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The Dodd-Frank Act: Impact on Investment Advisers

by

Scot E. Draeger and Caleb C.B. DuBois

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100 Middle Street, Portland, ME 04104 | 207 774-1200 | bernsteinshur.com

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ABOUT THE AUTHORS

Scot E. Draeger is the chairman of the Securities and Financial Services Industry Practice at Bernstein Shur. Mr. Draeger also serves on the board of directors of the firm and as co-chair of the Business Law Practice Group. Prior to joining Bernstein Shur, Mr. Draeger served as general counsel of Citi Fund Services and as director and senior vice president of Citigroup Corporate & Investment Bank in New York. Prior to that Mr. Draeger served as senior counsel in the General Counsel's Office of the U.S. Securities and Exchange Commission in Washington, D.C., and as senior legal counsel to SEC Commissioner Roel C. Campos. Mr. Draeger also served as professor of securities law and regulation at George Mason University School of Law. He remains active in regulatory and academic policy matters.

sdraeger@bernsteinshur.com
207 228-7336

Caleb C.B. DuBois is an associate in the Securities and Financial Services Industry Practice at Bernstein Shur. He specializes in representing investment advisers, broker-dealers, mutual funds, banks and other securities, and financial services industry entities and professionals.

cdubois@bernsteinshur.com
207 228- 7378

THE DODD-FRANK ACT: IMPACT ON INVESTMENT ADVISERS

EXECUTIVE SUMMARY

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act" or the "Act").[1] The Dodd-Frank Act is 848 pages long and widely considered the most comprehensive financial regulatory reform undertaken since the Great Depression. The Dodd-Frank Act implements changes that impact nearly every aspect of the financial services industry, including but not limited to affecting the oversight and supervision of financial institutions, creating a new agency responsible for implementing and enforcing compliance with consumer financial laws, introducing more stringent regulatory capital requirements, effecting significant changes in the securitization and derivatives markets, reforming the regulation of credit rating agencies, implementing changes to corporate governance and executive compensation practices, and requiring the registration of advisers to certain private funds.

Although the Dodd-Frank Act was signed into law on July 21, 2010, many of the rule-making efforts and information-gathering studies required by the Act have not yet been completed. These rule-making decisions and informational studies are necessary in order to fully implement many of the changes required by the Act. When it was first passed, many supporters of the Act suggested that tying up these loose ends would take approximately 12 to 18 months. However, as of the beginning of 2012, only 93 of the 400 rule-making requirements mandated by the Dodd-Frank Act have been finalized. Consequently, the full impact of the Dodd-Frank Act is still a long way from being realized. It is likely that many of the issues discussed in this summary will remain in a state of flux for several years to come.

The Dodd-Frank Act makes significant changes to the previously existing investment adviser regime by, among other things, amending certain provisions of the Investment Advisers Act of 1940 (the "Advisers Act"). This summary highlights many of the provisions of the Dodd-Frank Act that most significantly impact investment advisers and others in the asset management industry, including but not limited to

1) requiring advisers to private funds to register with the United States Securities and Exchange Commission (the "SEC" or the "Commission"),

2) creating new exemptions from registration and new exclusions from the definition of "investment adviser" under the Advisers Act,

3) creating new reporting requirements for advisers to private funds,

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[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

4) modifying the assets under management ("AUM") threshold and other requirements for registration with the SEC (resulting in a shift to enhanced oversight by state authorities for small and mid-sized advisers),

5) adding significant additional disclosures on Form ADV,

6) amending the pay-to-play rules,

7) refining regulation of family office structures,

8) modifying SEC examinations and enforcement powers,

9) creating a new Form PF for reporting certain private fund information,

10) applying a uniform fiduciary standard to broker-dealers and investment advisers,

11) changing the regulation of the derivative markets, and

12) adding new municipal securities adviser regulations.

Private Adviser Registration and Elimination of the Private Adviser Exemption

Through the use of the private adviser exemption in the Investment Advisers Act, advisers (e.g., general partners or managing members) to hedge funds and private equity funds have gone largely unregulated until now. Section 203(b)(3) of the Advisers Act previously exempted from the registration requirement advisers who during any 12-month period do not hold themselves out generally to the public as investment advisers and who have fewer than 15 clients. Historically, under most circumstances a private "fund" was counted as a single "client" and there was no "look-through" to count the investors in the fund. This is commonly referred to as the "private adviser exemption." Advisers specifically exempt under Section 203(b) were not subject to registration, reporting or recordkeeping provisions under the Advisers Act and were not subject to routine examination by SEC staff. Many advisers, including those to hedge funds, private equity funds and venture capital funds, historically relied on the private adviser exemption in order to avoid registration with and oversight by the SEC.

Title IV of the Dodd-Frank Act (the "Private Fund Investment Adviser Registration Act of 2010") repealed the private adviser exemption contained in Section 203(b)(3) of the Advisers Act. The primary purpose of Congress in repealing Section 203(b) was to require advisers to private funds to register under the Advisers Act. Thus, absent an independent exemption, the Dodd-Frank Act requires an investment adviser to even a single private fund (subject to the $150 million AUM threshold discussed below) to register with the SEC under and comply with the Advisers Act.

This change was initially scheduled to be effective as of July 21, 2011. However, on June 22, 2011, the SEC adopted final rules that extended the exemption such that advisers that were not registered with the SEC in reliance on the private adviser

exemption on July 20, 2011 (and continued to meet the requirements of the exemption thereafter) would be exempt from registration with the SEC until March 30, 2012.[2]

This change – the registration and full regulation of hedge fund managers, private equity fund managers and other private fund managers – was successfully fought by the industry for many decades through both lobbying and court battles. The regulation of these industries with combined assets in excess of $4 trillion will have a major impact on both the regulatory and the competitive landscape for all wealth management organizations.

Definition of "Private Fund"

Many of the provisions in the Dodd-Frank Act deal with the concept of a "private fund." In order to provide clarity as to what the term private fund means, the Dodd-Frank Act defines the term private fund as an issuer that would be an "investment company" under Section 3(a) of the Investment Company Act of 1940 (the "Investment Company Act") but for the exception provided from that definition by either Section 3(c)(1)[3] or 3(c)(7)[4] of the Investment Company Act (i.e., the exemptions commonly relied upon by hedge funds, collateralized debt obligation trusts, other structured finance vehicles and private equity funds to avoid registration under the Investment Company Act). According to these changes, unregistered advisers that manage funds relying on the Section 3(c)(1) or 3(c)(7) exemptions will be required to register under the Advisers Act unless another exemption is applicable. The scope of the definition of a private fund is important because certain exemptions in the Act are applicable only to advisers to private funds. By utilizing this definition of private fund, the Dodd-Frank Act substantially increases the number of advisers that will be subject to SEC registration and thus routine SEC examination.

New Limited Exemptions From Registration Under Dodd-Frank Act

The Dodd-Frank Act eliminates the private adviser exemption and replaces it with the general requirement that an investment adviser to any private fund must register with the SEC or state regulators. However, in place of the private adviser exemption, the Dodd-Frank Act added three new exemptions from registration: (i) the exemption for advisers to venture capital funds, (ii) the (small) private fund adviser exemption and (iii) the foreign private adviser exemption. These three exemptions became effective on July 21, 2011.

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[2] Advisers Act Rule 203-1(e).

[3] Under Section 3(c)(1), any issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than one hundred persons and that is not making and does not presently propose to make a public offering of its securities is not considered an investment company for purposes of the Investment Company Act.

[4] Under Section 3(c)(7), any issuer, the outstanding securities of which are owned exclusively by persons who at the time of acquisition of such securities are "qualified purchasers" and that is not making and does not at that time propose to make a public offering of such securities is not considered an investment company for purposes of the Investment Company Act.

The Advisers Act excludes certain advisers from being required to comply with certain provisions of the Advisers Act in one of two ways. First, the Advisers Act excludes certain persons from the definition of investment adviser. All persons excluded from the definition of investment adviser are intentionally deemed not to be investment advisers for purposes of the Act and thus are not subject to the Advisers Act.[5] Second, the Advisers Act may exempt certain persons who meet the definition of investment adviser and are not excluded from the definition from registering as an investment adviser with the SEC. Advisers who are exempt from registration remain subject to the antifraud provisions of the Advisers Act (Section 206 and certain rules thereunder) and a limited number of other substantive provisions of the federal securities laws. This means that exempt advisers are exempted only from the provisions of the Advisers Act that apply exclusively to advisers that are required to register with the SEC. It is important to note that these three new provisions are exemptions from registration with the SEC for firms that fall within the statutory definition of investment adviser. These registration exemptions should be distinguished from exclusions from the definition of investment adviser (*e.g.*, the new family office exclusion discussed below). An entity exempt from SEC registration is still subject to certain provisions of the Advisers Act. An entity entitled to an exclusion from the Advisers Act escapes a much broader range of regulations.

Advisers to Venture Capital Funds. This exemption seeks to distinguish true venture capital (initial-stage financing) from later-stage private equity financing. The Dodd-Frank Act created the new Section 203(l) of the Advisers Act, which (i) provides that advisers that solely advise venture capital funds are exempt from registration under the Advisers Act and (ii) directs the SEC to define the term "venture capital fund." On June 22, 2011, the SEC adopted new Rule 203(l)-1 under the Advisers Act for the purpose of defining the term venture capital fund. In the final rule release,[6] the SEC states that with this exemption, Congress intended to distinguish advisers to venture capital funds from advisers to private equity funds (or other types of funds) for which Congress did not intend to provide an exemption. According to the SEC, the distinguishing features of venture capital funds are that they typically make long-term investments in smaller companies or early-stage companies that are held privately with the goal of eventually selling the companies or taking them public. In addition, the SEC noted that venture capital funds are generally not leveraged, contribute capital to companies that are not leveraged and are less connected to the public markets, and thus present less potential systemic risk.

Definition of Venture Capital Fund. Rule 203(l)-1 defines a venture capital fund generally as a fund that

1) represents to investors that it pursues a venture capital strategy;

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[5] Because of the broad scope of the definition of investment adviser, Section 202(a)(11) of the Advisers Act specifically excludes from the definition of investment adviser certain persons who are already supervised under other regulatory schemes or who are not the type of person the Advisers Act was intended to cover, such as banks, certain professionals such as lawyers and accountants, broker-dealers, publishers, credit rating agencies, etc.

[6] *See* Investment Adviser Act Rel. No. IA-3222 (June 22, 2011).

2) immediately after the acquisition of any asset, other than qualifying investments or short-term holdings, holds no more than 20 percent of the amount of the fund's aggregate capital contributions and uncalled capital commitments in "non-qualifying investments" (other than short-term holdings);

3) does not borrow, issue debt obligations, provide guarantees or otherwise incur leverage in excess of 15 percent of the fund's aggregate capital contributions and uncalled capital commitments, and any such borrowing is for a nonrenewable term of no longer than 120 calendar days (excluding certain guarantees by the fund of qualifying portfolio company obligations up to the amount of the value of the fund's investment);

4) except in extraordinary circumstances, does not offer investors redemption or other liquidity rights but may make distributions to all holders on a pro rata basis; and

5) is a private fund.

The final rule removes the requirement in the initially proposed rule that a venture capital fund must either (i) offer to provide (and, if such offer is accepted, actually provide) significant guidance and counsel concerning the management, operations or business objectives and policies of the qualifying portfolio company, or (ii) control the qualifying portfolio company.

Qualifying Investments. A venture capital fund must generally hold only "qualifying investments" (or short-term holdings).[7] Under the final rule, qualifying investments include

1) equity securities[8] issued by a qualifying portfolio company that are directly acquired by the fund from the company ("directly acquired equity");

2) equity securities issued by a qualifying portfolio company in exchange for directly acquired equity issued by the same qualifying portfolio company (this would allow a venture capital fund to participate in the reorganization of the capital structure of a portfolio company); or

3) equity securities issued by a company of which a qualifying portfolio company is a majority-owned subsidiary or a predecessor and that are acquired by the fund in exchange for directly acquired equity issued by such qualifying

[7] Under Rule 203(l)-1(c)(6), short-term holdings, which are not included in the calculation of non-qualifying investments, are cash and cash equivalents (as defined in 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.

[8] Consistent with the proposed rule, the final rule defines "equity security" by reference to the definition of equity security in Section 3(a)(11) of the Securities Exchange Act of 1934 (the "Exchange Act") and Rule 3a11-1 thereunder.

portfolio company. This would allow, in connection with an acquisition (or merger) of a qualifying portfolio company by (or with) another company, an eligible venture capital fund to acquire equity securities (including publicly traded equity) of the other company in exchange for directly acquired equity securities of a qualifying portfolio company.

A security received as a dividend by virtue of the fund's holding a qualifying investment would also be considered a qualifying investment.

These restrictions are to ensure that the fund's capital is being used to finance the business operations of the qualifying portfolio company as opposed to trading in secondary markets. The definition of qualifying investments excludes investments in equity securities acquired in secondary market transactions in order to maintain the distinction between venture capital and private equity funds.

Qualifying Portfolio Company. The final rule defines a "qualifying portfolio company" as any company that

1) is not a reporting or foreign traded company and does not have a control relationship with a reporting or foreign traded company at the time of the investment,

2) does not incur leverage in connection with the investment by the venture capital fund and distribute the proceeds of any such borrowing to the private fund in exchange for the private fund investment, and

3) is not itself an investment company or a private fund.

A qualifying portfolio company must not be a reporting or foreign traded company at the time of investment[9] by an eligible venture capital fund. With respect to a company, "reporting or foreign traded" means being subject to reporting requirements under Sections 13 or 15(d) of the Exchange Act or having a security listed or traded on any exchange or organized market operating outside the United States.

The final rule also excludes companies that both incur leverage in connection with the investment by the venture capital fund and distribute the proceeds of any such borrowing (or debt issuance) to the venture capital fund in exchange for the fund investment. Subsequent distributions of financing proceeds to the venture capital fund solely because it is an existing investor would not, according to the SEC, fall within the prohibition. This approach would not exclude companies that borrow in the ordinary course of business or prevent an eligible venture capital fund from providing financing or loans to a portfolio company (provided the financing meets

[9] A qualifying portfolio company need only not be a reporting or foreign traded company (or in a control relationship with one) *at the time of each investment* by a venture capital fund; the venture capital fund could continue to hold the securities of a portfolio company that goes public after its investment.

the definition of equity security or is made subject to the 20 percent limit for non-qualifying investments). The provision is intended to exclude leveraged transactions that finance buyouts (i.e., private equity transactions) from transactions that provide capital for the operation and business of portfolio companies.

Private funds, investment companies, asset-backed issuers relying on the Rule 3a-7 exemption under the Investment Company Act and commodity pools are excluded from the definition of qualifying portfolio companies. However, an eligible venture capital fund could use its non-qualifying basket to invest a limited portion of its assets in other funds.

Non-qualifying Investments. Under the final rule, a venture capital fund may invest up to 20 percent of its aggregate capital contributions and uncalled capital commitments (calculated immediately after the acquisition of the non-qualifying investment) in investments that would not meet the criteria of qualifying investments or short-term holdings such as nonconvertible debt, publicly traded securities or shares of other private funds. The inclusion of this “non-qualifying basket” is arguably the most important change to the final definition of venture capital fund from the initial rule proposal. The SEC compromised on this 20 percent limit by balancing the need for flexibility in a venture capital fund’s investments against the risk of allowing private equity funds to be included in the definition.

Non-qualifying investments (other than short-term holdings) can account for no more than 20 percent of the fund’s capital commitments immediately after the acquisition of the non-qualifying investment. Accordingly, a venture capital fund would need to calculate only the 20 percent limit when the fund acquires a non-qualifying investment. The fund may use either a historical cost or fair value methodology in its calculation, as long as the same method is applied consistently during the term of the fund. The SEC emphasized that only bona fide capital commitments may be used in the calculation in order to prevent funds from inflating their amount of non-qualifying investments.

Limitation of Leverage. An eligible venture capital fund cannot borrow funds, issue debt obligations, provide guarantees or otherwise incur leverage in excess of 15 percent of the fund’s contributed capital and uncalled capital commitments. Furthermore, any permitted borrowing must be for a nonrenewable term of no longer than 120 calendar days. However, the final rule adds an exception to the 120-day term limit for any guarantee of qualifying portfolio company obligations by the venture capital fund, up to the value of the fund’s investment in the qualifying portfolio company.

No Redemption Rights. An eligible venture capital fund may provide investors with redemption rights only in exceptional circumstances (e.g., a material change in the tax law after an investor invests in the fund or the enactment of laws prohibiting an investor’s participation in the fund’s investments in particular countries or industries). Investors, however, are permitted to receive pro rata distributions from time to time. The SEC clarified that advisers relying on the venture capital fund exemption would not be allowed to create de facto periodic redemption or transfer rights, for example,

by regularly identifying potential investors on behalf of fund investors seeking to transfer or redeem interests.

Application to Non-U.S. Advisers. A non-U.S. adviser may rely on the venture capital exemption if all its clients, whether U.S. or non-U.S., are eligible venture capital funds. As discussed above, an eligible venture capital fund must be a private fund. In the case of non-U.S. funds that are technically not 3(c)(1) or 3(c)(7) funds because they have not conducted a private offering in the United States, the rule specifically indicates that an adviser may treat as an eligible venture capital fund any non-U.S. fund that would be a private fund if the fund were to conduct a private offering in the United States (and would otherwise meet the definition of a venture capital fund).

Grandfathering Provision. The final definition of venture capital fund includes any private fund that

1) represented to its investors and potential investors at the time it offered its securities that it pursues a venture capital strategy;
2) sold securities to one or more investors prior to Dec. 31, 2010; and
3) does not sell any securities to or accept additional capital commitments from any person after July 21, 2011.

(Small) Private Fund Adviser Exemption. The Dodd-Frank Act created new Section 203(m) of the Advisers Act, which directs the SEC to provide an exemption from registration for any investment adviser that (i) acts solely as an adviser to private funds and (ii) has AUM in the United States of less than $150 million. On June 22, 2011, the SEC implemented the congressional directive and adopted final Rule 203(m)-1 (the "private fund adviser exemption").[10] The private fund adviser exemption provides an exemption from registration under the Advisers Act for any adviser with its principal office and place of business[11] in the U.S. (i.e., a U.S. adviser) that (i) acts solely as an adviser to "qualifying private funds" and (ii) manages private fund assets of less than $150 million. For the purposes of this rule, the principal office and place of business of an adviser is the executive office from which the activities of the adviser are directed, controlled and coordinated. The adopting release notes that this would be the location where the adviser controls or has ultimate responsibility for the management of private fund assets, even though day-to-day management of certain assets may take place at other offices.

Qualifying Private Fund. For the purposes of this rule, the term 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 pursuant to Section 54 of the Investment Company Act. In comparison to the proposed rule, the SEC expanded the definition of qualifying private fund for

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[10] *See* Investment Adviser Act Rel. No. IA-3222 (June 22, 2011).

[11] Under the private fund adviser exemption, "place of business" means "(i) an office at which the investment adviser regularly provides investment advisory services and solicits, meets with or otherwise communicates with clients and (ii) any other location that is held out to the general public as a location at which the investment adviser provides investment advisory services and solicits, meets with or otherwise communicates with clients."

purposes of Rule 203(m)-1 to include funds that qualify for any exclusion from the definition of an investment company under Section 3 of the Investment Company Act instead of merely the exclusions in Section 3(c)(1) or 3(c)(7) (e.g., real estate funds that qualify under Section 3(c)(5)(C)), provided that the adviser treats the fund in question as a private fund for all purposes of the Advisers Act. This addition was intended to prevent an adviser to private funds from losing the benefit of this exemption if one of its funds happened to qualify for another exclusion from the definition of investment company under the Investment Company Act. Consistent with its view in the venture capital fund exemption context (discussed above), the SEC stated that an adviser could treat as a private fund for purposes of Rule 203(m)-1 a non-U.S. fund that has not made an offering to U.S. persons.

In the adopting release, the SEC indicated that whether an adviser manages assets at a place of business in the United States is a factual determination that depends on whether the adviser provides "continuous and regular supervisory or management services" at that location. The SEC further stated that it would not view providing research or conducting due diligence to fall within that criterion if a person outside the United States ultimately makes and implements independent investment decisions.

Application to Non-U.S. Advisers. For a non-U.S. adviser, the private fund adviser exemption would be available so long as

1) the adviser has no client that is a U.S. person (generally as defined in Regulation S) except for qualifying private funds; and

2) all assets managed by the adviser at a place of business in the United States are solely attributable to private fund assets, the value of which is less than $150 million.

The adopting release clarifies that a non-U.S. adviser may utilize the private fund adviser exemption "without regard to the type or number of its non-U.S. clients or the amount of assets it manages outside the United States." In support of this interpretation, the SEC cited its long-held belief that non-U.S. activities of non-U.S. advisers do not substantially implicate U.S. regulatory interests and noted that these limitations on the extraterritorial application of the Advisers Act are consistent with general principles of international comity. However, non-U.S. advisers relying on this exemption will still be subject to the antifraud provisions of the Advisers Act (and the reporting obligations of exempt reporting advisers as discussed below).

For a discretionary or other fiduciary account maintained outside the United States for the benefit of a U.S. person, an adviser must treat such an account as a U.S. person if the account is held by a non-U.S. fiduciary who is a related person of the adviser. Consistent with the foreign private adviser exemption (discussed below), the rule additionally clarifies that a client would not be considered a U.S. person if the client was not a U.S. person at the time of becoming a client of the adviser.

Assets Under Management. An adviser relying on the private fund adviser exemption must annually file a Form ADV update amendment to report its amount of

private fund AUM. This marks a change from the proposed rule, which would have required an adviser to calculate on a quarterly basis its AUM for purposes of determining its eligibility for the exemption. The SEC made this change to reduce the reporting burden on such advisers and to avoid the impact of any short-term market fluctuation on AUM. An adviser is required to calculate its AUM within the 90 days preceding the filing of its annual updating amendment. The amount of AUM must be calculated in the same manner as it is calculated for Form ADV reporting purposes.

In the adopting release, the SEC noted that depending on the facts and circumstances, it may view two or more separately organized but operationally integrated advisory entities, each of which has less than $150 million in private fund AUM, as a single adviser for purposes of assessing the availability of exemptions from registration. In addition, whether an adviser to a single-investor fund could rely on the exemption would depend on the particular facts and circumstances. The SEC noted that while there are circumstances in which a single-investor fund may be treated as a private fund for these purposes (*e.g.*, funds that are meant for multiple investors but for a period of time have only one investor), advisers could not convert managed accounts to single-investor funds in order to qualify for the exemption.

Transition Period. An adviser that becomes ineligible to continue relying on the private fund adviser exemption because the value of its private fund AUM has exceeded $150 million would have a 90-day transition period from the filing of its annual updating amendment to Form ADV to register with the SEC. In addition, an adviser would no longer qualify for the private fund adviser exemption immediately upon accepting a client that is not a private fund.

Private Fund Advisers Are Prohibited From Using the Intrastate Adviser Exemption. The Dodd-Frank Act makes the Advisers Act Section 203(b)(1) registration exemption (i.e., the intrastate adviser exemption) inapplicable to investment advisers to private funds. This exemption relates to investment advisers whose clients are all residents of the state within which the investment adviser maintains its principal place of business and that do not furnish advice or issue analyses or reports with respect to securities listed or are admitted to unlisted trading privileges on any national securities exchange.

Foreign Private Advisers. The Dodd-Frank Act also created Section 202(a)(30) of the Advisers Act, which creates a narrow registration exemption for "foreign private advisers" with limited connections to U.S. investors. Under the Dodd-Frank Act, a foreign private adviser is defined as any investment adviser who

1) has no place of business in the U.S.,

2) has in total fewer than 15 clients and investors in the U.S. in private funds advised by the adviser,

3) has aggregate AUM attributable to clients and investors in the U.S. in private funds advised by the investment adviser of less than $25 million, and

4) does not (i) hold itself out generally to the U.S. public as an investment adviser or (ii) act as an investment adviser to any registered investment company or business development company.

On June 22, 2011, the SEC adopted new Rule 202(a)(30)-1 (the "foreign private adviser exemption") in order to implement the foreign private adviser exemption called for by the Dodd-Frank Act and to define certain undefined terms used in the exemption.[12]

Place of Business. Place of business under the foreign private adviser exemption has the same meaning as in the private fund adviser exemption as described above. The SEC stated that any office from which an adviser regularly communicates with clients, whether U.S. or non-U.S., would be a place of business, as would be any location where an adviser regularly conducts research or other activities intrinsic to the provision of investment advisory services. An office where solely administrative services and back-office activities are performed would not be included if they are not activities intrinsic to providing investment advisory services and do not involve communicating with clients. The SEC clarified that a non-U.S. adviser would not be presumed to have a place of business in the United States solely because it is affiliated with a U.S. adviser, but a non-U.S. adviser might be deemed to have a place of business in the United States if its personnel regularly conduct activities at an affiliate's place of business in the United States. An adviser's temporary location could also be considered a place of business depending on whether the adviser has let it generally be known that it will conduct advisory business at the location.

"Clients and Investors." Eligibility for the new foreign private adviser exemption is determined in part by the number of clients of an adviser. Under the private adviser exemption (which was deleted by the Dodd-Frank Act), it had long been established that in counting the clients of the adviser to a private fund, the fund itself (and not each individual investor in the fund) was considered the client. In order to avoid the situation where a foreign private adviser provided advice to one fund with more than 15 investors, the Dodd-Frank Act revised this long-held meaning such that each investor in a fund is now counted under the foreign private adviser exemption.

Under the final rule, an adviser would be allowed to treat the following as a single client

1) a natural person and

    a. that person's minor children;
    b. any relative, spouse or relative of the spouse of that person who has the same principal residence as such person;
    c. all accounts of which that person and/or the person's minor child or relative, spouse, or relative of the spouse who has the same principal residence as such person are the only primary beneficiaries; and
    d. all trusts of which that person and/or the person's minor child or relative, spouse (or spousal equivalent), or relative of the spouse who

[12] *See* Investment Adviser Act Rel. No. IA-3222 (June 22, 2011).

has the same principal residence as such person are the only primary beneficiaries;

2) a corporation, general partnership, limited partnership, limited liability company, trust or other legal organization to which the adviser provides investment advice based on the organization's investment objectives; and

3) two or more legal organizations that have identical shareholders, partners, limited partners, members or beneficiaries.

In addition, an adviser must count as clients those individuals or entities for whom the adviser provides advisory services even if the adviser does not receive compensation. The final rule avoids double-counting of clients and investors by providing that an adviser need not count a private fund as a client if the adviser counts any investor in that private fund for purposes of the foreign private adviser exemption. In addition, an adviser need not count a person as an investor in a private fund if the adviser counts such person as a client of the adviser.

Under the final rule, the definition of "investor" incorporates the counting methods required by Sections 3(c)(1) and 3(c)(7) of the Investment Company Act.[13] As such, any person who would be included in the number of beneficial owners of a 3(c)(1) fund or included in the determination of whether all of a 3(c)(7) fund's investors were qualified purchasers would be deemed an investor. Thus, the definition of investors for purposes of the foreign private adviser exemption generally incorporates the look-through rules applicable to counting investors in 3(c)(1) and 3(c)(7) funds. The SEC indicated that the look-through analysis is a facts and circumstances analysis. As examples of persons that would be included as investors in an adviser's private fund on a look-through basis, the SEC cited the following examples: (i) holders of the securities of a feeder fund formed or operated for the purpose of investing in such private fund and (ii) owners of total return swaps on such private fund. To avoid double-counting, an adviser would be able to treat as a single investor any person who is an investor in two or more private funds advised by the adviser.

In the United States. In general, the foreign private adviser exemption defines "in the United States" by reference to the definitions of "U.S. person" and "United States" in Regulation S under the Securities Act, except that, similar to the private fund adviser exemption, it would treat a discretionary account owned by a U.S. person but managed by a non-U.S. affiliate of the adviser as a person "in the United States" even though such person would not be considered a U.S. person under Regulation S. For determining whether an investor or client was in the United States, an adviser is generally required to look only to the point in time when the person either became a client or an investor. Clients or investors that were not in the United States at the time of becoming a client or an investor but later became a person in

[13] The rule also counts beneficial owners of "short-term paper" (as defined in Section 2(a)(38) of the Investment Company Act) issued by a private fund as investors (even though they are generally excluded from the 3(c)(1) calculation). Unlike in the proposed rule, however, knowledgeable employees (and certain related persons) as described in Rule 3c-5 under the Investment Company Act would not count as investors under the rule.

the United States would generally not need to be treated as being in the United States.

Assets Under Management. For purposes of the foreign private adviser exemption, as with the exemption of private fund advisers rule discussed above, foreign advisers would be required to calculate their regulatory AUM in the same manner as they are calculated for Form ADV reporting purposes.

Reporting Requirements for Exempt Reporting Advisers

Even certain investment advisers and fund managers that are exempt from SEC registration must still comply with certain SEC reporting obligations. The Dodd-Frank Act created three new exemptions from registration under the Advisers Act. However, advisers that rely on two of the exemptions – (i) the exemption for venture capital fund advisers and (ii) the exemption for advisers to private funds that have AUM in the U.S. of less than $150 million – are considered "exempt reporting advisers." For each of these exemptions, the Dodd-Frank Act directs the SEC to require these advisers to maintain such records and submit such reports as the SEC determines necessary or appropriate in the public interest or for the protection of investors. On June 22, 2011, to implement this reporting requirement the SEC adopted new Rule 204-4, which requires such exempt reporting advisers to file certain reports with the SEC on Form ADV (and pay the associated filing fees) within 60 days of relying on the exemption.[14]

Exempt reporting advisers are required to fill out only a subset of the questions on Form ADV. Specifically, exempt reporting advisers are required to complete the following items in Part 1A of Form ADV and corresponding sections of Schedules A, B, C and D:

1) Item 1 – basic identifying information,
2) Item 2.B. – identification of exemption being relied upon,
3) Item 3 – identification about form of organization,
4) Item 6 – information regarding other business activities engaged in by the adviser,
5) Item 7 – financial industry affiliations and information regarding the private fund managed by the adviser,
6) Item 10 – the adviser's control persons and
7) Item 11 – disciplinary history disclosures for the adviser and its employees.

Exempt reporting advisers were required to file an initial report on Form ADV by March 30, 2012. They will also be obligated to file annual updates to Form ADV, as is

[14] *See* Investment Adviser Act Rel. No. IA-3221 (June 22, 2011).

currently the case for registered advisers, on an annual basis within 90 days of the end of the adviser's fiscal year (or more frequently if specifically required by the instructions to Form ADV).

Form ADV provides a safe harbor for certain exempt reporting advisers relying on the "private fund adviser" exemption under Rule 203(m)-1. Such an adviser that has complied with all its reporting obligations as an exempt reporting adviser may continue advising private fund clients for up to 90 days after filing an annual updating amendment indicating that it has private fund assets of $150 million or more before filing its final report and application for registration. This transition period is not available to advisers relying on the "venture capital adviser" exemption in Section 203(l).

In the adopting release, the SEC indicated that it does not anticipate that the staff will conduct compliance examinations of exempt reporting advisers on a regular basis. Nonetheless, the SEC noted that exempt reporting advisers, which are exempt from registration pursuant to Sections 203(l) and 203(m) of the Advisers Act, are not specifically exempt from registration under Section 203(b), and thus the SEC has the authority under Section 204(a) of the Advisers Act to examine records of exempt reporting advisers and would do so if it receives indications of wrongdoing.

Increased Threshold for SEC Registration

Prior to the passage of the Dodd-Frank Act, investment advisers with less than $25 million in AUM were generally required to register as an investment adviser with one or more states, investment advisers with between $25 million to $30 million in AUM were generally permitted to register with either the SEC or applicable states, and advisers with more than $30 million in AUM were required to register with the SEC. Under the Dodd-Frank Act, Congress transferred most of the regulatory burden of monitoring smaller advisers to the states by increasing the threshold for SEC registration from $25 million to $100 million in AUM for most U.S. investment advisers. The purpose of this change is to allow the SEC to focus its examination resources on larger investment advisers.

New Registration Requirements. Effective July 21, 2011, the following advisers will be required to register with the SEC:[15]

1) advisers with $100 million in AUM;

2) advisers with between $25 million to $100 million in AUM (i.e., "mid-sized advisers") that
    a) are not required to be registered as an adviser with the state securities authority of the state where they maintain their principal office and place of business and

[15] See Investment Adviser Act Rel. No. IA-3221 (June 22, 2011).

b) are not subject to examination by the state securities authority of the state where they maintain their principal office and place of business (advisers in the State of New York and Wyoming only); and

3) advisers that would otherwise be required to register with 15 or more states (the previous rule required an adviser to be required to register with 30 or more states).

Unless another exception applies, advisers with less than $100 million in AUM will be required to register with one or more states. For an example of such exceptions, advisers that manage registered investment companies will be required to register with the SEC regardless of their AUM.

An adviser with $25 million to $100 million in AUM is generally prohibited from registering with the SEC if such adviser is "required to be registered" as an investment adviser and is "subject to examination" in its home state. Under the adopted rule, a mid-sized adviser that relies on an exemption from registration with its home state would not be considered required to be registered with its home state and thus would be required to register with the SEC. In addition, advisers will not be subject to examination in the states of Wyoming and New York. Thus, mid-sized advisers with their principal place of business in these states will be required to register with the SEC.

Impact of New Requirements. The SEC has indicated that these changes will require approximately 3,200 mid-sized advisers (those that have between $25 and $100 million of AUM) to withdraw their SEC registrations and instead register with the state securities authorities of their home states (and potentially other states in which they have clients). In order to implement this new regulatory shift, on June 22, 2011, the SEC passed new Rule 203A-5, which required every adviser that is registered with the SEC to file an amendment to its Form ADV by March 30, 2012, and to report the market value of its assets under management as determined within 90 days of such one-time filing to determine whether the adviser meets the revised eligibility rules for registration with the SEC. An adviser that does not meet the revised criteria will be required to withdraw its SEC registration by filing Form ADV-W no later than June 28, 2012. Under new Rule 203A-5(a), mid-sized advisers registered with the SEC as of July 21, 2011, were required to remain registered with the SEC (unless exempted from registration) until Jan. 1, 2012.

Buffer for SEC Registration. Under prior law, advisers with AUM between $25 million and $30 million were allowed to register at either the SEC or state level. This buffer was designed to prevent an adviser from having to switch frequently between state and SEC registration as a result of changes in the value of its assets under management or the departure of one or more clients. Final Rule 203A-1 also includes a similar buffer. Specifically, Rule 203A-1(a) implements a $10 million buffer by providing that an adviser otherwise subject to the $100 million threshold may but is not required to register with the SEC instead of the states if it has between $100 million and $110 million in AUM. Similarly, once registered with the SEC, an adviser need not withdraw its registration until it has less than $90 million of AUM. Advisers

with $110 million or more in AUM are required to register with the SEC (unless otherwise exempt).

The SEC adopted revisions to Item 2 of Part 1A of Form ADV in order to account for these changes. Item 2 of Form ADV now requires an adviser to indicate its basis for SEC registration.

Changes to Form ADV

Changes to Form ADV Disclosure. As a result of the Dodd-Frank Act, the SEC adopted changes to Form ADV that are designed to enhance its oversight of investment advisers.[16] The new rules require advisers to provide the SEC with additional information primarily about three areas of their business: (i) information regarding the private funds they advise; (ii) more information in general about their advisory business, including the types of clients they advise; their employees and advisory activities; and business practices that may present conflicts of interest, such as the use of affiliated brokers, soft dollar arrangements and payments for client referrals; and (iii) additional information about certain non-advisory activities and their financial industry affiliations. The SEC anticipates that the increased knowledge it will glean from the revised Forms ADV will enable it to better understand advisers' operations and business focus and will thereby facilitate its assessment of risks and conflicts and aid in its identification of firms for examination.

Private Fund Reporting. The most controversial new disclosure item is Item 7 of Form ADV, which requires fund-by-fund reporting of information regarding each private fund managed by an adviser, including exempt reporting advisers. This information will be publicly available on the SEC's website. Because the above information will be public, the SEC expects that it would supplement investors' due diligence efforts and allow service providers to identify the funds claiming to rely on their services. While the information may be of interest to regulators and investors, much of the information will likely be of significant interest to an adviser's competitors, other market participants and the media. The new rules modify Form ADV to require an adviser, in response to Item 7.B and Schedule D, to provide information about all the adviser's private funds. Non-U.S. advisers are permitted to forego reporting on private funds they advise that are organized outside the U.S., not offered in the U.S. and not beneficially owned by any U.S. person.

The adopted rules create a new Section 7.B.1 of Schedule D that expands the data advisers are required to disclose about their private funds. Among other items, the Schedule D submitted for each fund needs to disclose certain information about the fund, including

1) (i) the name of the private fund; (ii) its jurisdiction of organization; (iii) its general partner, directors, trustees or persons occupying similar positions; (iv) the Investment Company Act exclusion on which the fund relies; (v) the names and jurisdictions of each foreign financial regulatory authority with which the

[16] *See* Investment Adviser Act Rel. No. IA-3221 (Jun. 22, 2011).

fund is registered; and (vi) whether the fund is in a master-feeder arrangement;

2) whether the fund is a fund of funds (for these purposes, the Form ADV instructions specify that the fund should be considered a "fund of funds" if it invests 10 percent or more of its total assets in other pooled investment vehicles, whether or not they are also private funds);

3) the fund's investment strategy – hedge fund, liquidity fund, private equity fund, real estate fund, securitized asset fund, venture capital fund or other private fund;

4) the fund's gross asset value, the minimum investment commitment required of an investor in the fund and the approximate number of beneficial owners of the fund;

5) the approximate percentage of the fund beneficially owned by (i) the adviser and its related persons, (ii) funds of funds, and (iii) non-U.S. persons;

6) whether clients of the adviser are solicited to invest in the fund, and the percentage of the adviser's clients that have invested in the fund; and

7) information regarding the funds' auditors, prime brokers, custodians, administrators and marketers, including disclosing their locations and whether such service providers are related persons of the adviser.

In lieu of reporting a fund's name on its Schedule D, the new rules allow advisers to use an identification code, thereby preserving the anonymity of the name of the fund.

Additional Disclosures About the Adviser and its Advisory Business. The SEC also adopted new changes to Form ADV to require advisers to report additional information about the adviser and its business, including but not limited to

1) the number of the adviser's employees who are registered as insurance agents,

2) the types of clients it advises and the percentage that each client type represents of its total number of clients,

3) the percentages of AUM by client type,

4) disclosure of whether any soft dollar benefits received qualify for the safe harbor under Section 28(e) of the Securities Exchange Act of 1934 (the Exchange Act, and

5) whether or not the adviser itself has total assets (rather than AUM) of $1 billion or more as of its most recent fiscal year (designed to alert the SEC to which

firms will be required to comply with new rules addressing certain incentive-based compensation arrangements).

Additional Disclosures About the Adviser's Non-Advisory Activities and Affiliations. The SEC also adopted new changes to Form ADV to require advisers to report additional information about the adviser's non-advisory activities and affiliations, including but not limited to

1) disclosure of whether registered advisers and exempt reporting advisers or any related person are engaged in business as a registered municipal adviser, registered security-based swap dealer, major security-based swap participant (all of which are new types of SEC registrants under the Dodd-Frank Act) or as a trust company;

2) disclosure of a related person who is a sponsor, general partner or managing member of a pooled investment vehicle;

3) disclosure of certain information about each related person in the financial services industry, including but not limited to (i) its name, (ii) the relationship between the adviser and the related person, and (iii) whether the adviser and related person share employees or the same physical location.[17]

New Rules for the Calculation of Assets Under Management. Under Section 203 of the Advisers Act, "assets under management" ("AUM") is defined as the "securities portfolios" with respect to which an investment adviser provides "continuous and regular supervisory or management services." Previously, the instructions to Form ADV provided guidance on the calculation of AUM by allowing (but not requiring) advisers to include certain types of assets in the calculation, namely proprietary assets, assets an adviser manages without receiving compensation and assets of foreign clients. The final rules create a new defined term, "regulatory assets under management," and require advisers to include the foregoing categories in their calculation of regulatory AUM. Moreover, an adviser must calculate its regulatory AUM on a gross basis, without deducting outstanding indebtedness and other accrued but unpaid liabilities that are in client accounts. The SEC indicated that whether a client (e.g., a fund) uses investor capital or borrowed funds to purchase managed assets is not relevant to its determination of the size and significance of the adviser's activities.

The SEC also provides guidance on how private fund advisers must calculate the value of their regulatory AUM. In calculating its regulatory AUM with respect to its private funds, an adviser is now required to (i) include the value of any private fund

[17] The final rules added an exception providing that the adviser is not required to disclose this information for any related person if (i) the adviser has no business dealings with the related person in connection with its advisory services, (ii) the adviser does not conduct shared operations with the related person, (iii) the adviser does not refer clients or business to the related person, (iv) the adviser does not share supervised persons or premises with the related person and (v) the adviser has no reason to believe that its relationship with the related person otherwise creates a conflict of interest with its clients.

over which it exercises "continuous and regular supervisory or management services," regardless of the nature of the assets of the fund; (ii) include any uncalled capital commitments made to the fund; and (iii) value the private funds using a fair value methodology (even for illiquid or other securities that are not readily marketable). If the governing documents of a fund provide for a specific process for calculating fair value (e.g., providing the general partner discretion over the determination of fair value), then the adviser could rely on such process for calculating its regulatory AUM, provided it is done so consistently and in good faith. If, however, an adviser uses GAAP or another basis of accounting to calculate fair value for financial reporting purposes, the SEC expects such adviser to use the same basis for determining regulatory AUM.

This new method of calculating AUM applies uniformly for purposes of determining eligibility for SEC registration, reporting regulatory AUM on Form ADV and the new exemptions from registration under the Advisers Act created by the Dodd-Frank Act.

Amendments to Pay-to-Play Rule

There is an enhanced focus on prohibiting the use of political contributions and support as a mechanism for obtaining advisory business. Rule 206(4)-5 under the Advisers Act (the "Pay-to-Play Rule") generally prohibits investment advisers from making political contributions to a government entity or employee in order to secure or maintain a contract to provide investment advisory services to that same government entity. The Pay-to-Play Rule previously applied to advisers that were either registered with the SEC or unregistered in reliance on the private adviser exemption. On June 22, 2011, the SEC adopted final rules to extend the Pay-to-Play Rule to apply to the new classes of exempt advisers created by the Dodd-Frank Act – exempt reporting advisers and advisers relying on the foreign private adviser exemption.[18]

The final rules also amended the provision of the Pay-to-Play Rule that prohibits advisers from paying third-party solicitors and placement agents to solicit governmental entities unless such persons are themselves "regulated persons" (i.e., registered investment advisers or broker-dealers that are members of the Financial Industry Regulatory Authority ("FINRA")) and are subject to similar pay-to-play restrictions. Specifically, the SEC amended the rule by adding municipal advisers to the definition of regulated persons, thus permitting an adviser also to pay a municipal adviser to solicit governmental entities on its behalf. Under the rule a "municipal adviser" is defined as an adviser that (i) is registered with the SEC under Section 15B of the Exchange Act and (ii) is subject to pay-to-play rules adopted by the Municipal Securities Rulemaking Board ("MSRB") that are substantially equivalent to or more stringent than the Pay-to-Play Rule.

The final rule also extended the compliance date with respect to the Pay-to-Play Rule's restrictions on payments to third-party solicitors from Sept. 13, 2011, to June 13, 2012, in order to provide time for the MSRB and FINRA to adopt these rules and to

[18] *See* Investment Adviser Act Rel. No. IA-3221 (Jun. 22, 2011).

give third-party solicitors and placement agents additional time to come into compliance with the Pay-to-Play Rule.

Family Office Exclusion

Family offices are typically established by wealthy families to manage the assets of and provide other services (such as tax, accounting, trust administration and estate planning advice) to its family members. The SEC estimates that there are 2,500 to 3,000 single-family offices, generally servicing families with at least $100 million of investable assets. Family offices generally meet the definition of an investment adviser under Section 202(a) of the Advisers Act because family offices are in the business of providing advice about securities for compensation. Although some family offices have been excepted from the definition of investment adviser by exemptive order, many family offices have historically relied on the private adviser exemption. Some family offices that manage assets owned outside the relevant immediate family will no longer remain exempt from SEC regulation.

In order to prevent typical family offices from being treated as investment advisers after the Dodd-Frank Act eliminated the private adviser exemption, the Dodd-Frank Act added a new exclusion from the definition of investment adviser for family offices. Thus a company that is a family office is excluded from the definition of an investment adviser under the Advisers Act and would generally not be subject to any provisions of the Advisers Act. The Dodd-Frank Act also directed the SEC to define the term family office in a manner that is consistent with the previous SEC family office exemptive orders and that recognizes the range of organizational, management, and employment structures and arrangements employed by family offices.

On June 22, 2011, the SEC adopted Rule 202(a)(11)(G)-1 (the "Family Office Rule") under the Advisers Act to define the term "family office."[19] The rule was adopted to remain consistent with exemptive orders that were previously issued by the SEC to family offices to reflect the SEC's prior exemptive policy. The main policy behind the prior exemptive orders is that the Advisers Act was not designed to regulate families in the management of their own assets. The Family Office Rule provides that a family office would not be considered to be an investment adviser for purpose of the Advisers Act and defines a family office as a company that (i) has no clients other than family clients, (ii) is wholly owned by family clients and exclusively controlled (directly or indirectly) by family members and/or family entities, and (iii) does not hold itself out to the public as an investment adviser.

Under the rule, a family office is permitted to provide advisory services only to "family clients." However, the definition of family clients is broader than just individual family members. Family clients include: (i) current and former family members; (ii) key employees of the family office (and, under certain circumstances, former key employees); (iii) nonprofit organizations, charitable foundations and other charitable organizations funded exclusively by family clients; (iv) estates of current and former family members or key employees; (v) trusts existing for the sole current

[19] *See* Investment Adviser Act Rel. No. IA-3220 (Jun. 22, 2011).

benefit of family clients or, if both family clients and charitable and nonprofit organizations are the sole current beneficiaries, trusts funded solely by family clients; (vi) revocable trusts funded solely by family clients; (vii) certain key employee trusts; and (viii) companies wholly owned (directly or indirectly) exclusively by and operated for the sole benefit of one or more family clients (with certain exceptions).

The Family Office Rule also contains a grandfathering provision. The rule provides that the definition of a family office includes persons not registered or required to be registered under the Advisers Act on Jan. 1, 2010, that would meet all the required conditions under the Family Office Rule but for the provision of investment advice to certain clients, including, for example, (i) natural persons who at the time of their investment are officers, directors or employees of the family office who have invested with the family office before Jan. 1, 2010, and are accredited investors or (ii) any company owned exclusively and controlled by one or more family members. However, family offices that fall within the grandfathering provision remain subject to the antifraud provisions of the Advisers Act. In addition, the SEC reiterated in its adopting release that it is not rescinding exemptive orders previously issued to family offices, which according to the SEC may be slightly broader in some areas than the Family Office Rule, while narrower in other areas. Family offices currently operating under the exemptive orders could continue to rely on such orders or, if they meet the conditions of the Family Office Rule, they could rely on the new Family Office Rule. The Family Office Rule became effective on Aug. 29, 2011.

Exemptions From Registration for Advisers to Small Business Investment Companies

The Dodd-Frank Act added an exemption as Advisers Act Section 203(b)(7) that exempts from registration any investment adviser (other than an entity that has elected to be regulated as a business development company pursuant to Section 54 of the Investment Company Act) who solely advises (i) small business investment companies licensed under the Small Business Investment Act of 1958 (the “SBIA”), (ii) entities that have received notice to proceed to qualify for a license as a small business investment company under the SBIA, or (iii) applicants that are affiliated with one or more licensed small business development companies under the SBIA and have themselves applied for a license under the SBIA. We expect the SEC to engage in further rule making in this area.

Creation of Form PF

The Dodd-Frank Act established the Financial Stability Oversight Council (“FSOC”) for the purpose of providing comprehensive monitoring to identify risks to the stability of the U.S. financial system. The FSOC is charged with identifying threats to the financial stability of the U.S., promoting market discipline and responding to emerging risks to the stability of the U.S. financial system. In order to assist the FSOC with gathering information, the Dodd-Frank Act directs the SEC to collect information from advisers to hedge funds and other private funds as necessary for FSOC’s assessment of systemic risk. Under the Dodd-Frank Act, the SEC is permitted to require any SEC-registered investment adviser to maintain records and file reports

relating to private funds managed by the adviser as the SEC determines (1) necessary and appropriate in the public interest and for the protection of investors or (2) for the assessment of systemic risk by the Financial Stability Oversight Council. The Dodd-Frank Act further provides that these records and reports will include a description of

1) the amount of AUM and use of leverage,

2) counterparty credit risk exposure,

3) trading and investment positions,

4) valuation policies and practices of the fund,

5) types of assets held,

6) side arrangements or side letters,

7) trading practices, and

8) such other information as the SEC in consultation with the FSOC determines is necessary and appropriate in the public interest and for the protection of investors or for the assessment of systemic risk.

On Oct. 31, 2011, the SEC and CFTC adopted new reporting rules under the Advisers Act and Commodity Exchange Act.[20] The new SEC rule requires investment advisers registered with the SEC that advise one or more private funds and have at least $150 million in private fund AUM to file Form PF with the SEC. The new CFTC rule requires commodity pool operators ("CPOs") and commodity trading advisers ("CTAs") registered with the CFTC to satisfy certain CFTC filing requirements with respect to private funds by filing Form PF with the SEC, but only if those CPOs and CTAs are also registered with the SEC as investment advisers and are required to file Form PF under the Advisers Act. The new CFTC rule also allows such CPOs and CTAs to satisfy certain CFTC filing requirements with respect to commodity pools that are not private funds by filing Form PF with the SEC.

Advisers will be required to file Form PF electronically with the SEC on a confidential basis. The information contained in Form PF is designed to assist the FSOC in, among other things, its assessment of systemic risk in the U.S. financial system.

Under the new reporting requirements, only SEC-registered advisers with at least $150 million in private fund AUM will be required to file Form PF. Private fund advisers are further divided by size into two broad groups: large advisers and smaller advisers. Large private fund advisers would include any adviser with $1.5 billion or more in hedge fund AUM, $1 billion in liquidity fund or registered money market fund AUM, or $2 billion in private equity fund AUM. Large private fund advisers must provide more detailed information than smaller advisers on Form PF. The focus and

[20] *See* Investment Adviser Act Rel. No. IA-3308 (Oct. 31, 2011).

frequency of the reporting for large advisers depends on the type of private fund the adviser manages.

1) Large hedge fund advisers must file Form PF to update information regarding the hedge funds they manage within 60 days of the end of each fiscal quarter (instead of 15 days in the rule proposal). These advisers must report on an aggregated basis information regarding exposures by asset class, geographical concentration and turnover by asset class. In addition, for each managed hedge fund having a net asset value of at least $500 million, these advisers are required to report certain information relating to that fund's exposures, leverage, risk profile and liquidity. Large hedge fund advisers are not required to report position-level information.

2) Large liquidity fund advisers must file Form PF to update information regarding the liquidity funds they manage within 15 days of the end of each fiscal quarter. These advisers must provide information on the types of assets in each of their liquidity fund's portfolios, certain information relevant to the risk profile of the fund, and the extent to which the fund has a policy of complying with all or any aspects of the Investment Company Act's principal rule concerning registered money market funds (Rule 2a-7).

3) Large private equity fund advisers must file Form PF annually within 120 days of the end of the fiscal year. They must respond to questions focusing primarily on the extent of leverage incurred by their funds' portfolio companies, the use of bridge financing and their funds' investments in financial institutions.

Smaller private fund advisers include advisers with more than $150 million in private fund AUM that do not meet the large adviser thresholds. Smaller private fund advisers will be required to file Form PF only once a year within 120 days of the end of the fiscal year and to report only basic information regarding the private funds they advise. This basic information includes information regarding size, leverage, investor types and concentration, liquidity and fund performance. Smaller advisers managing hedge funds must also report information about fund strategy, counterparty credit risk, and use of trading and clearing mechanisms.

There will be a two-stage phase-in period for compliance with Form PF filing requirements. Most private fund advisers will be required to begin filing Form PF following the end of their first fiscal year or fiscal quarter as applicable, to end on or after Dec. 15, 2012. However, advisers with $5 billion or more in private fund assets must begin filing Form PF following the end of their first fiscal year or fiscal quarter as applicable, to end on or after June 15, 2012.

The information reported on Form PF will remain confidential. This information will supplement the information that advisers are now required to file on Form ADV with respect to information about the private funds an adviser advises. The information reported on Form ADV will be available to the public.

Changes to SEC Examinations

As a general matter, due to the vastly expanded demands on an already under-resourced SEC, the SEC's examination program will move to a more risk-based approach to selecting when and how to conduct examinations of investment advisers.

Examinations for Private Funds. The Dodd-Frank Act provides that the records and reports of any private fund managed by an SEC-registered investment adviser are deemed to be the records and reports of the investment adviser. Accordingly, private fund records are subject to review by the SEC in an examination of the adviser. In addition, the Dodd-Frank Act requires that the SEC conduct periodic inspections of the records of private funds maintained by SEC-registered investment advisers in accordance with a schedule established by the SEC. This suggests that the SEC is required to establish a regular inspection cycle for registered private fund advisers. In recent years, the SEC has taken a risk-based approach to investment adviser inspection, which generally means that larger advisers and certain advisers that warrant more frequent inspection have been examined more frequently than other advisers. According to certain reports, in recent years fewer than 10 percent of investment advisers have been examined by the SEC each year.

The SEC is also permitted to conduct such additional, special and other examinations of private fund advisers as the SEC may prescribe as necessary and appropriate in the public interest and for the protection of investors or for the assessment of systemic risk. The concept of conducting examinations for the assessment of systemic risk is a new exam concept introduced by the Dodd-Frank Act.

Examination Study. The Dodd-Frank Act required the SEC to review and analyze the need for enhanced examination and enforcement resources for investment advisers. On Jan. 17, 2011, the SEC issued its report on the results of this study. The report outlines the findings of the study, including the SEC staff's opinion that the SEC will not have sufficient capacity in the near or long term to conduct effective examinations of registered investment advisers with adequate frequency. The report notes that the SEC's examination program requires a source of funding that is adequate to permit the SEC to meet new challenges and prevent examination resources from being outstripped by growth in the number of registered investment advisers. The study includes the staff's recommendation that Congress consider three possible approaches to address the capacity constraints concerning adviser examinations:

1) Congress could authorize the SEC to impose "user fees" on SEC-registered advisers that could be retained by the SEC to fund the investment adviser examination program;

2) Congress could authorize one or more SROs to examine, subject to SEC supervision, all SEC-registered investment advisers with statutorily mandated membership in such SROs for investment advisers; or

3) FINRA could be authorized to examine firms registered both as broker-dealers and as investment advisers for compliance with the Advisers Act.

Closure on SEC Examinations and SEC Investigations After Receiving a Wells Notice. Historically, many months (or even years) could go by subsequent to SEC examination or investigational activity with an adviser under the cloud of possible SEC action. The Exchange Act now provides that no later than 180 days after the date on which SEC staff completes the on-site portion of a compliance examination or inspection or receives all records requested from the entity being examined or inspected (whichever is later), the SEC staff must provide the entity being examined or inspected with written notification indicating either that the examination or inspection has concluded, has concluded without findings or that the staff requests the entity undertake corrective action. This requirement also includes an exception that could allow additional time for certain complex examinations or inspections and for situations where SEC staff requests corrective action that cannot be completed before the required deadline.

In addition, the Exchange Act now also provides that no later than 180 days after the date on which the SEC staff provides a Wells Notice to any person, the SEC staff must either file an action against that person or provide notice to the director of the SEC Division of Enforcement of its intent not to file an action. This requirement includes exceptions that could allow additional time for certain complex enforcement investigations.

Changes to SEC Enforcement Powers

Expansion of Aiding and Abetting Liability Provisions. Prior to the Dodd-Frank Act, the SEC could charge aiding and abetting violations only under the Exchange Act and the Advisers Act and had to prove actual "knowledge" on the part of a defendant or respondent charged with an aiding and abetting violation. The Dodd-Frank Act now permits the SEC to charge aiding and abetting violations under the Securities Act and the Investment Company Act as well. In addition, it also authorizes the SEC to seek a penalty (rather than only injunctive relief) for aiding and abetting violations under the Advisers Act. In addition, the Dodd-Frank Act amends these acts (including the Exchange Act) to expand the state of mind element necessary for aiding and abetting violations of the securities laws. The prior standard required that an aider or abettor "knowingly" provide substantial assistance to another person's violations. The Dodd-Frank Act provides for liability for those who aid and abet violations knowingly or recklessly. Thus, these changes will make it easier for the SEC to bring aiding and abetting charges.

In addition, the Dodd-Frank Act requires the comptroller general to conduct a study on the impact of authorizing a private right of action against any person who aids or abets another person in violation of the securities laws. Doing so would vastly expand the private liability exposure for securities industry participants and would conflict with U.S. Supreme Court decisions on the issue.

Collateral Suspensions or Bars. The Dodd-Frank Act also authorizes the suspension or bar of a regulated person who violates securities laws in one part of the financial

services industry from associating with a regulated entity in another part of the industry. For example, if an individual associated with a broker-dealer is the subject of an enforcement action, the SEC may now suspend or bar that person not only from associating with a broker-dealer but also from associating with an investment adviser, municipal securities dealer, municipal adviser, transfer agent or nationally recognized statistical rating organization ("NRSRO").

Prior to enactment of the Dodd-Frank Act, there was no associational bar or similar provision with respect to municipal advisers, nor was there a formal associational bar with respect to NRSROs. However, before enactment of the Dodd-Frank Act there existed a statutory provision for revoking the registration of an NRSRO if any person associated with it was found to have willfully violated any provision of the Securities Act of 1933 and if it were necessary for the protection of investors and in the public interest.

Authorization to Issue Penalties in Administrative Proceedings. Prior to the Dodd-Frank Act, the SEC could impose only a civil penalty in an administrative proceeding against an individual associated with an entity subject to SEC jurisdiction, such as a broker-dealer or an investment adviser. This required the SEC to bring an action in federal district court to seek a civil penalty against a person not associated with a regulated entity. The Dodd-Frank Act now allows the SEC to seek a civil penalty against any person in an administrative proceeding before an administrative law judge rather than in federal court. Dodd-Frank adopts a three-tiered penalty system that is already contained in the Exchange Act, though it also increases by 50 percent the penalty amounts that the SEC can seek in administrative proceedings. These changes will likely increase the number of administrative enforcement actions filed by the SEC but will also provide defendants the opportunity to resolve cases through administrative action rather than through a potentially more significant federal district court action.

Uniform Fiduciary Standard of Conduct for Broker-Dealers and Investment Advisers

Currently, differing standards of care apply to the variety of investment professionals used by investors. Historical studies and SEC rule proposals evidenced that investors are confused about the distinctions in the duties owned to them by investment advisers, financial advisers, brokers, financial planners, investment planners, wealth advisers, etc. In particular, investors are often surprised to learn that under current laws and regulations, brokers not owe their clients a fiduciary duty.

The Dodd-Frank Act required the SEC to conduct studies and evaluations of the effectiveness of existing legal and regulatory requirements applicable to broker-dealers, investment advisers and associated persons who provide personalized investment advice and recommendations about securities to retail customers. The Act also amends Section 15 of the Exchange Act and Section 211 of the Advisers Act to expressly permit the SEC to adopt rules that provide a standard of conduct for broker-dealers and investment advisers when they provide personalized investment advice to retail customers. The Dodd-Frank Act defines "retail customer" for these purposes as a natural person (or such person's legal representative) who receives

personalized investment advice about securities from a broker-dealer or investment adviser and uses that advice primarily for personal, family or household purposes.

An investment adviser is a fiduciary whose duty is to serve the best interests of its clients, including an obligation not to subordinate clients' interests to its own. Included in the fiduciary standard are the duties of loyalty and care. In contrast, broker-dealers are required only to deal fairly with their customers. An important aspect of a broker-dealer's duty of fair dealing is the suitability obligation, which generally requires a broker-dealer to make recommendations that are consistent with the interests of its customer. Historically, broker-dealers were generally not subject to a fiduciary duty. Broker-dealers are subject to statutory, commission and SRO requirements that are designed to promote business conduct that protects customers from abusive practices, including practices that may be unethical but may not necessarily be fraudulent.

On Jan. 22, 2011, the SEC submitted to Congress a staff study[21] recommending the adoption of a uniform fiduciary standard of conduct for broker-dealers and investment advisers (the same standard currently applied to investment advisers) when those financial professionals provide personalized investment advice about securities to retail investors. The report indicates that the SEC staff's recommendations are guided by an effort to establish a standard to provide for the integrity of advice given to retail investors and to recommend a harmonized regulatory regime for investment advisers and broker-dealers when providing the same or substantially similar services in order to better protect retail investors. The staff found that (i) retail investors do not understand the differences between investment advisers and broker-dealers or the standards of care applicable to broker-dealers and investment advisers, (ii) many retail investors find the standards of care confusing and are uncertain about the meaning of the various titles and designations used by investment advisers and broker-dealers, and (iii) many retail investors expect that both investment advisers and broker-dealers are obligated to act in the investors' best interests.

The SEC staff created the recommendations listed below to address investor confusion and to provide for a stronger and more consistent regulatory regime for broker-dealers and investment advisers providing personalized investment advice about securities to retail investors. The goals of the SEC's recommendations are heightened investor protection, heightened investor awareness and preservation of investment options. The staff recommended that the SEC establish a uniform fiduciary standard for investment advisers and broker-dealers when they provide investment advice about securities to retail customers. The staff further recommended that this uniform fiduciary standard be consistent with the standard currently provided to investment advisers. However, this does not mean that investment advisers and broker-dealers would be exactly the same. The staff noted that the receipt of commission-based compensation for the sale of securities by a broker-dealer would not in and of itself violate the uniform fiduciary standard of conduct applied to a broker-dealer and that the uniform fiduciary standard does not

[21] See *Study on Investment Advisers and Broker-Dealers*, available at www.sec.gov/news/studies/2011/913studyfinal.pdf.

necessarily require broker-dealers to have a continuing duty of care or loyalty to a retail customer after providing personalized investment advice.

The staff also recommended that the SEC consider harmonization of certain aspects of the investment adviser and broker-dealer regulatory regimes so that investors would receive the same or substantially similar protections when obtaining the same or substantially similar services from an investment adviser or broker-dealer. The staff recommended that the SEC consider harmonizing rules regarding, among other things, (i) advertising and communication; (ii) use of finders and solicitors; (iii) supervision; (iv) licensing, registration, and whether or not disclosures on Form ADV and Form BD should be harmonized; and (v) continuing education requirements.

Commissioners Kathleen L. Casey and Troy A. Paredes prepared a statement on Jan. 21, 2011, opposing the study's release to Congress, stating that among other things the study (i) fails to adequately justify its recommendation that the SEC fundamentally change the regulatory regime; (ii) fails to adequately articulate or substantiate the problems that would be purportedly addressed by the change; (iii) does not adequately recognize the risk that its recommendations could adversely impact investors by removing various fees structures, account options and types of advice that broker-dealers provide; (iv) fails to identify whether retail investors are being harmed by one scheme or the other and thus lacks the basis to conclude that a uniform standard would enhance investor protection; and (v) fails to fulfill its statutory mandate to evaluate the effectiveness of existing legal or regulatory standards of care applicable to broker-dealers and investment advisers. Overall, these commissioners felt that the study was incomplete and would benefit from additional analysis rooted in economics and data. Nonetheless, the majority of the SEC commissioners, industry trade groups, members of the securities bar and academics strongly support a uniform standard.

There is no statutory deadline for follow-on rule making to this study. SEC rule making is expected.

Changes to the Derivatives Market

The Dodd-Frank Act brings four broad changes to the over-the-counter derivatives market as it relates to the asset management industry. First, Dodd-Frank grants new authority to the SEC and CFTC to regulate the OTC derivatives market that departs from the prior framework of limited regulation in this area that arose out of the Commodity Futures Modernization Act of 2000. Second, Dodd-Frank introduces new statutory anti-manipulation provisions covering OTC derivatives and grants the SEC and CFTC new authority to adopt rules in this area. Third, in the future many derivatives transactions will trade through clearinghouses and exchanges. Fourth, some large investment advisers and private fund managers may be considered "major swap participants" and be subject to significant new regulatory obligations. While broker-dealers and others that are significant participants in the OTC derivatives area will have greater interest in the Dodd-Frank OTC derivatives changes, these four areas should be the most significant considerations for investment advisers and funds.

The Dodd-Frank Act is the first attempt to bring comprehensive regulation to the OTC derivatives market in the U.S. since the Commodity Futures Modernization Act of 2000 generally placed these markets outside the regulatory authority of the SEC and CFTC. The SEC and CFTC will now have dual regulatory oversight over derivatives. The SEC will oversee regulation of "security-based swaps" and the CFTC will oversee "swaps" (though the prudential regulators, such as the Federal Reserve Board, also have an important role in setting capital and margin for swap entities that are banks). The SEC and CFTC will have joint regulatory authority over "mixed swaps" that have characteristics of both swaps and security-based swaps, and these mixed swaps will generally be treated as security-based swaps. Participants in both swap and security-based swap markets will therefore be subject to regulation by both the SEC and the CFTC; this is similar in some respects to current dually registered broker-dealer/futures commission merchants.

The SEC has not yet adopted final rules with respect to many of its rule-making obligations in the derivatives markets. The SEC, however, has approved an interim final rule providing exemptions from the Securities Act, Trust Indenture Act and other provisions of the federal securities laws to allow certain security-based swaps to continue to trade and be cleared as they had been prior to the Dodd-Frank Act changes. That interim relief will extend until the SEC adopts rules further defining security-based swaps and eligible contract participants.

In addition, the Dodd-Frank Act subjects "swap dealers," "securities-based swap dealers," "major swap participants" and "major security-based swap participants" to new regulation by the CFTC and SEC. Among other things, entities in these categories will be required to register with the SEC or CFTC and be subject to recordkeeping and reporting requirements, margin and capital requirements, and business conduct guidelines. It would appear unlikely that an adviser of a private investment fund would fit these definitions by virtue of providing investment advice to the fund regarding swap transactions. However, advisers should assess whether private funds or other vehicles that they manage might meet these definitions and become subject to the related regulation.

Investor Qualification Standards

Accredited Investor Definition. The Dodd-Frank Act directed the SEC to adjust the net worth standard applicable to natural persons in the definition of "accredited investor" used in Regulation D and Rule 215 under the Securities Act. Under the current versions of Rule 501(a) of Regulation D and Rule 215, accredited investor is defined to include, among other things, any natural person

1) whose individual net worth or joint net worth with that person's spouse at the time of his purchase exceeds $1 million and

2) who had an individual income in excess of $200,000 in each of the two most recent years or joint income with that person's spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year.

The Dodd-Frank Act requires that the SEC adopt rules to revise this definition as it relates to natural persons to exclude the value of a person's primary residence in meeting the $1 million net worth threshold. The income requirement of the second provision remains unchanged by the Dodd-Frank Act.

On Dec. 21, 2011, the SEC adopted amendments to the net worth standard of the accredited investor definition in Rule 215(e) and 501(a)(5) under the Securities Act. In both cases, the net worth standard is as follows: "Any natural person whose individual net worth or joint net worth with that person's spouse exceeds $1 million." As a general matter, for purposes of calculating net worth

1) the person's primary residence may not be included as an asset;

2) indebtedness that is secured by the person's primary residence, up to the estimated fair market value of the primary residence at the time of the sale of securities, is not included as a liability (except if the amount of such indebtedness outstanding at the time of sale of securities exceeds the amount outstanding 60 days before such time other than as a result of the acquisition of the primary residence, the amount of such excess shall be included as a liability); and

3) indebtedness that is secured by the person's primary residence in excess of the estimated fair market value of the primary residence at the time of the sale of securities is included as a liability.

Accordingly, the amendments clarify that the net worth of an investor is calculated by excluding the investor's net equity in his or her primary residence. However, any indebtedness associated with an individual's primary residence is included as part of the general net worth calculation.

Qualified Clients and Impact on Performance-Based Compensation. The Dodd-Frank Act also adjusts the "qualified client" standard under Advisers Act Rule 205-3 as it relates to that rule's exemption from the Section 205 prohibition on an adviser receiving performance-based compensation (*i.e.*, compensation tied to capital gains upon or the capital appreciation of advisory client assets). Under the rule, an adviser may charge a performance-based fee to a qualified client (i.e., a client that meets certain wealth thresholds). The Dodd-Frank provision requires that any rule adopted by the SEC with respect to Advisers Act Section 205 that uses a dollar amount test must adjust for the effects of inflation beginning not later than July 21, 2011, and every five years thereafter, with such adjustments being rounded to the nearest multiple of $100,000.

Advisers Act Rule 205-3 previously used a $750,000 AUM test and a $1.5 million net worth test for purposes of determining an investor's status as a qualified client. On July 12, 2011, the SEC issued an order revising these dollar amount tests for inflation. In particular, the order changes the $750,000 AUM test to $1 million and changes the net worth test to $2 million. These changes were effective Sept. 19, 2011. Registered investment advisers that impose performance fees should review advisory

agreements and private fund subscription documents to consider whether revisions need to be made to comply with this SEC order.

Municipal Securities Adviser Regulation

The Dodd-Frank Act amends Section 15B of the Exchange Act to require the registration of municipal advisers with the SEC and provide for their regulation by the MSRB. In general terms, municipal advisers include

1) financial advisers to states and local governments and obligated persons with respect to the issuance of municipal securities or the investment of bond proceeds;

2) swap advisers to municipal issuers and conduit borrowers; and

3) third-party solicitors of business (in connection with municipal securities products) for brokers, dealers, municipal securities dealers, other municipal advisers or investment advisers.

The Dodd-Frank Act also includes a specific antifraud prohibition and imposes a fiduciary duty on municipal advisers. The new registration requirement became effective on Oct. 1, 2010.

Conclusion

The Dodd-Frank Act makes significant changes to the previously existing investment adviser regime. Given the fact that many of the rule-making efforts and information-gathering studies required by the Act have not yet been completed, many commenters believe that the full impact of the Act will not be realized for many years. In addition, as a result of the length and complexity of the Dodd-Frank Act, many commenters also believe that the implementation of the Act will result in a lack of clarity for participants in the investment management industry. A fear exists that this overall complexity and lack of clarity will lead to capriciousness in the application of the new rules to investment advisers. An additional problem with complexity is that it encourages efforts to game the system by exploiting the loopholes that complexity inevitably creates.

The Dodd-Frank Act and resulting SEC and CFTC rules have already implemented numerous changes that are having a substantial impact on the investment management industry. In addition, new regulations that come down in the future will also have a significant impact on the investment management industry. To date, the most pressing concerns for investment advisers are that the Dodd-Frank Act (i) eliminated the private adviser exemption, requiring advisers to hedge funds and other private funds to register with the commission; (ii) reallocated responsibility for the oversight of investment advisers by delegating generally to the states responsibility for advisers that have less than $100 million in AUM; (iii) increased recordkeeping and reporting obligations for both registered advisers and certain advisers that are exempt from registration; (iv) encouraged a uniform fiduciary standard for brokers and advisers; and (v) modified the SEC's enforcement powers.

Where the Dodd-Frank Act goes from here is unclear. However, it is a virtual certainty that the investment management industry will be struggling with the impact of the Dodd-Frank Act for the next several years.