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SEC Proposes Rules Exempting Certain Private Fund Advisers from Investment Adviser Registration

The Securities and Exchange Commission (the "***SEC***") has published for comment proposed rules (the "*Proposed Exemption Rules*")[1] to implement certain new exemptions from registration under the Investment Advisers Act of 1940, as amended (the "***Advisers Act***"). As required by the Private Fund Investment Advisers Registration Act of 2010 (the "***Private Fund Advisers Act***") enacted in July 2010 as Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "***Dodd-Frank Act***"), the Proposed Exemption Rules provide exemptions for (a) advisers to "venture capital funds," (b) advisers with less than $150 million in private fund assets under management in the United States and (c) certain foreign private advisers. In a separate companion release (the "***Implementing Release***")[2], the SEC has also proposed rules (the "***Proposed Reporting Rules***" and, together with the Proposed Exemption Rules, the "***Proposed Rules***") to set forth the SEC reporting requirements to which certain exempt advisers will be subject.

This Client Alert summarizes the Proposed Rules.

Background

The Private Fund Advisers Act repealed, with effect from July 21, 2011 (the "***Effective Date***"), the private adviser exemption now contained in Section 203(b)(3) of the Advisers Act[3]. Many managers of hedge funds, private equity funds and similar investment vehicles currently rely upon the private adviser exemption. Many of these managers will be required to register as investment advisers with the SEC when the repeal becomes effective. At the same time, the Private Fund Advisers Act also created, or directed the SEC to create by rule, three new exemptions from registration that will be available to certain private fund managers from and after the Effective Date. The new exemptions apply to (i) advisers solely to venture capital funds, without regard to the number of such funds advised by the adviser or the size of such funds (the "***Venture Capital Adviser Exemption***"); (ii) advisers solely to private funds with less than $150 million in assets under management in the United States, without regard to the number or type of private funds advised (the "***Private Fund Adviser Exemption***"); and (iii) non-U.S. advisers that have (A) less than $25 million in aggregate assets under management from U.S. clients and private fund investors in the United States, and (B) fewer than 15 such

[1] SEC Release No. IA-3111 (Nov. 19, 2010) (the "***Rules Release***").

[2] SEC Release No. IA-3110 (Nov. 19, 2010).

[3] Section 203(b)(3) of the Advisers Act currently exempts any investment adviser from registration if the investment adviser (i) has had fewer than 15 clients in the preceding 12 months, (ii) does not hold itself out to the public as an investment adviser, and (iii) does not act as an investment adviser to a registered investment company or a company that has elected to be a business development company. Advisers specifically exempt under Section 203(b) are not subject to reporting or recordkeeping provisions under the Advisers Act, and are not subject to examination by the SEC.

clients and investors (the "***Foreign Private Adviser Exemption***" and, together with the Venture Capital Adviser Exemption and the Private Fund Adviser Exemption, the "***New Exemptions***"). The Proposed Exemption Rules would set forth specific conditions that an adviser must satisfy to claim each of the New Exemptions.

The Venture Capital Adviser Exemption is set forth in Section 203(l) of the Advisers Act. Section 203(l), however, does not define the term "venture capital fund" but directs the SEC to do so by rule. Proposed Rule 203(l)-1 sets forth the SEC's proposed definition of that term. Section 203(m) of the Advisers Act directs the SEC to establish the Private Fund Adviser Exemption by rule. The SEC is proposing Proposed Rule 203(m)-1 for that purpose. Although advisers who qualify for either the Venture Capital Adviser Exemption or the Private Fund Adviser Exemption ("***Exempt Reporting Advisers***") will be exempt from SEC registration, they will be obligated to maintain such records and file with the SEC such reports as the SEC determines are necessary or appropriate in the public interest or for the protection of investors. The SEC also will have authority to examine the books and records of Exempt Reporting Advisers. The Proposed Reporting Rules set forth proposed reporting requirements for Exempt Reporting Advisers.

The Foreign Private Adviser Exemption will be set forth in amended Section 203(b)(3) of the Advisers Act (as amended as of the Effective Date). Proposed Rule 202(a)(30)-1 would define a number of terms relevant to this exemption and otherwise help to define its scope.

An adviser that has at least $100 million in assets under management (or that otherwise qualifies under the Advisers Act to register with the SEC) and that qualifies for any of the New Exemptions could elect to register (or remain registered) with the SEC. However, the New Exemptions do not provide an exemption from any applicable state securities law requirements and an adviser who relies on any of the New Exemptions may still be required to register with one or more state securities authorities.

DEFINITION OF VENTURE CAPITAL FUND

Proposed Rule 203(l)-1 would define a venture capital fund as a private fund that: (i) invests in equity securities of private companies in order to provide operating and business expansion capital (as more fully defined below, "***qualifying portfolio companies***"); *provided* that at least 80% of each company's securities owned by the fund must have been acquired directly from the qualifying portfolio company (rather than from selling securityholders); (ii) directly, or through its investment advisers, offers or provides significant managerial assistance to, or controls, each qualifying portfolio company; (iii) does not borrow or otherwise incur leverage (other than limited short-term borrowing); (iv) does not offer its investors redemption or other similar liquidity rights except in extraordinary circumstances; (v) represents itself as a venture capital fund to investors; and (vi) is not registered under the Investment Company Act of 1940, as amended (the "***Investment Company Act***"), and has not elected to be treated as a "business development company" (a "***BDC***") under the Investment Company Act. An adviser would be eligible to claim the Venture Capital Adviser Exemption only if it (i) solely advises venture capital funds that meet all of the elements of the proposed definition, or (ii) qualifies for the grandfathering provisions discussed below.

Qualifying Portfolio Companies

A "qualifying portfolio company" is defined as any company that: (i) is not publicly traded; (ii) does not incur leverage in connection with the investment by the private fund; (iii) uses the capital provided by the fund for operating or business expansion purposes rather than to buy out other investors; and (iv) is not itself a fund (i.e., is an operating company). In addition to equity securities of qualifying portfolio companies, the venture capital fund may also hold cash (and cash equivalents) and short-term U.S. Treasuries.

Private Companies

At the time of each investment by the venture capital fund, the qualifying portfolio company may not be publicly traded nor may it control, be controlled by, or be under common control with, a publicly traded company. Under the proposed definition, a venture capital fund could continue to hold securities of a qualifying portfolio company that subsequently becomes public.

Equity Securities, Cash and Cash Equivalents and Short-Term U.S. Treasuries

To qualify for the exemption under the proposed definition of "venture capital fund," a fund may not invest in debt instruments (unless they meet the definition of "equity security") of a qualifying portfolio company or otherwise lend money to a qualifying portfolio company. The definition of "equity security" for these programs would be taken from Section 3(a)(11) of the Securities Exchange Act of 1934, as amended, and Rule 3a11-1 thereunder. This definition of "equity security" is broad enough to include common stock, preferred stock, warrants, securities convertible into common stock, limited partnership interests, certain similar securities and certain warrants, rights and options.

In addition to equity securities, pending receipt of all capital commitments from investors or pending distribution to investors of cash as a return on their investments, the venture capital fund may also hold cash and cash equivalents or U.S. Treasuries with a remaining maturity of 60 days or less.

Fund and Qualifying Portfolio Company Leverage

Proposed Rule 203(l)-1 would exclude from the definition of "venture capital fund" any fund that uses leverage or finances its investments in qualifying portfolio companies or the buyout of existing investors with borrowed money (e.g., leveraged buyout funds). In addition, a qualifying portfolio company may not borrow or issue debt securities in connection with the venture capital fund's investment in it. This latter restriction, however, would not prohibit qualifying portfolio companies from borrowing in the ordinary course of their businesses (e.g., to finance inventory or capital equipment, manage cash flows, and meet payroll). Any financing or loan (unless it met the definition of equity security) to a qualifying portfolio company that was provided by, or was a condition of a contractual obligation with, a fund or its adviser as part of the fund's investment in such company would generally be viewed as a type of financing undertaken "in connection with" the fund's investment.

Capital Used for Operating and Business Purposes

Under Proposed Rule 203(l)-1, a qualifying portfolio company is prohibited from distributing company assets to other security holders in connection with the venture capital fund's investment in the company (and thus may not, for example, redeem, exchange or repurchase any of its own securities in connection with such investment). The SEC states in the Rules Release that it has proposed this restriction because, in its view, venture capital funds (unlike many hedge funds and private equity funds) by definition invest capital directly in portfolio companies for the purpose of funding the expansion and development of the company's business rather than buying out existing security holders, otherwise purchasing securities from shareholders or leveraging the capital investment with debt financing.

Operating Companies

Proposed Rule 203(l)-1 would limit a venture capital fund's investments to operating companies and exclude from the definition of "qualifying portfolio company" any private fund or other pooled investment vehicle. This exclusion is intended to prevent a venture capital fund from circumventing the intended scope of the exemption by investing in other pooled investment vehicles that are not themselves subject to the criteria in the Proposed Rule.

Management Involvement

The proposed definition of "venture capital fund" would require the fund or its investment adviser to: (i) offer to provide significant guidance and counsel with respect to the management, operations or business objectives and policies of the qualifying portfolio company (and, if accepted, actually provide such guidance and counsel), or (ii) control the qualifying portfolio company. Managerial assistance generally means active involvement in the business, operations or management of the qualifying portfolio company, or less active control of the qualifying portfolio company, such as through board representation or similar voting rights.

Limitation on Leverage

Under Proposed Rule 203(l)-1, a venture capital fund may not borrow, issue debt obligations, provide guarantees or otherwise incur leverage in excess of 15% of the fund's capital contributions and uncalled committed capital, and any such borrowing, indebtedness, guarantee or leverage must be for a non-renewable term of no longer than 120 calendar days.

No Redemption Rights

Under Proposed Rule 203(l)-1, a venture capital fund would be prohibited from issuing securities that provide investors redemption rights except in "extraordinary circumstances" but could issue securities entitling investors to receive *pro rata* distributions. Although venture capital funds typically return capital and profits to investors only through *pro rata* distributions rather than redemptions, such funds may also provide extraordinary rights for an investor to withdraw from the fund under foreseeable but unexpected circumstances or rights to be excluded from particular investments due to regulatory or other legal requirements (e.g., a change in the tax law after an investor invests in the fund, or the enactment of laws that may prohibit an investor's participation in the fund's investment in particular countries or industries). The Proposed Rules do not specify a minimum period of time that an investor must remain in the fund.

Represents Itself as a Venture Capital Fund

Proposed Rule 203(l)-1 would require each fund advised by the adviser to represent itself as being a venture capital fund to its investors and potential investors by, for example, describing its investment strategy as venture capital investing or as a fund that is managed in compliance with the elements of such Proposed Rule. This requirement is intended to prevent (a) a fund that did not engage in typical venture capital activities from being treated as a venture capital fund simply because it met the other elements specified in the Proposed Rule and (b) an adviser to a venture capital fund that is otherwise relying on the exemption from identifying the fund as a hedge fund or multi-strategy fund (e.g., stating that venture capital is one of several strategies used to manage the fund) or including the fund in a hedge fund database or hedge fund index.

Is a Private Fund

Proposed Rule 203(l)-1 would require that a venture capital fund be a private fund. A "private fund", for purposes of the New Exemptions, is an issuer that relies upon the registration exemptions provided by Section 3(c)(1) or 3(c)(7) of the Investment Company Act (most privately-offered investment funds rely upon one of these exemptions). Registered investment companies (e.g., mutual funds) and any company that has elected to be regulated as a BDC will not qualify as a private fund.

Application to Non-U.S. Advisers

The Rules Release states that a non-U.S. adviser may rely on the venture capital exemption if all of its clients, whether U.S. or non-U.S., are venture capital funds. At the same time, the SEC is soliciting comment on whether the Proposed Rule should be revised to make the exemption available to advisers (i) whose principal office and place of business are outside of the United States, and (ii) who advise clients other than venture capital funds, so long as all such clients of such adviser that are not venture capital funds are non-United States persons.

Grandfathering Provision

The SEC is proposing to allow investment advisers to treat any existing private fund client as a venture capital fund for purposes of the Venture Capital Adviser Exemption if the fund is a private fund that: (i) represented to investors and potential investors at the time the fund offered its securities that it is a venture capital fund; (ii) has sold securities to one or more investors prior to December 31, 2010; and (iii) does not sell any securities to, including accepting any additional capital commitments from, any person after July 21, 2011 (the "***grandfathering provision***"). The grandfathering provision would extend to any such fund that has accepted capital commitments by the specified dates even if none of the commitments has been called. As a result, an adviser would be able to claim the Venture Capital Adviser Exemption if it solely advises private funds that (i) meet the new definition of "venture capital fund", and/or (ii) qualify for the grandfathering provision.

EXEMPTION FOR INVESTMENT ADVISERS SOLELY TO PRIVATE FUNDS WITH LESS THAN $150 MILLION IN ASSETS UNDER MANAGEMENT IN THE UNITED STATES

As previously noted, Section 203(m) of the Advisers Act requires the SEC to provide by a rule an exemption for investment advisers whose only clients are private funds and who have less than $150 million in assets under management in the United States. Proposed Rule 203(m)-1 would implement this Private Fund Adviser Exemption and resolve several interpretive questions raised by Section 203(m).

Advises Solely Private Funds

Proposed Rule 203(m)-1 would exempt an adviser that advises solely private funds without any limitation on the number of its clients, as long as the aggregate value of the adviser's private fund assets is less than $150 million. In the case of an adviser with a principal office and place of business outside of the United States (a "***non-U.S. adviser***"), the SEC proposes to provide the exemption as long as all of the adviser's clients that are United States persons are private funds and the $150 million cap is not exceeded in relation to its U.S. management activities (as discussed below). As a consequence, a non-U.S. adviser could enter the U.S. market and take advantage of the exemption without regard to the type or number of its non-U.S. clients.

Private Fund Assets

Proposed Rule 203(m)-1 would require an adviser to aggregate the value of all assets of private funds it manages in the United States to determine if the adviser remains below the $150 million threshold and to calculate the value of private fund assets by reference to Form ADV[4], under which the SEC proposes to provide a uniform method of calculating assets under management for several purposes of the Advisers Act. In the case of a sub-adviser, it would have to count only that portion of the private fund assets for which it has responsibility.

In calculating its assets under management, an adviser would include both the assets appearing on the balance sheets of its private fund clients and any uncalled capital commitments. Each adviser would have to determine the amount of its private fund assets quarterly, based on the fair value of the assets at the end of the quarter. Valuations at cost would not be permitted. As market value changes therefore could put the value of the assets managed by an adviser above the $150 million threshold at which registration is required, Proposed Rule 203(m)-1 allows an adviser one calendar quarter (three months) to register with the SEC after becoming ineligible for the exemption due to an increase in the value of its private fund assets. The transition period would be available only to an adviser that has complied with all applicable SEC reporting requirements.

Assets Managed in the United States

Proposed Rule 203(m)-1 would deem all of the assets managed by an adviser to be managed "in the United States" if the adviser's "principal office and place of business" is in the United States, even though the adviser has offices outside of the United States. A non-U.S. adviser, however, would be required to count only private fund assets it manages from a place of business in the United States toward the $150 million limit. An adviser's "principal office and place of business" will be deemed for these purposes to be the location where the adviser controls and is ultimately responsible for the management of private fund assets, and thus as *the* place where all the advisers' assets are managed, even though day-to-day management of certain assets may also take place at another location.

United States Person

Under Proposed Rule 203(m)-1(b), a non-U.S. adviser could not rely on the exemption if it advises any client that is a United States person other than a private fund. The SEC proposes to define a "United States person" by incorporating the definition of a "U.S. person" in Regulation S under the Securities Act of 1933, as amended (the "***Securities Act***"). Regulation S looks generally to the residence of an individual to determine whether the individual is a United States person, and generally treats legal partnerships and corporations as United States persons if they are organized or incorporated in the United States, and trusts by reference to the residence of the trustee. It treats discretionary accounts generally as United States persons if the fiduciary is a resident of the United States.

Proposed Rule 203(m)-1 contains a special rule for discretionary accounts maintained outside of the United States for the benefit of United States persons. Under the Proposed Rule, an adviser must treat a discretionary or other fiduciary account as a United States person if the account is held for the benefit of a United States person by a non-U.S. fiduciary who is a related person of the adviser. An adviser could not, for example, treat as non-U.S. persons discretionary accounts that it establishes with an offshore affiliate for the benefit of U.S. clients if such affiliate delegates the actual management of the account back to the adviser.

FOREIGN PRIVATE ADVISERS

Section 403 of the Dodd-Frank Act replaces the current private adviser exemption from registration under the Advisers Act with a new exemption for "foreign private advisers". This new Foreign Private Adviser Exemption is codified as amended Section 203(b)(3).

Under Section 202(a)(30) of the Advisers Act, a foreign private adviser is defined as any investment adviser that: (i) has no place of business in the United States; (ii) has, in total, fewer than 15 clients in the United States and investors in the United States in private

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[4] Form ADV is a standard form that non-exempt advisers complete and file with the SEC (or, if applicable, with state securities authorities) to register as an investment adviser. The SEC is proposing that Exempt Reporting Advisers also be required to file certain information on Form ADV. See "SEC Reporting by Exempt Reporting Advisers" below.

funds advised by the adviser; (iii) has aggregate assets under management attributable to clients in the United States and investors in the United States in private funds advised by the adviser of less than $25 million; and (iv) does not hold itself out generally to the public in the United States as an investment adviser. Section 202(a)(30) authorizes the SEC to increase the $25 million threshold if it so chooses; however, the SEC has not proposed any such increase in the Rules Release.

Clients

Proposed Rule 202(a)(30)-1 includes a safe harbor that foreign private advisers could follow in counting clients to determine whether they have, in total, fewer than 15 clients in the United States or investors in the United States in private funds advised by them. The safe harbor would be similar, although not identical, to the safe harbor that advisers currently can use (pursuant to Rule 203(b)(3)-1) in determining whether they qualify for the private advisers exemption in existing Section 203(b)(3).

Specifically, Proposed Rule 202(a)(30)-1 would allow an adviser to treat as a single client a natural person and: (i) that person's minor children (whether or not they share the natural person's principal residence); (ii) any relative, spouse, or relative of the spouse of the natural person who has the same principal residence; (iii) all accounts of which the natural person and/or the person's minor child or relative, spouse, or relative of the spouse who has the same principal residence are the only primary beneficiaries; and (iv) all trusts of which the natural person and/or the person's minor child or relative, spouse, or relative of the spouse who has the same principal residence are the only primary beneficiaries. Proposed Rule 202(a)(30)-1 would also permit an adviser to treat as a single "client" (i) 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 (ii) two or more legal organizations that have identical shareholders, partners, limited partners, members, or beneficiaries.

Finally, the SEC proposes to add a provision that would avoid double-counting of private funds and their investors by advisers. This provision would specify that an adviser need not count a private fund as a client if the adviser counted any investor, as defined in the rule, in that private fund as an investor in that private fund for purposes of determining the availability of the exemption.

Private Fund Investor

An "investor" in a private fund would be defined in Rule 202(a)(30)-1 as any person who would be included in determining the number of beneficial owners of the outstanding securities of a private fund under Section 3(c)(1) of the Investment Company Act or whether the outstanding securities of a private fund are owned exclusively by qualified purchasers under Section 3(c)(7) of the Investment Company Act. In order 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. Advisers would not be permitted to avoid the investor number limitation by setting up intermediate accounts through which investors may access a private fund and not be counted for purposes of the exemption.

The SEC states in the Rules Release that defining the term "investor" by reference to Sections 3(c)(1) and 3(c)(7) will limit the ability of a non-U.S. adviser to avoid application of the registration provisions of the Advisers Act. For example, advisers would have to "look though" nominee and similar arrangements to the underlying holders of private fund securities to determine whether they have fewer than 15 clients and private fund investors in the United States, and would have to count as an investor a third person who is not the nominal owner of a private fund's securities but has made the determination to invest in the private fund indirectly through the record owner (e.g., feeder fund investors in a master/feeder structure).

The SEC proposes to treat as investors beneficial owners (i) who are "knowledgeable employees" with respect to the private fund, and certain other persons related to such employees (collectively "***knowledgeable employees***"), even though knowledgeable employees are not required to be qualified purchasers under Section 3(c)(7), and (ii) of "short-term paper" issued by the private fund, even though these persons are not counted as beneficial owners for purposes of Section 3(c)(1). Under the Proposed Rules, holders of short-term paper, like other debt holders, would also be counted as investors because a private fund's losses directly affect these holders' interest in the fund just as they affect the interest of other debt holders in the fund.

In the United States

Proposed Rule 202(a)(30)-1 defines the key term "in the United States" by reference to the definitions of "U.S. person" and "United States" in Regulation S under the Securities Act. In addition, a person that is "in the United States" may be treated as not being "in the United States" if such person was not "in the United States" at the time of becoming a client or, in the case of an investor in a private fund, at the time the investor acquires the securities issued by the fund.

The SEC proposes to treat as a U.S. person discretionary accounts owned by a U.S. person and managed by a non-U.S. affiliate of the adviser that would not be considered a "U.S. person" under Regulation S in order to discourage non-U.S. advisers from creating such discretionary accounts with the goal of circumventing the exemption's limitation with respect to persons in the United States.

Place of Business

For purposes of proposed Rule 203(a)(30)-1, an adviser's "place of business" means any office where the investment adviser regularly provides advisory services, solicits, meets with, or otherwise communicates with clients, and any location held out to the public as a place where the adviser conducts any such activities. As previously stated, the Foreign Private Adviser Exemption is not available to any foreign adviser who has any United States place of business.

Assets Under Management

For purposes of Rule 202(a)(30)-1, the SEC proposes to define "assets under management" by reference to the calculation of "regulatory assets under management" applicable under Item 5 of Form ADV. As discussed above, the SEC is proposing for these purposes to implement a uniform method of calculating assets under management that can be used for several purposes under the Advisers Act, including the Foreign Private Adviser Exemption. As previously stated, a foreign adviser can claim the Foreign Private Adviser Exemption only if its total assets under management attributable to clients in the United States and investors in the United States in private funds advised by the adviser are less than $25 million.

SEC REPORTING BY EXEMPT REPORTING ADVISERS

The Private Fund Advisers Act requires Exempt Reporting Advisers (i.e., advisers who rely upon either the Venture Capital Adviser Exemption or the Private Fund Adviser Exemption) to maintain such records and to file with the SEC such reports as the SEC shall determine are necessary or appropriate. Pursuant to such authority, the SEC is proposing to adopt Proposed Rule 204-4. This rule would require Exempt Reporting Advisers to file, and to periodically update, reports with the SEC by completing a limited subset of items on Form ADV. Each Exempt Reporting Adviser would submit its SEC reports through the same electronic filing system (the Investment Adviser Registration Depository) that registered advisers use to submit registration filings to the SEC. Any such reports filed by an Exempt Reporting Adviser would be publicly available on the SEC website.

Reporting Required

The SEC is proposing to amend Form ADV to permit it also to serve as a reporting form for Exempt Reporting Advisers and to specify the seven items that Exempt Reporting Advisers must complete. These consist of the following items in Part 1A of Form ADV: Items 1 (Identifying Information), 2.C. (SEC Reporting by Exempt Reporting Advisers), 3 (Form of Organization), 6 (Other Business Activities), 7 (Financial Industry Affiliations and Private Fund Reporting), 10 (Control Persons), and 11 (Disclosure Information). Exempt Reporting Advisers would also be required to complete corresponding sections of Schedules A (Direct Owners and Executive Officers), B (Indirect Owners), C (Amendments to Schedules A and B), and D (Additional Information regarding Certain Items in Part 1A). The SEC would not require Exempt Reporting Advisers to complete Part 2 of Form ADV (the client brochure).

Exempt Reporting Advisers may be particularly interested in the proposed reporting requirements that relate to managed funds. Currently, Item 7 of Form ADV requires each registered adviser to disclose in Section 7.B of Schedule D certain basic information concerning any "investment-related partnership" that the adviser or a related person advises. The SEC is proposing to revise this requirement to require advisers (including Exempt Reporting Advisers) to report pooled investment vehicles regardless of whether they are organized as limited partnerships. At the same time, the SEC would not require advisers to report funds that are advised by their affiliates, as it assumed that in many cases the affiliate itself will be subject to reporting requirements. Also, the SEC would not require sub-advisers to report private funds that are reported by another adviser on Schedule D and would permit an adviser sponsoring a master-feeder arrangement to submit a single Schedule D for the master fund and all of the related feeder funds. Finally, the SEC is

proposing to permit an adviser with its principal office and place of business outside the United States not to report private funds that are not organized in the United States and that are not offered to, or owned by, U.S. Persons[5].

In addition to redefining the funds subject to the disclosure requirement, the SEC is proposing to expand the information that must be disclosed. At present, Section 7.B of Schedule D requires an adviser to a private fund that is a limited partnership or limited liability company to identify (i) the name of the fund, (ii) the name of the general partner or manager, (iii) whether the adviser's clients are solicited to invest in the fund, (iv) the approximate percentage of the adviser's clients that have invested in the fund, (v) the minimum investment commitment, and (vi) the current value of the total assets of the fund. Under the revised disclosure requirements, the SEC would require advisers (including Exempt Reporting Advisers) to continue to provide this or similar information, but would also ask the adviser to report for each fund (i) the exclusion from Investment Company Act registration on which the fund relies, (ii) whether the fund is subject to a foreign regulatory authority, (iii) whether the fund's securities are exempt from Securities Act registration, (iv) the fund's gross and net assets, (v) the investment strategy (as encompassed by one of seven broad categories to be defined in Form ADV) that the adviser employs for the fund, and (vi) a breakdown of the fund's assets and liabilities by class and categorization in the fair value hierarchy established under U.S. GAAP.

Further, the SEC is proposing for the first time to require advisers (including Exempt Reporting Advisers) to disclose on Form ADV certain information regarding five types of service providers that private funds typically employ; i.e., auditors, prime brokers, custodians, administrators and marketers. The adviser would be required to identify each such service provider, state its location and state whether it is a related person of the adviser. Certain additional disclosures would also be required for certain categories of service providers. Specifically, the adviser would be required to disclose (i) for auditors, whether the auditor is independent and is registered with the Public Company Account Oversight Board and subject to its regular inspection, and whether audited statements are distributed to fund investors; (ii) for the prime broker, whether it is SEC-registered and whether it acts as the fund's custodian, (iii) for the administrator, whether it prepares and sends account statements to investors and what percentage of the fund's assets are valued by the administrator or another person that is not a related person of the adviser, and (iv) for marketers, their SEC file number (if any) and the address of any website they use to market the fund. The proposed disclosure requirements would not require advisers (including Exempt Reporting Advisers) to disclose the identities of the investors in their managed funds or specific fund investments.

The SEC has not at this time proposed recordkeeping requirements for Exempt Reporting Advisers but has stated that it will do so at a later date[6].

Updating Requirements

Proposed Rule 204-1(a) would require an Exempt Reporting Adviser, like a registered adviser, to amend its reports on Form ADV: (i) at least annually, within 90 days of the end of the adviser's fiscal year; and (ii) more frequently, if required by the instructions to Form ADV. Accordingly, the rule would require an Exempt Reporting Adviser to update Items 1 (Identification Information), 3 (Form of Organization), or 11 (Disciplinary Information) promptly if they become inaccurate in any way, to update Item 10 (Control Persons) if it becomes materially inaccurate and to file an amendment to its Form ADV when it ceases to be an Exempt Reporting Adviser.

Each Exempt Reporting Adviser would be required to file its initial report with the SEC on Form ADV no later than August 20, 2011.

COMMENT PERIOD

The SEC will be publishing the Rules Release and the Implementing Release in the Federal Register. The SEC will accept comments on the Proposed Rules until the 45th day following the date of such publication.

We encourage you to contact us if you have any questions regarding the Proposed Rules or the Private Fund Advisers Act.

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[5] The definition of "U.S. Person" for these purposes would track that in Regulation S under the Securities Act, modified in relation to certain discretionary accounts as discussed above.

[6] The Implementing Release also sets forth certain other proposed rules relating to certain other amendments to the Advisers Act made by the Dodd-Frank Act (including rules addressing the eligibility of "mid-sized advisers" and certain other persons to register as investment advisers with the SEC). These additional proposed rules are outside the scope of this Client Alert.