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Private Equity Alert

SEC Adopts Final Rules for the Registration of Hedge Fund and Other Private Fund Advisers and Delays Registration Deadline

By David Wohl

Historically, many advisers to hedge funds and other private funds have relied on an exemption contained in Section 203(b)(3) of the Investment Advisers Act of 1940, as amended (the "Advisers Act"), which generally exempts from registration any investment adviser who during the course of the preceding twelve months has had fewer than fifteen clients, and who does not hold itself out generally to the public as an investment adviser (the "Private Adviser Exemption"). Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") repeals the Private Adviser Exemption effective as of July 21, 2011, and replaces it with several narrower exemptions. As discussed below, the new exemptions generally will not apply to U.S.-based advisers of larger private equity funds that engage in traditional leveraged investments, and therefore these advisers will be required to register with the Securities and Exchange Commission (the "SEC") by March 30, 2012.

On June 22, 2011, pursuant to Title IV of the Dodd-Frank Act, the SEC adopted final rules to implement expanded registration and disclosure requirements for advisers to hedge funds and other private funds under the Advisers Act. The final rules modify certain provisions the SEC proposed in October and November 2010 and include, among other items, a definition of "venture capital fund" for purposes of the venture capital registration exemption, guidelines for determining an adviser's eligibility under the $150 million private fund adviser registration exemption, definitions of a number of terms related to the foreign private adviser registration exemption and increased disclosure requirements for advisers to private funds. In addition, the SEC issued a final rule defining the term "family office" for purposes of the exception from the definition of "investment adviser" mandated by Section 409 of the Dodd-Frank Act. Finally, the SEC confirmed that it would delay the effective date of the registration requirement for investment advisers required to register with the SEC as a result of Dodd-Frank Act amendments to the Advisers Act until March 30, 2012.

Exemption for Advisers to Venture Capital Funds

The Dodd-Frank Act added Section 203(l) to the Advisers Act, which provides that private fund managers who are advisers solely to "venture capital funds," without regard to the number of such private funds advised or the size of such private funds, are exempt from registration under the Advisers Act (the "Venture Capital Exemption"). Advisers relying on this exemption are required to provide the SEC with reports and keep records as the SEC deems necessary, as described below.

Weil News

- Weil advised Berkshire Partners and OMERS Private Equity in connection with their $2.1 billion acquisition of Husky International, a Canada-based manufacturer of injection molding machines, molds and integrated systems
- Weil advised THL Partners in connection with its $180 million investment in Puerto Rico based First BanCorp, a holding company for FirstBank
- Weil advised Avista Capital Partners in connection with its acquisition of Anthony International
- Weil advised The Gores Group in connection with its acquisition of Sage Automotive Interiors, a supplier of high-performance specialty fabric materials
- Weil advised INC Research (a portfolio company of Avista Capital Partners and Ontario Teachers' Pension Plan) in connection with its acquisition of Kendle International, a US-based contract research organization
- Weil advised Environmental Resources Management (a portfolio company of Bridgepoint) in connection with its sale to Charterhouse Capital Partners
- Weil advised GMT Communication Partners in connection with its acquisition of the legal, tax and accounting businesses of Thomson Reuters in Denamark and Sweden
- Weil advised HgCapital in connection with its acquisition of Mainio Vire, Finland's largest social care company

Venture Capital Fund

The SEC has adopted Rule 203(l)-1, which defines "venture capital fund" as a private fund (defined as a fund that relies on the exception from the definition of "investment company" contained in Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940, as amended (the "1940 Act")) that: (i) represents to investors that it pursues a venture capital strategy; (ii) immediately after the acquisition of any asset, other than "qualifying investments" or short-term holdings, holds no more than 20% of the amount of the fund's aggregate capital contributions and uncalled committed capital in assets (other than short-term holdings) that are not "qualifying investments," valued at cost or fair value (depending on how the fund has historically valued its investments); (iii) does not borrow or otherwise incur leverage in excess of 15% of the fund's aggregate capital contributions and uncalled committed capital, and any such borrowing or leverage is for a non-renewable term of no longer than 120 calendar days, except that any guarantee by the fund of obligations of a qualifying portfolio company (a "QPC") up to the amount of the value of the fund's investment in the QPC is not subject to the 120 calendar day limit; (iv) does not offer its investors redemption or other similar liquidity rights except in extraordinary circumstances; and (v) is not registered under the 1940 Act and has not elected to be treated as a business development company under the 1940 Act.

Qualifying Investments

The rule defines "qualifying investments" generally as: (i) any equity security issued by a QPC that has been acquired directly by the fund from the QPC; (ii) any equity security issued by a QPC in exchange for an equity security issued by the QPC described in clause (i) above; or (iii) any equity security issued by a company of which a QPC is a majority-owned subsidiary (or a predecessor), and is acquired by the fund in exchange for an equity security described in clause (i) or (ii) above.

Qualifying Portfolio Companies

To qualify as a QPC, a company: (i) at the time of investment by the fund must not be subject to the reporting requirements of the Securities Exchange Act of 1934, as amended (the "1934 Act"), or listed or traded on any foreign exchange (nor can the QPC control, be controlled by or be under common control with such a company); (ii) may not borrow or issue debt obligations in connection with the fund's investment in such company and distribute to the fund the proceeds of such borrowing or issuance in exchange for the fund's investment; and (iii) may not be an investment company, a private fund, an issuer that would be an investment company but for the exemption provided by Rule 3a-7 under the 1940 Act (relating to certain issuers of asset-backed securities), or a commodity pool.

The SEC noted that for purposes of determining whether a portfolio company was a QPC, a fund may disregard a wholly-owned intermediate holding company formed solely for tax, legal or regulatory reasons to hold the fund's investment in a QPC. Such structures are used to address the particular needs of venture capital funds or their investors and are not intended to circumvent the rule's general limitation on investing in other investment vehicles. The SEC also noted that an investment in a fund of venture capital funds would not be a qualifying investment, although a venture capital fund could invest in such funds of funds using its 20% "non-qualifying" basket.

Grandfathering Provision

A private fund will qualify as a "venture capital fund" under the grandfathering provision of the rule if it: (i) represented to investors at the time the fund offered its securities that it pursues a venture capital strategy; (ii) has sold securities to one or more third-party investors prior to December 31, 2010; and (iii) does not sell any securities to any person after July 21, 2011 (including accepting any additional capital commitments from existing investors).

Non-U.S. Advisers and Funds

The SEC stated 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, and the rule as adopted contains a note that clarifies that an adviser may treat as a private fund eligible for the exemption any issuer formed under the laws of a jurisdiction other than the United States that has not offered or sold its securities in the United States or to U.S. persons in a manner inconsistent with being a private fund, provided that the adviser treats the issuer as a private fund under the Advisers Act for all purposes.

Notable Changes from Proposed Rule

The most significant change to the final rule from the SEC's original proposal is the inclusion of the 20% basket for non-qualifying investments. This gives a fund limited flexibility to invest in other types of assets without jeopardizing its ability to rely on the exemption from registration. In addition, the SEC eliminated the proposed requirement that a venture capital fund or its adviser offer to provide managerial assistance to, or control, each portfolio company. The rule as adopted also excludes from the 120-day leverage limit any guarantee of a QPC's obligations by the fund, up to the value of the fund's investment in the QPC. The SEC stated that these guarantees by a fund may help a QPC obtain credit for working capital purposes, rather than be used by the fund to leverage its investment in the company, and therefore such guarantees do not present the same types of systemic risks Congress meant to address in the Dodd-Frank Act. However, such guarantees are still subject to the overall 15% leverage limit. Finally, with respect to the grandfathering provision, the proposed rule required a fund to have represented to investors that it was a "venture capital fund," while the final rule only requires that the fund represent that it pursues a venture capital strategy. This change, related to the new 20% non-qualifying investments basket, ostensibly will allow more funds to rely on the grandfathering provision.

Effective Date of Rule

The rule will be effective July 21, 2011.

Exemption for Private Fund Advisers With Less Than $150 Million in Assets in the United States

The Dodd-Frank Act directed the SEC to exempt from registration any investment adviser solely to private funds with less than $150 million in assets under management in the United States (the "Private Fund Adviser Exemption"). As with the Venture Capital Exemption, advisers relying on this exemption are required to provide the SEC with reports and keep records as the SEC deems necessary. The SEC has adopted Rule 203(m)-1 to clarify interpretative matters with respect to whether an adviser qualifies for this exemption. The final rule is substantially similar to the rule as proposed, with a few important modifications.

Advises Solely Private Funds

For purposes of this exemption, the term "private fund" is generally defined by the rule as a fund that: (i) relies on the exception from the definition of "investment company" contained in Section 3(c)(1) or 3(c)(7) of the 1940 Act; and (ii) is not registered under Section 8 of the 1940 Act and has not elected to be treated as a business development company under the 1940 Act. The final rule clarifies that an issuer that qualifies for an exclusion from the definition of "investment company" as defined in Section 3 of the 1940 Act in addition to those provided by Sections 3(c)(1) and 3(c)(7) may also be treated as a "private fund," provided that the investment adviser treats the issuer as a private fund for all purposes under the Advisers Act. An adviser based in the United States that advises a different type of client (such as a managed account) would not be eligible for the exemption. In its release, the SEC noted that a fund with only a single investor may or may not qualify as a "private fund," depending on applicable facts and circumstances. For example, a fund that seeks to raise capital from multiple investors but has only a single, initial investor for a period of time could qualify as a private fund, as could a fund in which all but one of the investors have redeemed their interests.

The rule provides that an adviser whose principal office and place of business is outside of the United States (a "non-U.S. adviser") will be eligible to use the exemption so long as all of the non-U.S. adviser's clients that are U.S. persons are qualifying private funds. The principal office and place of business of an adviser is the executive office from which the officers, partners or managers of the adviser direct, control and coordinate its activities. This location can be different from where day-to-day management of certain assets takes place. The type and number of non-U.S. clients will not be taken into account in determining a non-U.S. adviser's eligibility for the exemption. Importantly, in the final rule the SEC added a note that clarifies that a client will not be considered a U.S. person if the client was not a U.S. person at the time of becoming a client of the adviser. This will permit a non-U.S. adviser to continue to rely on Rule 203(m)-1 if a non-U.S. client that is not a private fund, such as a natural person client residing abroad, relocates to the United States or otherwise becomes a U.S. person.

Calculation of Private Fund Assets

The rule requires 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. Assets must be valued on an annual basis (the proposed rule required quarterly valuation) at fair value (not at cost) using methods required by revised Form ADV. Fair value does not have to be determined in accordance with U.S. generally accepted accounting principles ("GAAP"), although the SEC stated it believes many advisers currently value their assets in accordance with GAAP or other international accounting standards. Because an adviser relying on the exemption must report the amount of its assets under management in its annual updating amendment to Form ADV, an adviser may lose the benefit of the exemption, and will be required to register with the SEC unless another exemption is available, as a result of an increase in the value of its assets under management in excess of $150 million. Instructions to revised Form ADV provide a safe harbor for an adviser relying on the Private Fund Adviser Exemption if it exceeds the $150 million threshold. Such an adviser that has complied with all of its reporting obligations under the exemption 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 under the exemption and filing its full application for registration.

"Assets under management" is defined in the rule by reference to the requirements of revised Form ADV. The SEC has revised the instructions to Form ADV to require the calculation of "assets under management" to consist of the securities portfolios and value of any private fund with respect to which an adviser provides continuous and regular supervisory or management services, regardless of whether such assets are proprietary, managed without compensation, or are assets of foreign clients, each of which may be currently excluded. Further, the SEC will now require (i) outstanding indebtedness and other accrued but unpaid liabilities which remain in a client's account and are managed by the adviser and (ii) any uncalled capital commitments of a private fund to be included in the calculation of assets under management.

Assets Managed in the United States

Advisers with their principal office and place of business in the United States will have all of their private fund assets counted as "assets under management in the United States" regardless of whether they have offices outside of the United States. Non-U.S. advisers, however, will only be required to include private fund assets managed from a place of business (defined as any office where the investment adviser regularly provides advisory services, solicits, meets with, or otherwise communicates with clients, and any other location held out to the public as a place where the adviser conducts any such activities) in the United States toward the $150 million limit. This means that a non-U.S. adviser may have an unlimited number of U.S. investors (and assets under management attributable to those investors) in private funds but still qualify for this exemption so long as it does not manage assets from a place of business in the United States in excess of $150 million.

Effective Date of Rule

The rule will be effective July 21, 2011.

Exemption for Foreign Private Advisers

Section 403 of the Dodd-Frank Act added a new exemption from Advisers Act registration for a "foreign private adviser." Foreign private advisers are not subject to the limited reporting and recordkeeping requirements imposed under the Venture Capital Exemption and the Private Fund Adviser Exemption. To qualify, an adviser must meet all of the following criteria: (i) have no place of business in the United States; (ii) have fewer than 15 clients and investors in the United States in private funds; (iii) have assets under management attributable to clients in the United States and investors in the United States in private funds of less than $25 million or such higher amount as the SEC, by rule, deems appropriate; and (iv) not hold itself out to the public in the United States as an investment adviser.

The SEC has adopted Rule 202(a)(30)-1, which clarifies the following terms for purposes of the exemption:

Clients and Investors

The rule clarifies how to count clients of foreign private advisers by incorporating the safe harbor for counting clients currently in Rule 203(b)(3)-1 under the Advisers Act, as modified to eliminate the provision allowing advisers not to count those clients from which they receive no compensation (i.e., non-paying clients will now be counted). Specifically, the following may be treated as a single client for purposes of the rule: (i) a natural person, and: (ii) any minor child of the natural person; (iii) any relative, spouse, spousal equivalent, or relative of the spouse or of the spousal equivalent of the natural person who has the same principal residence; (iv) all accounts of which the natural person and/or the persons referred to above are the only primary beneficiaries; and (v) all trusts of which the natural person and/or the persons referred to above are the only primary beneficiaries. Additionally, in general, (i) a corporation, partnership, limited liability company or other legal organization (a "legal organization") to which an adviser provides investment advice based on its investment objectives rather than the individual investment objectives of the legal organization's owners and (ii) two or more legal organizations that have identical owners, may also be treated as a single client. The rule also contains provisions on how to count investors in private funds and that avoid double-counting private funds and their investors. These portions of the final rule are substantially similar to the rule as originally proposed, except that "knowledgeable employees" (as defined in Rule 3c-5 under the 1940 Act) are not counted as investors in a private fund.

In the United States

The definition of foreign private adviser uses the term "in the United States" in several contexts. The rule defines the phrase "in the United States" by incorporating the definition of a "U.S. person" and "United States" under Regulation S under the Securities Act of 1933, as amended (the "1933 Act"). The rule further states that 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, each time the investor acquired the securities issued by the private fund. The SEC clarified that in order to take advantage of this provision, an investor must be outside the United States each time he or she acquires private fund securities.

Place of Business

"Place of business" is defined by reference to Rule 222-1(a) under the Advisers Act and means any office where the investment adviser regularly provides advisory services, solicits, meets with, or otherwise communicates with clients, and any other location held out to the public as a place where the adviser conducts any such activities.

Assets under Management

"Assets under management" is defined in the rule by reference to the requirements of revised Form ADV as described above in the discussion of the Private Fund Adviser Exemption.

Effective Date of Rule

The rule will be effective July 21, 2011.

Additional SEC Disclosure Requirements

The SEC adopted significant amendments to Part 1A of Form ADV to expand the disclosures required by registered advisers, especially with respect to advisers of private funds. In addition, the SEC clarified the means by which advisers relying on the Venture Capital Exemption and the Private Fund Adviser Exemption (collectively, "Exempt Reporting Advisers") will satisfy their reporting obligations. The amendments to Form ADV will be effective 60 days after publication in the Federal Register.

Form ADV Amendments

Private Funds. The SEC adopted amendments to Item 7.B. and Schedule D of Form ADV that expand the information advisers must report regarding the private funds they advise. Both registered advisers and Exempt Reporting Advisers are required to complete Item 7.B. and the related portions of Schedule D. All reported information will be publicly available.

Item 7.B. requires an adviser to complete a separate Section 7.B. of Schedule D for each private fund that it advises. An adviser must provide basic information regarding the organizational, operational, and investment characteristics of each fund. The SEC has narrowed the reporting requirement so that advisers are no longer required to report on the funds of their related persons (which in most cases are now required to be reported by the related person that is either registered under the Advisers Act or is an Exempt Reporting Adviser), adopted measures that will help to avoid multiple reporting for each private fund and eliminated proposed provisions in order to protect sensitive information. An adviser with a principal office and place of business outside the United States is not required to complete Schedule D for any private fund that, during the adviser's most recent fiscal year, was not a U.S. person, was not offered in the United States and was not beneficially owned by any U.S. person.

Advisers must report, among other things: (i) the name of the fund and the state or country in which the fund is organized and the identity of general partners, managers, directors or trustees of the fund; (ii) whether the fund is part of a master-feeder arrangement or is a fund of funds; (iii) information about the regulatory status of the fund; (iv) within seven broad categories, the type of investment strategy the fund employs and whether the fund invests in securities of registered investment companies; and (v) limited information regarding investors in the fund, including (A) the minimum amount that investors are required to invest, (B) the approximate number of beneficial owners of the fund and the approximate percentage of the fund beneficially owned by the adviser and its related persons, funds of funds and non-U.S. persons and (C) the extent to which clients of the adviser are solicited to invest, and have invested, in the fund. The SEC did not adopt proposed provisions that would have required an adviser to disclose each private fund's net assets, to report private fund assets and liabilities by class and categorization in the fair value hierarchy established under GAAP and to specify the percentage of each fund owned by particular types of beneficial owners.

Advisory Business. Amendments to Item 5 of Form ADV require additional information from advisers on the scope of their business, the types of services provided and the types of clients who receive such services. Also required to be disclosed is the percentage of assets under management for each client type.

Other Business Activities and Financial Industry Affiliations. Amendments to Items 6 and 7 of Form ADV require an adviser to disclose any services that it provides as, among other things, a trust company, registered municipal advisor, registered security-based swap dealer or major security-based swap participant, as well as additional information regarding its financial industry affiliations. Advisers that engage in other businesses under a different name are required to disclose that fact and additional details.

Participation in Client Transactions. Item 8 of Form ADV requires an adviser to report information about its transactions, if any, with clients, including whether the adviser or a related person (including a foreign related person) engages in transactions with clients as a principal, otherwise sells securities to clients, or has discretionary authority over client assets. The SEC adopted three amendments to this item: (i) an adviser that indicates it has discretionary authority to determine the brokers or dealers for client transactions or that it recommends brokers or dealers to clients must additionally report whether any of such brokers or dealers are related persons of the adviser; (ii) an adviser that indicates that it receives soft dollar benefits must also report whether all those benefits qualify for the safe harbor under Section 28(e) of the 1934 Act for eligible research or brokerage services; and (iii) an adviser must report whether it or its related person receives direct or indirect compensation for client referrals.

Custody. In addition to certain technical amendments, the SEC revised Item 9 of Form ADV, which deals with custody issues, to require 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 to its clients.

Incentive-Based Compensation Arrangements. To allow the SEC to adopt rules and guidelines under the Dodd-Frank Act with other federal agencies regarding incentive-based compensation arrangements, the SEC adopted, as proposed, an amendment to Form ADV to require each adviser to indicate whether the adviser had $1 billion or more in assets, as determined on the adviser's balance sheet for its most recent fiscal year end. On March 29, 2011, the SEC and other federal regulators proposed a joint rule that addresses certain excessive incentive-based compensation arrangements, including those of investment advisers with $1 billion or more in assets, pursuant to Section 956 of the Dodd-Frank Act. The proposed rule has not yet been adopted.

Exempt Reporting Advisers

The SEC adopted rules stating that Exempt Reporting Advisers must file reports with the SEC electronically on Form ADV using the same process used by registered investment advisers. An Exempt Reporting Adviser must submit its initial Form ADV within 60 days after relying on the applicable exemption from registration.

The SEC adopted, as proposed, a requirement that Exempt Reporting Advisers complete the following items of Part 1A of Form ADV: Items 1 (Identifying Information), 2.B. (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). In addition, Exempt Reporting Advisers must also complete corresponding sections of Schedules A, B, C, and D. Items 1, 3, and 10 elicit basic identification details such as name, address, contact information, form of organization, and who controls the adviser. Items 6 and 7.A. provide details regarding other business activities in which the adviser and its affiliates are engaged. Item 11 requires advisers to disclose the disciplinary history of the adviser and its employees and to complete a separate schedule containing details of each disciplinary event. Item 7.B. and Section 7.B. of Schedule D require advisers to private funds to disclose information regarding each private fund they advise, as described above.

The amendments require an Exempt Reporting Adviser, like a registered adviser, to amend its report on Form ADV: (i) at least annually, within 90 days after the end of the adviser's fiscal year; and (ii) more frequently, if required by the instructions to Form ADV. Items 1 (Identification Information), 3 (Form of Organization), and 11 (Disclosure Information) must be updated promptly if they become inaccurate in any way, and Item 10 (Control Persons) must be updated promptly if it becomes materially inaccurate.

Definition of "Family Office"

Pursuant to Section 409 of the Dodd-Frank Act, the SEC adopted Rule 202(a)(11)(G)-1 defining the term "family office" for purposes of the exclusion from the definition of "investment adviser" contained in the Advisers Act. The SEC adopted the proposed rule with some modifications. Family offices that meet the definition will not be subject to the registration or other requirements of the Advisers Act.

Family offices are entities established by wealthy families to manage their wealth. Family offices generally have expertise in managing portfolios of securities as well as in estate, financial and tax planning and charitable giving. Family offices have historically been viewed as "investment advisers" under the Advisers Act, but have avoided registration by relying on (i) the Private Adviser Exemption or (ii) SEC exemptive orders. The Dodd-Frank Act eliminates the Private Adviser Exemption effective as of July 21, 2011, but mandated that family offices as defined by the SEC be excluded from regulation under the Advisers Act. Under the rule, a "family office" is not an "investment adviser" and, therefore, is not subject to any of the provisions of the Advisers Act or the registration requirements of any state.

In the rule, the SEC has largely codified the terms of prior exemptive orders and set forth three general conditions to being defined as a family office: (i) the family office must have no clients other than "family clients"; (ii) only "family clients" own the family office and only "family members" and/or their controlled entities control the family office; and (iii) the family office not hold itself out to the public as an investment adviser.

Participation Limited to Family Clients

Family Client. Participation in the family office must be limited to "family clients" of a single family. Family clients generally include current and former family members, certain employees ("key employees") of the family office (and, under certain circumstances, former key 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 certain exceptions).

Family Members. The term "family member" means all lineal descendants (including by adoption, stepchildren, foster children, and individuals that were minors when another family member became a legal guardian of that individual) of a common ancestor (who may be living or deceased), and such lineal descendants' spouses or spousal equivalents; provided that the common ancestor is no more than 10 generations removed from the youngest generation of family members. This definition represents an expansion of the definition in the proposed rule, which defined "family member" by reference to the "founder" of the family office and implicitly assumed that the founder was the initial generator of the family's wealth. The SEC noted that the revised definition permits reliance on the rule by family offices that are established by persons several generations removed from the initial wealth generator.

Former Family Members. The rule as proposed permitted former family members (e.g., spouses who are no longer family members as a result of a divorce) to retain investments managed by the family office during the period of time in which the person was a family member but not to make new investments. The final rule eliminates this restriction and permits a former family member to continue to make investments with the family office. In addition, stepchildren are included in the definition of "former family member" in the final rule.

Key Employees. The rule permits the family office to provide investment advice to "key employees," which term includes any natural person (including a key employee's spouse who holds a joint, community property or similar shared ownership interest with the key employee) who is (i) an executive officer, director, trustee, or general partner of the family office or person acting in a similar capacity or (ii) any other employee of the family office who as part of his or her regular duties participates in the investment activities of the family office and has done so either at the family office or elsewhere for at least 12 months. Persons performing solely clerical, secretarial or administrative functions are not key employees. Key employees are generally permitted to structure their investments through trusts and other entities that are solely funded and controlled by the key employee. Upon the termination of employment, a key employee would generally not be permitted to make additional investments through the family office (except for additional investments that the key employee was contractually obligated to make), although existing investments could be maintained.

Involuntary Transfers. In the event of an involuntary transfer (e.g., by reason of death of a family client) of an interest in managed assets to a non-family client, such as a third-party charity, the final rule provides a one year transition period during which the family office can continue to manage the involuntarily transferred assets. The proposed rule provided for a four-month period.

One Family Ownership and Control

The exclusion from the Advisers Act is limited to family offices that are wholly-owned by family clients and controlled directly or indirectly by family members and that have no clients other than family clients of a single family. The SEC explained that this test is designed to distinguish between family offices that need not be subject to regulation and family-run investment advisory businesses that should be regulated under the Advisers Act. The SEC stated that it considered, but decided not to adopt, provisions that would permit a family office to serve members of more than one family. However, the SEC noted that reliance on the rule is not limited to family offices that are operated on a not-for-profit basis.

Holding Out to the Public as an Investment Adviser

The rule contains no specifics as to what it means to be holding out to the public as an investment adviser. The general proposition is that the family office should not be advertising or holding itself out as being in the business of managing money for others or as being open to new advisory clients. In its release, the SEC clarified that a family office that is currently registered as an investment adviser and expects to de-register in reliance on the rule will not be prohibited from relying on the rule solely because it held itself out to the public as an investment adviser while it was registered under the Advisers Act.

Grandfathering Provisions

Consistent with a mandate in the Dodd-Frank Act, the rule permits a family office that was not registered (or required to be registered) as an investment adviser with the SEC on January 1, 2010 to continue to provide investment advice to any person who, at the time of investment, (i) was an officer, director or employee of the family office and had invested before January 1, 2010 (even though such person does not meet the definition of "family client") and (ii) was an accredited investor as defined in Regulation D under the 1933 Act.

Also grandfathered are situations where a registered investment adviser could be viewed as receiving investment advice from a family office resulting from the family office's ongoing management of co-investments with or for such registered investment adviser. The grandfathering would not apply (i) if the family office provides investment advice to the registered investment adviser on other investments or (ii) if the value of the registered investment adviser's assets subject to the family office's advice exceeds 5% of the value of the total assets over which the family office provides investment advice.

Any family office currently operating under an SEC exemptive order may continue to rely on that order.

Effective Date of Rule

The rule will be effective 60 days after publication in the Federal Register.

Compliance Dates for Registration

Advisers Currently Relying on Private Adviser Exemption. The SEC adopted a transition provision for advisers that are required to register due to the Dodd-Frank Act's repeal of the Private Adviser Exemption, which includes many advisers to hedge funds and private equity funds. An adviser that is relying on, and is entitled to rely on, the Private Adviser Exemption on July 20, 2011 may delay registering with the SEC until March 30, 2012. The SEC noted that because initial applications for registration can take up to 45 days to be approved, advisers relying on this transition provision should file a complete application on Form ADV by February 14, 2012.

Exempt Reporting Advisers. Exempt Reporting Advisers (*i.e.*, those advisers relying on the Venture Capital Exemption or the Private Fund Adviser Exemption) must file their first reports on Form ADV between January 1 and March 30, 2012.

Examinations of Exempt Reporting Advisers

The SEC stated that while it has the authority to do so, it does not anticipate that its staff will conduct routine compliance examinations of Exempt Reporting Advisers. However, the SEC will conduct examinations where there are indications of wrongdoing (e.g., those examinations prompted by tips, complaints and referrals).

Pay-to-Play Rule

The SEC also adopted amendments to Rule 206(4)-5 under the Advisers Act (commonly known as the "pay-to-play rule"). The rule has been amended so that it applies both to Exempt Reporting Advisers and foreign private advisers. The SEC specifically noted that the application of the rule to Exempt Reporting Advisers and foreign private advisers is necessary and appropriate to prevent these advisers and others from engaging in fraudulent pay-to-play practices in the United States.

In addition, the SEC amended the rule to add municipal advisors to the categories of registered entities (referred to in the rule as "regulated persons" and including registered investment advisers and broker-dealers) excepted from the rule's prohibition on advisers paying third parties to solicit government entities. To qualify as a municipal advisor (and therefore be a regulated person), a solicitor must be registered under Section 15B of the 1934 Act and subject to pay-to-play rules adopted by the Municipal Securities Rulemaking Board.

The amendments to the rule will be effective 60 days after publication in the Federal Register. The SEC extended the date by which advisers must comply with the ban on third-party solicitation from September 13, 2011 to June 13, 2012.

Additional Private Fund Reporting on Form PF

As discussed above, the SEC adopted amendments to Form ADV that substantially increase the amount of information an adviser must include regarding the private funds it manages. In addition, on January 26, 2011, pursuant to Title IV of the Dodd-Frank Act, the SEC and the Commodity Futures Trading Commission jointly proposed rules to implement extensive reporting requirements for advisers to private funds (including hedge funds, liquidity funds and private equity funds) under the Advisers Act and the Commodity Exchange Act. The proposed SEC rule would require investment advisers registered with the SEC that advise one or more private funds to file a Form PF with the SEC. The SEC indicated that proposed Form PF is still under consideration.

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