management of private fund assets, and therefore is *the* place where all the adviser's assets are managed, although day-to-day management of certain assets may also take place at another location.

31. Rule 203(m)-1(b)(1).
32. Rule 203(m)-1(b)(2).
33. Rule 203(m)-1(d)(7).
34. Regulation S looks generally to the residence of an individual to determine whether the individual is a U.S. person, and also addresses the circumstances under which a legal person, such as a trust, partnership or a corporation, is a U.S. person. Regulation S generally treats legal partnerships, and corporations as U.S. persons if they are organized or incorporated in the U.S., and analyzes trusts by reference to the residence of the trustee. It treats discretionary accounts generally as U.S. persons if the fiduciary is a resident of the U.S..
35. Rule 203(m)-1(d)(8).
36. "Related person" has the same meaning as in Rule 206(4)-2(d)(7). *See* Rule 203(m)-1(d)(6).
37. *See* 17 C.F.R. 230.902(k)(1)(vii); 17 C.F.R. 230.902(k)(2)(i).
38. This will permit a non-U.S. adviser to continue to rely on Rule 203(m)-1 if a non-U.S. client that is not a private fund, such as a natural person client residing abroad, relocates to the U.S. or otherwise becomes a U.S. person.
39. Release No. IA-3222, Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less than $150 Million in Assets under Management, and Foreign Private Advisers., at 182-183.
40. Rule 203(m)-1(d)(4).
41. *See* Rules 203(m)-1(a)(2); 203(m)-1(b)(2); 203(m)-1(d)(1) (defining "assets under management" to mean "regulatory assets under management" in item 5.F of Form ADV, Part 1A); 203(m)-1(d)(4) (defining "private fund assets" to mean the "assets under management" attributable to a "qualifying private fund").
42. The Commission noted that proprietary assets included, without limitation, advisers' principals' (or other employees') investments alongside clients, such as co-investments.
43. Form ADV: Instructions for Part 1A, instr. 5.b.(1).
44. *See* Form ADV: Instructions for Part 1A, instr. 5.b.(2).
45. *See* Form ADV: Instructions for Part 1A, instr. 5.b.
46. *See* Form ADV: Instructions for Part 1A, instr. 5.b.(4). This valuation requirement is described in terms similar to the definition of "value" in the Investment Company Act, which looks to market value when quotations are readily available and, if not, then to fair value. *See* Investment Company Act, Section 2(a)(41). While many advisers will calculate fair value in accordance with GAAP or another international accounting standard, other advisers acting consistently and in good faith may utilize another fair valuation standard. Consistent with this good faith requirement, the Commission would expect that an adviser that calculates fair value in accordance with GAAP or another basis of accounting for financial reporting purposes will also use that same basis for purposes of determining the fair value of its regulatory assets under management.
47. *See* Release No. IA-3222, Exemptions for Advisers to Venture Capital funds, Private Fund Advisers with Less than $150 million in Assets under Management, and Foreign Private Advisers.
48. Rule 203(m)-1(c).
49. General Instruction 15 to Form ADV. Advisers to whom the transition period is available will have up to 180 days after the end of their fiscal years to register.
50. This is the location where the adviser controls, or has ultimate responsibility for, the management of private fund assets, and therefore is *the* place where all the adviser's assets are managed, although day-to-day management of certain assets may also take place at another location.
51. Rule 203(m)-1 defines a "place of business" by reference to Rule 222-1(a) as any office where the adviser "regularly provides advisory services, solicits, meets with, or otherwise communicates with clients," and "any other location that is held out to the general public as a location at which the investment adviser provides investment advisory services, solicits, meets with, or otherwise communicates with clients." Whether a non-U.S. adviser has a place of business in the U.S. depends on the facts and circumstances, as discussed below in connection with the foreign private adviser exemption. The Commission stated that for purposes of Rule 203(m)-1, however, the analysis frequently will turn not on whether a non-U.S. adviser has a U.S. place of business, but on whether the adviser manages assets, or has "assets under management," at such a U.S. place of business. Under the Advisers Act, "assets under management" are the securities portfolios for which an adviser provides "continuous and regular supervisory or management services." The Commission noted that it would not view providing research or conducting due diligence to be "continuous and regular supervisory or management services" at a U.S. place of business if a person outside of the U.S. makes independent investment decisions and implements those decisions.
52. Section 202(a)(30) authorizes the Commission to increase the $25 million threshold "in accordance with the purposes of this title."
53. Rule 202(a)(30)-1(c).
54. "Spousal equivalent" has the same meaning as in Rule 202(a)(11)(G)-1(d)(9).
55. *See* Rule 202(a)(30)-1(b)(4)-(5).

56. *See* Rule 202(a)(30)-1(b)(4); 202(a)(30)-1(c)(2).

57. *See* Rule 202(a)(30)-1(b)(5).

58. *See* Rule 202(a)(30)-1(a) and (b), at note to paragraph (a) and (b).

59. *See* Rule 202(a)(30)-1(c)(2)(i).

60. Rule 202(a)(30)-1(c)(2). *See generally* Sections 3(c)(1) and 3(c)(7) of the Investment Company Act.

61. Sections 3(c)(1) and 3(c)(7) of the Investment Company Act refer to beneficial owners and owners, respectively, of "securities" (which is broadly defined in Section 2(a)(36) of the Investment Company Act to include debt and equity).

62. *See* Rule 202(a)(30)-1(c)(2)(ii).

63. *See* Release No. IA-3222, Exemptions for Advisers to Venture Capital funds, Private Fund Advisers with Less than $150 million in Assets under Management, and Foreign Private Advisers.

64. *See* Rule 202(a)(30)-1(c)(2), at note to paragraph (c)(2).

65. *See* Release No. IA-3222, Exemptions for Advisers to Venture Capital funds, Private Fund Advisers with Less than $150 million in Assets under Management, and Foreign Private Advisers.

66. *See* Section 208(d) of the Advisers Act; Section 48(a) of the Investment Company Act.

67. A "master-feeder fund" is an arrangement in which one or more funds with the same or consistent investment objectives (feeder funds) invest all or substantially all of their assets in a single fund (master fund) with the same or consistent investment objective and strategies. The Commission has taken the same approach within its rules that require a private fund to "look through" any investor that is formed or operated for the specific purposes of investing in a private fund. *See* Rule 2a51-3(a) under the Investment Company Act; *see also* Privately Offered Investment Companies, Investment Company Act Rel. No. 22597 (Apr. 3, 1997) (explaining that Rule 2a51-3(a) would limit the possibility that "a company will be able to do indirectly what it is prohibited from doing directly [by organizing] … a 'qualified purchaser' entity for the purpose of making an investment in a particular Section 3(c)(7) exempt fund available to investors that themselves did not meet the definition of 'qualified purchaser'").

68. *See* Release No. IA-3222, Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less Than $150 million in Assets under Management, and Foreign Private Advisers.

69. *See* Release No. IA-3222, Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less Than $150 million in Assets Under Management, and Foreign Private Advisers.

70. Rule 202(a)(30)-1(c)(3).

71. Rule 202(a)(30)-1(c)(3)(i).

72. Rule 202(a)(30)-1(c)(3)(ii).

73. Rule 202(a)(30)-1(c)(3)(iii).

74. Rule 202(a)(30)-1(c)(3)(i), at note to paragraph (c)(3)(i).

75. Release No. IA-3222, Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less Than $150 million in Assets under Management, and Foreign Private Advisers.

76. Rule 202(a)(30)-1(c)(3)(i).

77. Release No. IA-3222, Exemptions for Advisers to Venture Capital funds, Private Fund Advisers with Less than $150 million in Assets under Management, and Foreign Private Advisers. The Commission adopted Rule 7d-2, along with Rule 237 under the Securities Act, in order to allow Participants who move to the U.S. to continue to manage their Canadian retirement accounts. *See Offer and Sale of Securities to Canadian Tax-Deferred Retirement Savings Accounts*, Securities Act Release No. 7860 (June 7, 2000) [65 FR 37672 (June 15, 2000)]. U.S. registration requirements were affecting those Participants' ability to purchase or exchange securities for such accounts. Rule 7d-2 generally allows non-U.S. funds to treat as a private offering certain offerings to Participants who are in the U.S.

78. Rule 222-1 does not distinguish between U.S. and non-U.S. clients. *See* Release No. IA-3222, Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less than $150 million in Assets under Management, and Foreign Private Advisers.

79. Release No. IA-3222, Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less than $150 million in Assets under Management, and Foreign Private Advisers.

80. Release No. IA-3222, Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less than $150 million in Assets under Management, and Foreign Private Advisers.

81. Release No. IA-3222, Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less than $150 million in Assets under Management, and Foreign Private Advisers.

82. *See* Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Act Release No. 1633 (May 15, 1997) [62 FR 28112 (May 22, 1997)].

83. *See id*; *see also* Release No. IA-3222, Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less Than $150 million in Assets Under Management, and Foreign Private Advisers.

84. *See* Rule 202(a)(30)-1(c)(1); instructions to Item 5.F of Form ADV, Part 1A.

85. *See* Thomas P. Lemke and Gerald T. Lins, Regulation of Investment Advisers, § 1:35.

86. *See* Securities Act Rel. No. 7288 (May 9, 1996). Thomas P. Lemke and Gerald T. Lins, Regulation of Investment Advisers, § 1:35.

87. Dodd-Frank Act, Section 409.

88. Release No. IA-3220, Family Offices.

89. "Spousal equivalent" means "a cohabitant occupying a relationship generally equivalent to that of a spouse." Rule 202(a)(11)(G)-1(d)(9).

90. Release No. IA-3220, Family Offices.

91. Release No. IA-3220, Family Offices.

92. Release No. IA-3220, Family Offices.

93. Charitable lead trusts are entities in which a charity receives payments from the trust for a specified period as a current beneficiary, but the remainder of the trust is distributed to specified beneficiaries.

94. Charitable remainder trusts are entities in which specified individuals or entities receive payments from the trust for a specified period as a current beneficiary, but a charity receives the remainder of the trust.

95. The Commission intended broadly to capture charitable and non-profit organizations as commonly understood under both trust law and tax law. Release No. IA-3220, Family Offices.

96. No. IA-3220, Family Offices.

97. No. IA-3220, Family Offices.

98. No. IA-3220, Family Offices.

99. "Affiliated family office" means "a family office wholly owned by family clients of another family office and that is controlled (directly or indirectly) by one or more family members of such other family office and/or family entities affiliated with such other family office and has no clients other than family clients of such other family office." Rule 202(a)(11)(G)-1(d)(1).

100. Thomas P. Lemke and Gerald T. Lins, Regulation of Investment Advisers, § 1:35.

101. *See* Securities Act Rel. No. 7288 (May 9, 1996). *See* Thomas P. Lemke and Gerald T. Lins, Regulation of Investment Advisers, § 1:35.

102. No. IA-3220, Family Offices.

103. Rule 202(a)(11)(G)-1(e)(2).

104. *See, e.g.,* Break Creek Inc., Investment Advisers Act Rel. No. 1931 (Mar. 9, 2001) (notice) and 1935 (Apr. 4, 2001) (order); Riverton Management, Inc., Investment Advisers Act Rel. No. 2459 (Dec. 9, 2005) and 2471 (Jan. 6, 2006) order).

105. Release No. IA-3220, Family Offices.

106. Release No. IA-3220, Family Offices.

107. Release No. IA-3222, Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less Than $150 million in Assets Under Management, and Foreign Private Advisers.

108. Release No. IA-3222, Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less Than $150 million in Assets Under Management, and Foreign Private Advisers.

109. Release No. IA-3222, Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less Than $150 million in Assets under Management, and Foreign Private Advisers.

110. The Commission has taken this position in Richard Ellis, Inc., SEC Staff No-Action Letter (Sept. 17, 1981) (discussing the staff's views of factors relevant to the determination of whether a separately formed advisory entity operates independently of an affiliate).

111. Advisers Act, Section 203A(b).

112. Rule 203-1(e); Release No. IA-3221, Rules Implementing Amendments to the Investment Advisers Act of 1940.

113. Release No. IA-3222, Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less Than $150 million in Assets under Management, and Foreign Private Advisers (noting that the Commission does not apply most of the substantive provisions of the Advisers Act to the non-U.S. clients of a non-U.S. adviser registered with the Commission). In practice, the Commission has sometimes imposed certain additional conditions for no-action relief. The Commission stated that its staff will provide guidance, as appropriate, regarding the application of the Advisers Act in this respect in the context of the new foreign private adviser exemption and the private fund adviser exemption.