

## SEC Adopts New Regulatory Scheme for Investment Advisers

On June 22, 2011, the Securities and Exchange Commission (the "SEC") announced the adoption of sweeping new rules for registration of and regulatory reporting by investment advisers under the Investment Advisers Act of 1940 (the "Advisers Act"). These rules will particularly affect advisers of hedge funds and other private funds through the elimination of the "private adviser exemption" effective as of July 21, 2011, pursuant to the terms of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").

The Dodd-Frank Act was previously described in our July 2010 Securities Law Update entitled "Summary of Corporate Governance Changes in the Dodd-Frank U.S. Financial Regulatory Reform Act," archived on our Website at [http://www.burnslev.com/apps/uploads/publications/Securities\\_Update\\_Dodd-Frank\\_July2010.pdf](http://www.burnslev.com/apps/uploads/publications/Securities_Update_Dodd-Frank_July2010.pdf).

"These rules will fill a key gap in the regulatory landscape," SEC Chairman Mary L. Schapiro reportedly said. "In particular, [they] will give the Commission, and the public, insight into hedge fund and other private fund managers who previously conducted their work under the radar and outside the vision of regulators."

A number of significant regulatory changes will result from the new rules, including, but not limited to, the following:

- Advisers to hedge funds and other private funds will generally be required to register with the SEC unless they are of a certain size and subject to state regulation and examination;
- Regulatory responsibility for certain "mid-sized" advisers will be reallocated between the SEC and the states, depending primarily upon the total assets under management by each adviser and the extent to which each adviser is currently subject to state regulation;

- A new uniform measure of "assets under management" will be imposed upon all private fund advisers for purposes of determining registration, reporting and regulatory requirements applicable to them;
- Private fund advisers will be required to disclose more information about their funds, their operations, and certain professionals associated with their funds;
- Reporting requirements will be imposed on "exempt" advisers, pursuant to new SEC authority created under the Dodd-Frank Act; and
- Exemptions from registration will be available for advisers to venture capital funds and funds with less than \$150 million of assets under management, as well as for foreign private advisers (as now defined in the rules).

A new rule also defines "family offices," which will be excluded from the definition of "investment advisers" that would otherwise be subject to regulation under the Advisers Act.

In addition, the SEC has expanded the reach of its "pay-to-play" rule for investment advisers, which is generally designed to prevent advisers from influencing the award of advisory contracts (such as for government pension funds) by means of political contributions to government officials, and to add municipal advisors to the category of "regulated persons" for purposes of exempting them from certain prohibitions.

While the changes are expected to require many private fund advisers to register and report to the SEC who had not done so in the past, there will also be many fund advisers who previously registered with the SEC but will now be required to register with state authorities. The SEC estimates that 3,200 SEC-registered advisers will be required to withdraw their registrations and register with one or more state authorities because of the new rules.

For a full copy of the SEC's explanation of its amendments to the Advisers Act, see SEC Release No. IA-3221 at <http://www.sec.gov/rules/final/2011/ia-3221.pdf>. For a copy of the SEC's discussion of new exemptions for advisers to venture capital funds, funds with less than \$150 million under management, and certain foreign private advisers, see SEC Release No. IA-3222 at <http://www.sec.gov/rules/final/2011/ia-3222.pdf>. A full copy of the SEC's explanation of its new definition for "family offices" appears in SEC Release No. IA-3220 at <http://www.sec.gov/rules/final/2011/ia-3220.pdf>.

What follows is a summary of certain key rule changes cited by the SEC in its releases, along with a look at the impetus for, rationale and effect of certain rules, as stated by the SEC.

### A. NEW SCHEME FOR REGISTRATION AND EXEMPTION

The SEC noted that the Dodd-Frank Act mandated the repeal of the "private adviser exemption" (section 203(b)(3) of the Advisers Act) effective as of July 21, 2011, so that investment advisers can no longer claim exemption from registration and regulation on the grounds that they: i) had fewer than 15 clients in the last 12 months; ii) have not held themselves out to the public as investment advisers; and iii) have not acted as advisers to any registered investment company or business development company.

According to the SEC, the primary purpose of this legislative repeal was to require private fund advisers to register under the Advisers Act, including hedge funds, private equity funds and other types of pooled investment vehicles excluded from the definition of "investment companies" under the Investment Company Act of 1940.

As a result, all private fund advisers will need to register with, file disclosure reports with and keep records as required by the SEC, unless: (i) their funds have a sufficiently

small amount of assets under management and they are subject to state regulation and examination (as explained hereafter); or (ii) they qualify for a registration exemption.

Pursuant to new sections 203(l) and (m) of the Advisers Act, the SEC has issued rules that create new exemptions for investment advisers that solely advise venture capital funds or solely advise private funds with assets under management in the U.S. of less than \$150 million. Since these advisers are exempt from registration, but not from all reporting requirements, they are referred to as “exempt reporting advisers.”

The new rules also create exemptions from registration for “family offices” and for “foreign private advisers” who have no place of business in the U.S., have fewer than 15 clients in the U.S. and investors in the funds they advise, and have less than \$25 million in aggregate assets under management (as explained hereafter).

These new exemptions are not mandatory, however, as an affected adviser can choose to register or remain registered with the SEC (subject to compliance with rules pertinent to minimum levels of assets under management, as explained hereafter).

#### **A1. The Venture Capital Fund Exemption**

Under the new rules, a venture capital fund is defined as a private fund that:

- Holds no more than 20 percent of the fund’s capital commitments in “non-qualifying” investments, which generally are investments other than equity securities of a portfolio company or short-term holdings (as explained hereafter);
- Does not borrow or otherwise incur leverage (excluding certain guarantees and short-term borrowing);
- Does not offer its investors redemption or other similar liquidity rights except in extraordinary circumstances;
- Represents itself as pursuing a venture capital strategy to investors (essentially a strategy based on investing in and building a portfolio company rather than trading in and out of its securities); and
- Is not registered under the Investment Company Act and has not elected to be treated as a business development

company (as defined by rule).

#### **A1a. Qualifying Investments of Venture Capital Funds**

Pursuant to the final rule 203(l)-1, a qualifying investment consists of:

- Any equity security issued by a qualifying portfolio company that is directly acquired by the private fund from the portfolio company;
- Any equity security issued by a qualifying portfolio company in exchange for directly acquired equity issued by the same portfolio company (thereby permitting venture capital funds to participate in recapitalizations); and
- Any equity security issued by a company of which a qualifying portfolio company is a majority-owned subsidiary or a predecessor, and that is acquired by the fund in for directly acquired equity (thereby permitting a venture capital fund to acquire securities in connection with a merger involving a portfolio company).

The term “equity security,” under the new rules, includes stock, preferred stock, warrants and other securities convertible into common stock in addition to limited partnership interests.

Under the rule that limits non-qualifying assets to 20 percent of a fund’s capital commitments, the fund need not dispose of a non-qualifying investment simply because of a change in value of that investment. However, a fund holding appreciated non-qualifying investments could not invest in more investments unless and until the value of non-qualifying commitments falls below 20 percent.

To determine if a fund satisfies the 20 percent limit, the fund may use either historical cost or fair value, the SEC noted, as long as the same method is consistently applied to all investments of a qualifying fund during the term of the fund.

#### **A1b. Allowable Short-term Holdings of a Venture Capital Fund**

A qualifying venture capital fund may also invest in cash, cash equivalents, U.S. treasuries with a remaining maturity of 60 days or less, and shares of registered money market funds. Such short-term investments

are not included in the calculation of “non-qualifying investments.”

#### **A1c. Qualifying Portfolio Companies of a Fund**

Under the new rules, a qualifying portfolio company is defined as any company that:

- Is not a reporting or foreign traded company and does not have a control relationship with such a company;
- Does not incur leverage in connection with the investment by the private fund and distribute proceeds from such borrowing to the private fund in exchange for the private fund investment; and
- Is not itself a fund (i.e., an operating company).

The bar on leverage is aimed at leveraged buyout funds and other funds that use portfolio assets to finance other investments or to buyout existing investors rather than using capital solely for the purpose of developing portfolio companies.

#### **A1d. Elimination of a Management Involvement Test**

The SEC declined to adopt its originally proposed element that would have required a venture capital fund to have “a significant level of involvement in developing a fund’s portfolio companies,” noting commenter concerns about what is customary, as well as the inability to apply any clear test to determine management involvement.

#### **A1e. Limitations Leverage**

Under new rule 203(l)-1, a venture capital fund is a private fund that does not borrow, issue debt, provide guarantees or otherwise incur leverage in excess of 15 percent of the fund’s capital contributions and uncalled committed capital. Furthermore, to the extent such borrowing or leverage exists, it must be for a non-renewable term of no longer than 120 calendar days.

In practice, said the SEC, this could mean that a qualifying fund could leverage an investment transaction up to 100 percent when acquiring a portfolio company, provided that the total leverage in the fund does not exceed 15 percent of total capital commitments.

Pursuant to public comments, the SEC also excluded from the 120-day calendar limit any guarantee of qualifying portfolio

company obligations up to the value of the fund's investment in the company.

#### **A1f. Prohibition of Redemption Rights**

To qualify as a venture capital fund, a private fund cannot issue securities that provide for redemption rights, except in "extraordinary circumstances." According to the SEC, venture capital funds generally distribute assets on a pro rata basis only as investments mature.

However, a fund might allow for certain withdrawal, exclusion or opt-out rights under the "extraordinary circumstances" of a material change in tax law after an investor makes an investment or of newly enacted laws that prohibit an investor's continuing participation. "Whether or not specific redemption or 'opt out' rights... should be treated as 'extraordinary' will depend on particular facts and circumstances," the SEC explained.

#### **A1g. Requirement to Represent the Pursuit of a Venture Capital Strategy**

A qualifying fund must represent itself as pursuing a venture capital strategy. Without this element, said the SEC, a fund that did not engage in typical venture capital strategies could temporarily seek exemption from registration solely because it met sufficient elements of the rule (by holding only short-term investments, for instance).

#### **A1h. Private Fund Requirement**

A venture capital fund, by definition, cannot be a registered investment company or business development company as defined by rule.

#### **A1i. Application to Non-U.S. Advisers**

The final rules do not define a venture capital fund as one advised by a U.S. adviser, and thus, a non-U.S. adviser may rely on the venture capital exemption by meeting the applicable tests.

#### **A1j. Grandfathering Provisions**

The SEC has "grandfathered" into the venture capital fund exemption any private fund that:

- Represented to investors at the time the fund offered its securities that it pursues a venture capital strategy;
- Sold securities to one or more investors prior to December 31, 2010; and

- Will not sell securities to or accept capital commitments from any person after July 21, 2011.

Under this provision, capital calls for a qualifying fund made after July 21, 2011 would be consistent with the grandfathering policy, as long as the investor became obligated before July 21, 2011 to make a future capital contribution.

#### **A2. The Exemption for Advisers to Private Funds of Less Than \$150 Million**

The SEC said that it was directed by Section 203(m) of the Advisers Act to exempt from registration anyone acting as an investment adviser solely for private funds having less than \$150 million in assets under management in the U.S. The SEC referred to this exemption as a new "private fund adviser" exemption.

#### **A2a. Advising Solely Private Funds**

In the new regulatory scheme, an adviser with one or more fund clients who are not private funds will not qualify for the private fund adviser exemption. Unlike the prior regulatory scheme, the new rules permit an adviser to advise an unlimited number of private funds, but only if their aggregate asset value under management in the U.S. remains below \$150 million.

In the case of an adviser with a principal office and place of business outside of the U.S., the exemption is available as long as all of the adviser's clients that are U.S. persons are qualifying private funds with total assets under the threshold amount. Thus, the amount of assets managed outside of the U.S. is irrelevant as to that foreign adviser.

#### **A2b. Private Fund Assets under Management - Calculations and Transitions**

To determine if an adviser is acting on behalf of funds having less than an aggregate of \$150 million under management, revised Form ADV requires the calculation of all assets, including proprietary assets, assets managed without compensation, and uncalled capital commitments.

Furthermore, an adviser must determine the amount of its aggregate private fund assets based on their market value, or their fair value where a market value is unavailable. Form ADV also requires the adviser to calculate those assets on a gross basis (i.e., without deducting liabilities, such as accrued

fees and expenses or borrowing). The SEC provided in Rule 203(m)-1 that the amount of private fund assets under management must be calculated and reported annually on Form ADV. Advisers thus may be required to register under the Advisers Act as a result of annual increases in value of their funds under management. However, the SEC clarified that changes in the value of fund assets under management which occur between annual filings shall not affect any exemption.

Also, an adviser that has complied in the past with reporting requirements for exempt reporting advisers can apply for registration with the SEC for up to 90 days after filing an annual Form ADV while continuing to act as a private fund adviser.

#### **A2c. Assets Managed in the U.S.**

Under rule 203(m)-1, all of the private fund assets of an adviser with a principal office and place of business in the U.S. are considered to be "assets under management in the U.S." even if the adviser has some offices outside of the U.S. Thus, assets outside of the U.S. are to be counted in determining assets under management for a U.S. adviser.

A non-U.S. adviser, by contrast, need only count private funds that it manages at a place of business in the U.S. toward the \$150 million asset limit of the exemption. "The rule is designed to encourage the participation of non-U.S. advisers in the U.S. market," the SEC said.

#### **A2d. Definition of United States Person**

Under rule 203(m)-1(b), a non-U.S. adviser may not rely on the private fund adviser exemption if it has any client that is a U.S. person other than a private fund.

Generally, the rule defines a "United States person" consistent with Regulation S of the Securities Act of 1933, which is primarily contingent upon the residence of the individual in question. Regulation S also treats legal partnerships and corporations as U.S. persons if they are organized or incorporated in the U.S., and it defines trust locations according to the residence of the trustee (for most purposes).

Unlike Regulation S, rule 203(m)-1 also has a special provision requiring an adviser relying on the private fund adviser

exemption to treat a discretionary or fiduciary account as a U.S. person, even though it is held by a non-U.S. fiduciary, if the account is held for the benefit of a U.S. person who is a related person of the adviser.

### **A3. The Foreign Private Adviser Exemption**

The SEC noted that under Section 202(a)(30) of the Advisers Act, a foreign private adviser is any investment adviser that:

- Has no place of business in the U.S.;
- Has fewer than 15 clients in the U.S., including U.S. investors in private funds advised by the investment adviser;
- Has aggregate assets under management attributable to U.S. clients and U.S. investors in private funds advised by the adviser of less than \$25 million; and
- Does not hold itself out to the public generally in the U.S. as an investment adviser.

#### **A3a. Definition of Clients**

By rule, an adviser may treat as a single client any natural person plus:

- That person's minor children;
- Any relative, spouse, spousal equivalent or relative of the spouse or of the spousal equivalent having the same principal residence as the natural person;
- All accounts on which the natural person and/or the person's minor child or relative, spouse, spousal equivalent, or relative of the spouse or spousal equivalent are the only primary beneficiaries (with the same principal residence); and
- All trusts for which the persons named above are the only primary beneficiaries.

An adviser may also treat as a single client:

- A corporation, general partnership, limited partnership, limited liability company, trust, or other legal organization to which the adviser provides investment advice; and
- Two or more of such legal organizations that have identical shareholders, partners, limited partners, members or beneficiaries.

The SEC explicitly rejected a proposal that

advisers would not have to count as "clients" any person for whom the adviser provides services without compensation.

#### **A3b. Definition of Investors in Private Funds**

The SEC noted that the term "investor" is not currently defined under the Advisers Act in adopting a new definition for that term.

Rule 202(a)(30)-1 defines an "investor" in a private fund as "any person who would be included in determining the number of beneficial owners of the outstanding securities of a private fund." Under a related rule, the beneficial owner of short-term paper issued by the private fund is also an "investor."

In a change from the proposed rules, the SEC determined that beneficial owners who are "knowledgeable employees" of a private fund should not be treated as "investors" because they frequently invest in the funds for which they work, and they are essentially insiders with less need for securities law protections.

#### **A3c. Definition for "In the U.S."**

The new rules employ the phrase "in the United States" in several ways, and thus, the SEC thought it was important to define that terminology as follows:

- For any place of business, the phrase shall mean any such business located in the U.S. as defined in Regulation S (see explanation elsewhere herein);
- For any client or private fund investor, the phrase shall mean any such investor who is a U.S. person, as defined in Regulation S, except that any account held for the benefit of a person "in the U.S." by a non-U.S. dealer or other professional fiduciary is deemed "in the U.S." if the dealer or professional is a related person of the investment adviser; and
- For the public generally, "in the U.S." shall have a meaning consistent with that provided by Regulation S.

#### **A3d. Definition of Place of Business**

New rule 202(a)(30)-1 defines "place of business" to mean "any office where the investment adviser regularly provides investment advisory services, solicits, meets with or otherwise communicates with clients

[as well as] any location held out to the public as a place where the adviser conducts any such activities."

#### **A3e. Definition of Assets under Management**

For purposes of the "foreign private adviser exemption," rule 202(a)(30)-1 defines "assets under management" by reference to the calculation called for in Item 5 of Form ADV applicable to other exemptions (see Section A2b of this Update).

#### **A4. Advisory Affiliates and Exemptions**

The SEC anticipated interpretive questions regarding whether assets under management by affiliates can be excluded for purposes of any exemptions under the new rules.

"We would treat as a single adviser two or more affiliated advisers that are separately organized but operationally integrated," said the SEC, noting that otherwise, advisers could simply reorganize into an endless number of affiliates, each of which could purport to rely upon a fund adviser exemption not otherwise available to them.

#### **A5. Exemption for Family Offices Providing Investment Advice to Family Investors**

To clarify any confusion surrounding the new regulatory scheme for private funds, the SEC adopted new rule 202(a)(11)(G)-1 under the Advisers Act to define the term "family office," clarifying that operations which qualify as family offices are not subject to any of the provisions of the law, as amended.

In the event that some family offices do not meet the new regulatory definition of a family office, said the SEC, those offices can still provide advisory services to family members, but they will need to register under the Advisers Act or seek an exemptive order as in the past.

Rule 202(a)(11)(G)-1, which excludes family offices from registration requirements, contains three conditions:

- The exclusion can only be used by a family office that provides advice about securities only to "family clients" as defined by rule;
- The exclusion requires that family clients wholly own the family office and family members and/or entities exclusively control the office; and
- The exclusion precludes a family office

from holding itself out to the public as an investment adviser.

The SEC noted that the exclusion does not pertain to family offices serving multiple families (because of the definition of “family members” provided in section 5b. herein).

#### **A5a. Definition of Family Clients**

By rule, “family clients” may include:

- Current and former family members;
- Certain employees of the family office, and certain former employees;
- Charities funded exclusively by family clients, estates of current and former family members or key employees;
- Trusts existing for the sole current benefit of family clients, or if both family clients and charitable and non-profit organizations are the sole current beneficiaries, trusts funded solely by family clients;
- Revocable trusts funded solely by family clients, certain key employee trusts; and
- Companies wholly owned exclusively by, and operated for the sole benefit of family clients (with rare exceptions to be determined by the SEC).

#### **A5b. Definition of “Family members”**

By rule, “family members” include:

- All lineal descendants of a common ancestor;
- Current and former spouses and spousal equivalents of those descendants (provided that the common ancestor is 10 generations removed or less); and
- All of their children by adoption and current and former stepchildren.

#### **A5c. Permitted Involuntary Transfers**

Rule 202(a)(11)(G)-1 prevents an involuntary transfer of assets to someone other than a “family client” from causing the family office to lose its exclusion. This rule allows a family office to continue to provide advice pertinent to those assets for up to one year following their transfer.

#### **A5d. Family Trusts and Estates**

Rule 202(a)(11)(G)-1 treats as a family client certain family trusts, provided they were established for testamentary and charitable

purposes. The rule treats as a “family client” the following entities:

- Irrevocable trusts in which one or more family clients are the only current beneficiaries;
- Revocable trusts in which one or more family clients are the sole grantors; and
- Estates of family members, former family members, key employees of the family office or former key employees.

#### **A5e. Non-profit and Charitable Organizations**

The same rule treats as a family client any non-profit organization, charitable foundation, charitable trust or other charitable organization that is funded exclusively by one or more family clients.

#### **A5f. Other Family Entities**

The rule also treats as a family client any company (including a pooled investment vehicle) that is wholly owned by one or more family clients and operated for the sole benefit of family clients.

#### **A5g. Key Employees**

The rule also permits the family office to provide investment advice to:

- Any executive officer, director, trustee, general partner or natural person serving in a similar capacity at the family office or its affiliate; and
- Any other employee of the family office or its affiliate (other than clerical or administrative employees) who regularly participates in investment activities of the family office or its affiliate and has done so for at least 12 months.

#### **A5h. Grandfathering Provisions**

The SEC noted that section 409(b) of the Dodd-Frank Act includes a provision which allows exemptions for certain non-qualifying family offices that provided investment advice to family clients prior to January 1, 2010 and still do so.

However, any family office currently exempt from registration under the Advisers Act in reliance on the private adviser exemption, but which does not meet the new “family office” definition, shall in any event be required to register with the SEC under the Advisers Act by March 30, 2012.

## **B. COMPANIES SUBJECT TO AND ELIGIBLE FOR SEC REGISTRATION**

Section 203A of the Advisers Act, enacted in 1996, preempts certain state laws that purport to regulate investment advisers who are registered with and regulated by the SEC. However, it also prohibits an investment adviser regulated by the state in which it maintains its principal office and place of business from registering with the SEC, unless it has at least \$25 million of assets under management.

Now, as a result of the Dodd-Frank Act and the SEC’s related rules, there is a new category of “mid-sized advisers” having between \$25 million and \$100 million of assets under management who are also subject to state regulation and prohibited from registering with the SEC.

But unlike small advisers, the mid-sized advisers must register with the SEC if: (i) the adviser is not required to be registered as an investment adviser with the securities commissioner (or equivalent regulator) of the state in which the adviser has its principal office and place of business; or (ii) if so registered, the adviser is not subject to examination as an investment adviser by that state authority.

#### **B1. Certain Small and Mid-size Advisers Permitted to Register with the SEC**

The SEC concluded that it would be advantageous for the public to permit certain types of small and mid-sized advisers to register at the federal level rather than being subject to registration and regulatory requirements of one or more states.

As a result, rule 203A-2 permits the following six types of advisers to register with the SEC voluntarily:

- Nationally recognized statistical rating organizations (“NRSROs”) such as bond rating services;
- Pension consultants who are advising plans with assets of at least \$200 million;
- Multi-state advisers who are required to register as an investment adviser with 15 or more states;
- Investment advisers affiliated with any adviser registered with the SEC;
- Investment advisers expecting to be

eligible for SEC registration within 120 days of filing a Form ADV; and

- Certain Internet advisers under specified circumstances (see rule 203A-2(f)).

## **B2. Transition Time for Moving to State Registration**

Under new rule 203A-5, each adviser registered with the SEC as of January 1, 2012 must file an amendment to its Form ADV no later than March 30, 2012. After that, mid-sized advisers that are no longer eligible for SEC registration must withdraw their registrations by filing Form ADV-W no later than June 28, 2012.

Conversely, mid-sized advisers registered with the SEC as of July 21, 2011 must remain registered with the SEC until at least January 1, 2012, when software programming for the electronic Investment Adviser Registration Depository (the “IARD”) is expected to be completed.

## **B3. Amendments to Form ADV**

Pursuant to rule amendments, Item 2 of Form ADV requires each investment adviser applying for registration to indicate its basis for registration with the SEC and an annual report as to whether it is eligible to remain registered.

## **B4. Calculation of Assets under Management**

The SEC decided to change the longstanding practice of allowing an adviser to exclude certain types of assets under management for purposes of determining registration and regulatory requirements applicable to the adviser.

Under the revised instructions to Form ADV, advisers must include in their regulatory assets under management any securities portfolios for which they provide “continuous and regular supervisory or management services,” regardless of whether these assets are family or proprietary assets, assets managed without receiving compensation, or assets of foreign clients.

Revised instructions to Form ADV also specify that an adviser must calculate its regulatory assets under management on a “gross basis” without deduction of “any outstanding indebtedness or other accrued but unpaid liabilities.” The use of a net assets test could allow highly leverage funds to avoid systemic risk reporting by avoiding registration.

Furthermore, an adviser must include in its calculation of regulatory assets under management the value of any uncalled capital commitments made to a private fund managed by the adviser. The SEC reasoned that this was a fair requirement because advisers are often compensated based on total capital commitments.

Finally, an adviser must use the “market value” of private fund assets, or use the “fair value” of such assets where no market value is ascertainable.

## **B5. A Buffer Zone for Mid-Sized Advisers**

Rule 203A-1 raises the threshold above which a mid-sized adviser must absolutely register with the SEC (rather than one or more states) to \$110 million, but allows such an adviser, once registered with the SEC, to remain registered until it has less than \$90 million of assets under management. This provision is intended to prevent advisers from having to switch frequently between state and SEC registrations due to fluctuations in market value of their assets under management.

## **B6. Elimination of Safe Harbor**

The SEC rescinded rule 203A-4, which provided a safe harbor from SEC registration for an investment adviser that is registered with a state regulatory authority of the state of its principal office and place of business based on a “reasonable belief” that it is prohibited from registering with the SEC.

## **B7. Mid-sized Advisers and Form ADV**

By rule amendment, Form ADV will require a mid-sized adviser registering with the SEC to affirm, upon application and annually thereafter, that is either:

- Not required to be registered as an adviser with the state securities authority in the state where it maintains its principal office and place of business; or
- Not subject to examination as an adviser by that state.

## **C. REQUIRED REPORTING FOR EXEMPT REPORTING ADVISERS**

The SEC also adopted a new rule that requires advisers relying on exemptions from registration to submit and periodically update reports about their organization, using specific subsections of Form ADV.

## **C1. Required Reporting**

Rule 204-4 requires exempt reporting advisers to file Form ADV reports with the SEC electronically through the IARD within 60 days of relying on the exemption from registration provided under the Advisers Act.

Exempt reporting advisers will not only have to identify the exemption(s) on which they rely annually, but will have to complete items of Form ADV pertinent to their identification, form of organization, certain business activities, financial industry affiliations, control persons and other disclosure issues (such as disciplinary histories for the adviser and its employees).

## **C2. Public Record Nature of Reports**

Although a number of commenters urged the SEC to keep information contained in Form ADV private, the SEC declined to do so. “We believe that the public reporting requirements we are adopting will provide a level of transparency that will help us to identify practices that may harm investors,” the SEC concluded.

## **C3. Requirement to Update Reports**

Amended rule 204-1 requires exempt reporting advisers to file certain periodic amendments to Form ADV no less than annually.

Prompt updates must also be supplied whenever necessary if certain information provided in Form ADV becomes inaccurate. Changes in information concerning identification of the adviser, its form of organization, its control persons, or the disciplinary history of its key employees could all necessitate the prompt filing of interim updates.

## **C4. Final Reports**

When an adviser ceases to be an exempt reporting adviser, new rule 204-4 requires the adviser to file an amendment to its Form ADV to indicate that it is filing a final report under exempt status.

Such an adviser, if it has complied with all reporting requirements, may continue advising private fund clients for a period of 90 days after filing an updating amendment indicating that it has more than \$150 million of assets under management (before filing a final report as an exempt adviser and an application for registration).

## D. FORM ADV: FILING AND REPORTING REQUIREMENTS GENERALLY

As amended, Form ADV requires each reporting adviser to provide the SEC with new information about three areas of operation. The new information pertains to:

- Each of the private funds to which an adviser provides services;
- The advisory business activities and business practices that might present significant conflicts of interest for an adviser; and
- The non-advisory activities and financial industry affiliations of the adviser.

### D1. Private Fund Reporting

The SEC modified Item 7B of Form ADV to require the filing of a separate Schedule D (disclosure schedule) for each “private fund” served by the adviser, including pooled investment vehicles (which fall within the “private fund” definition of the Advisers Act).

For each separate schedule, an adviser must identify the type of investment strategy the fund employs, report whether the fund invests in securities of registered investment companies, and provide the gross asset value of the fund.

The adviser must also provide information regarding investors in each fund, including:

- The minimum amount an investor must contribute;
- The approximate number of beneficial owners of the fund and the approximate percentage of the fund owned by the adviser and its related persons or by funds of funds and non-U.S. persons; and
- The extent to which clients of the adviser are solicited to invest and have invested in the fund.

### D2. Disclosures Regarding Employees, Clients and Advisory Activities

Item 5 of Part 1A of Form ADV requires a registered adviser to provide certain basic information regarding the scope of the adviser’s business, the types of services it provides and the types of clients to whom it provides those services.

Items 5C and 5D of the form require each registered adviser to disclose:

- The approximate number of clients it has (if over 100);
- The approximate percentage of clients that are not U.S. persons;
- The types of clients that it advises and the percentage that each client type comprises out of the adviser’s total client base; and
- The approximate percentage of assets under management attributable to each client type.

### D3. Business Activities and Financial Industry Affiliations

Items 6 and 7 of Part 1A of Form ADV require all advisers to report those financial services the adviser, or a related person is actively engaged in providing, choosing from various lists of financial services set forth in those disclosure items.

An adviser must also report whether it, or a related person is a trust company, registered municipal advisor, registered security based swap dealer, or major security based swap participant (the latter three of which are new SEC registrants under the Dodd-Frank Act). For related persons, an adviser must also report if it is an accountant, accounting firm, lawyer or law firm.

Section 7A of Schedule D also requires advisers to provide certain identifying information for any type of related person listed. Advisers must provide specifically requested details about the relationship between the adviser and the related person, including whether the related person is registered with a foreign financial regulatory authority, whether they share employees or a location, and whether any named related person is exempt from registration.

### D4. Participation in Client Transactions

Item 8 of Form ADV requires a registered adviser to report information about its transactions with clients, including whether the adviser, or a related person engages in transactions with clients as a principal, sells securities to them or has discretionary authority over their assets.

Additional disclosure details must be provided, as requested on the form, pertinent to:

- The adviser’s discretionary authority to choose brokers or dealers for client transactions;
- The “soft dollar benefits” received by an adviser; and
- Any direct or indirect compensation received for client referrals.

### D5. Custody Disclosures

Item 9 of Form ADV requires each registered adviser to indicate the total number of persons that act as qualified custodians for the adviser’s clients in connection with advisory services the adviser provides.

### D6. Special Reporting for \$1 Billion in Assets under Management

A new disclosure item on Form ADV requires each adviser to indicate whether it had \$1 billion or more in total assets managed on the adviser’s balance sheet as of the last day of the most recent fiscal year. This information will be used to identify advisers who might be subject to rules regarding certain excessive incentive-based compensation addressed by the Dodd-Frank Act.

### D7. Other Amendments to Form ADV Unrelated to the Dodd-Frank Act

The SEC also amended Form ADV to require an adviser to report i) contact information for its chief compliance officer; ii) whether the adviser is a public reporting company under the Exchange Act; and iii) its “legal entity identifier,” if applicable.

## E. PAY TO PLAY AMENDMENTS

Rule 206(4)-5 (the “pay to play” rule of the Advisers Act) adopted on June 30, 2010, was designed to prohibit investment advisers from making political contributions to influence their selection as investment advisers for government investment accounts, such as public pension plans.

While the rule does not ban or limit political contributions, it imposes a two-year time out on receiving compensation for conducting advisory business with a government entity, commencing after the date of a contribution.

As part of its recent rulemaking, the SEC amended the scope of this rule so that it now applies to exempt reporting advisers and foreign private advisers, as well as registered advisers generally.

Advisers will continue to be permitted to hire as a placement agent an SEC registered investment adviser or a broker-dealer, but only if they are subject to a “pay to play” rule adopted by FINRA that is at least as stringent as the investment adviser “pay to play” rule.

The amended rule also excludes from its provisions municipal advisers who qualify as “regulated persons” subject to separate “pay to play” rules of the Municipal Securities Rulemaking Board (as long as that board imposes substantially equivalent rules or more stringent restrictions consistent with the SEC’s “pay to play” rule objectives).

## **F. EFFECTIVE DATES**

The new SEC rules granting exemptions from registration to advisers of venture capital funds, private fund advisers with less than \$150 million in assets under management, and foreign private advisers go into effect as of July 21, 2011.

Similarly, rule 203A-5(a), granting a temporary extension of the deadlines by which certain mid-sized advisers must withdraw their SEC registrations, goes into effect on July 21, 2011. The same is true for rule 203-1, which grants a temporary extension of the registration deadline for advisers who have previously relied upon the soon to be defunct “private adviser” exemption.

All other rules, including the new rules for “family offices,” will go into effect as of 60 days after publication in the Federal Register (which is expected soon).

### ***Explanatory Notes:***

*This update is intended to call your attention to a number of rule changes of possible interest and relevance, but it is not intended to constitute a legal opinion or definitive summary of all changes that could be material to you.*

*Please contact a member of the Securities Law Group at Burns & Levinson if you have any questions about these rule changes or want to learn more about our expertise in this area.*

Burns & Levinson's Securities Law Group represents public and private companies, underwriters and investment banks, venture capital and investment funds, real estate investment funds, investment advisors, broker-dealers, stockholder groups and individuals in public and private securities offerings and transactions, SEC, FINRA and stock exchange compliance, corporate governance, fund formation and offerings, SEC enforcement and securities litigation.

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If you have any questions regarding this Burns & Levinson Securities Law Update, please contact one of the individuals named above.

If you would like to be added to or removed from the mailing list for Burns & Levinson Securities Law Updates or other Burns & Levinson publications, please call 617.345.3000 or send your name and email address to [clientservices@burnslev.com](mailto:clientservices@burnslev.com).

#### **ABOUT BURNS & LEVINSON'S SECURITIES LAW GROUP**

Burns & Levinson's attorneys have extensive experience representing public and private issuers, stockholder groups and individual investors. Our attorney team counsels clients on IPOs and follow-on offerings of equity, debt and other securities (including shelf registration takedowns), corporate acquisitions involving registered and restricted stock, mergers and acquisitions where one or both parties are publicly traded, private investment in public equity (PIPE) transactions, private placements, venture capital financings, and complex securities law transactions and issues, including corporate governance/Sarbanes-Oxley and SEC and stock exchange reporting and compliance.

In the securities compliance area, we advise our clients on corporate governance/Sarbanes-Oxley and SEC and stock exchange reporting and compliance. Specifically, we assist our clients in fulfilling their ongoing SEC and stock exchange reporting obligations, managing sensitive disclosure issues internally and with industry analysts, preparing proxy statements and handling stockholder meetings, structuring employee benefit plans and executive compensation packages under the SEC's "short-swing profit" reporting and liability rules, effecting resales of securities in the public trading markets under

the SEC's Rule 144, and advising boards of directors and board committees concerning the requirements and restrictions imposed on their actions by the securities laws and corporate governance laws such as Sarbanes-Oxley. We have served as special securities counsel to the Boards and Audit Committees of publicly traded companies looking for opinions or advice of counsel other than their regular outside counsel.

We have counseled clients both domestic and international, from emerging growth companies to large public companies, and are positioned to provide clients with timely, expert, efficient and cost effective advice that they need to meet their business objectives. We take a practical and proactive approach to the rapidly changing securities disclosure and corporate governance laws, providing our clients with timely updates, identifying specific situations in which the new laws will impact particular clients either operationally or structurally, and working with clients to implement the changes that are either required or advisable to comply with the new regulatory schemes and investor sentiment.

#### ***Underwriters and Investment Banks***

Our attorneys also represent underwriters in initial and follow-on public offerings and investment banks in private placements and mergers and acquisitions.