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SEC Clarifies Exemptions For Advisers

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On November 19, 2010, the Securities and Exchange Commission (the "SEC") published proposed rules to implement certain provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") that created exemptions from the requirement to register under the Investment Advisers Act of 1940 (the "Advisers Act") for advisers to venture capital funds, private fund advisers with less than $150 million in assets under management and foreign private advisers. Comments to the rule proposals are due 45 days after publication of the proposed rules in the Federal Register. The SEC rule proposals are available at http://www.sec.gov/rules/proposed/2010/ia-3111.pdf.

Significantly, the proposed rule release sets forth the SEC's view that advisers exempt from registration because they are advisers solely to (i) venture capital funds or (ii) private funds with less than $150 million in assets under management (collectively, "Exempt Reporting Advisers") will be subject to SEC examinations under Section 204(a) of the Advisers Act and will be required to make ongoing Form ADV Part 1 filings with the SEC (see "*Form ADV and Examinations for Exempt Reporting Advisers*"below). In contrast, advisers that rely on the exemption from registration for foreign private advisers will be exempt from SEC examination and Form ADV reporting requirements.

Venture Capital Exemption

The SEC's proposed rules clarify certain aspects of the Dodd-Frank Act exemption for advisers solely to "venture capital funds." Primarily, the rules set forth the definition of "venture capital fund" for purposes of the exemption and, importantly, provide a grandfathering exemption for existing venture capital funds.

Definition of Venture Capital Fund

The proposed rules would define a "venture capital fund" as a "private fund" (i.e., a limited partnership or other pooled vehicle excluded from the definition of "investment company" under Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 (the "Company Act")) that meets the following six criteria:

1. The fund represents to its investors and potential investors that it is a venture capital fund.

2. The fund owns solely (i) cash or cash equivalents, (ii) U.S. treasuries with a remaining maturity of 60 days or less, and (iii) "equity securities" of "qualifying portfolio companies," and at least 80% of the equity securities of each qualifying portfolio company were acquired directly from the qualifying portfolio company (as opposed to an acquisition of equity from an existing shareholder).

For purposes of the rule, "equity securities" include common stock and securities convertible into common stock, and therefore would include typical convertible preferred stock issued by most venture backed companies as well as standard convertible notes issued in "bridge financings." "Equity securities" would not include most other debt instruments.

A "qualifying portfolio company" means any company that meets the following qualifications:

- At the time of any investment by the private fund, the company is not "publicly traded" (i.e. subject to the reporting requirements of the Securities Exchange Act of 1934 or having securities listed or traded in a foreign jurisdiction) and is not a control affiliate of a public company. Importantly, because of the requirement that all of the fund's securities be equity securities of qualified portfolio companies, a fund could not invest in "private investment in public equity" (PIPE) transactions. However, since the definition of qualified portfolio company looks to the time of investment, funds could continue to hold public securities after a company's initial public offering so long as no follow-on investments were made in that company.
- The company does not borrow or issue debt obligations, redeem or repurchase securities of the company, or distribute company assets in connection with the private fund's investment.
- The company is not itself a "private fund." Accordingly, a fund of funds or special purpose holding vehicle, even if focused on venture capital or a particular venture capital investment, would not meet the definition of venture capital fund and advisers to such vehicles would not qualify for the venture capital exemption.

In the proposing release, the SEC specifically solicited public comments as to whether a limited basket for purchasing publicly traded securities should be permitted and whether the short-term borrowing permission was appropriate.

3. With respect to each qualifying portfolio company, the fund either (i) "controls" such company or (ii) has an arrangement whereby the fund (or its adviser) *offers* to provide significant guidance and counsel concerning the management, operations or business objectives and policies of the company (and if the offer is accepted, such guidance and counsel is provided).

4. The fund does not (i) borrow, issue debt obligations, provide guarantees or otherwise incur leverage in excess of 15% of the fund's aggregate capital commitments and (ii) any such borrowing, indebtedness, guarantee or leverage has a non-renewable term of no longer than 120 days.

5. The fund does not permit its investors to withdraw or redeem their interests, except in extraordinary circumstances.

6. The fund is a "private fund" not registered as an investment company (i.e. a mutual fund) pursuant to Section 3(c)(1) or 3(c)(7) of the Company Act and has not elected to be treated as a business development company under the Company Act.

Grandfathering Exemption

The definition of "venture capital fund" would include any private fund that (i) represented to investors and potential investors at the time of the offering that it was a venture capital fund, (ii) issues interests in the fund to one or more third party investors prior to December 31, 2010, and (iii) does not issue any additional interests after July 21, 2011 (i.e., held its initial closing prior to 2011 and its final closing prior to the Dodd-Frank Act registration effective date of July 20, 2011). Therefore, funds that satisfy the "grandfathering" criteria would not be required to satisfy the proposed definition of venture capital fund outlined above.

Exemption for Private Fund Advisers with Less Than $150 Million in Assets Under Management

Proposed Rule 203(m)-1 provides an exemption from registration for any investment adviser that solely advises private funds that, in the aggregate, have less than $150 million in assets under management in the United States.

Non-U.S. Advisers

Importantly, the proposed rule makes clear that an adviser with its principal office and place of business outside the United States (a "Non-U.S. Adviser") can rely on the exemption if (i) all of its U.S. clients are "private funds" and (ii) it only manages "private funds" from any place of business in the U.S (i.e., it does not manage separate advisory accounts from a U.S. place of business). Therefore, a Non-U.S. Adviser could advise a managed account of a foreign individual or entity (using the Regulation S definition of "U.S. person") from a place of business outside of the U.S. and still be able to rely on the exemption.

Importantly, the SEC took a relatively liberal view as to the interpretation of "assets under management in the United States" for purposes of counting assets toward the $150 million limit. None of the assets of a Non-U.S. Adviser that are invested in a U.S. or non-U.S. private fund and that are managed from outside the United States would need to be included for purposes of the test. Furthermore, the release states that in order for private fund assets to be deemed to be managed in the United States, the adviser would need to provide "continuous and regular supervisory or management services from an office in the United States." Under the proposed rule, most foreign advisers would be exempt from registration regardless of the amount of assets attributable to non-U.S. managed accounts or United States investors in non-U.S. funds.

U.S. Advisers

An adviser with its principal office and place of business in the U.S. (a "U.S. Adviser") would need to consider all of its client accounts (both U.S. and non-U.S.) in determining whether it solely advises private funds. Moreover, all of the private fund assets of a U.S. Adviser (whether managed in the United States or elsewhere) would be counted toward the $150 million limit.

Assets Under Management

Finally, the proposed rule also clarifies how and when to calculate an adviser's assets under management for purposes of the $150 million test. The proposed rule requires that an adviser calculate aggregate assets under management in the United States with respect to private funds in accordance with the new proposed Form ADV calculation requirements. The new Form ADV requirements specifically state that advisers must include uncalled capital commitments as assets under management. The SEC also proposes that the $150 million exemption must be tested on a quarterly basis and that fund assets be valued at their fair value (cost values cannot be used). If an adviser exceeds $150 million in United States assets under management during a fiscal quarter, it must register with the SEC by the end of the following quarter.

Foreign Private Advisers

Given the potentially broad application of the $150 million exemption described above, the foreign private adviser exemption in Section 203(b)(3) may end up with limited applicability. Pursuant to the Dodd-Frank Act, a foreign private adviser is exempt from registration with the SEC provided that it: (i) has no place of business in the United States; (ii) has, in total, fewer than 15 United States clients and United States investors in private funds advised by the adviser; (iii) has aggregate assets under management attributable to United States clients and United States investors 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.

Proposed Rule 202(a)(30)-1 provides that a natural person and his or her minor children, relatives and/or spouse living at the same principal residence, and related accounts will generally be treated as one client for purposes of the rule. Moreover, multiple legal entities with identical owners will be considered one client. Consistent with the SEC's new guidance for calculating assets under management, the SEC specifically stated that accounts that are not charged fees must still be counted as "clients" for purposes of the foreign private adviser exemption.

“Investors” will generally be defined as any person who would be included in determining the number of beneficial owners of a private fund under Section 3(c)(1) of the Company Act, or in determining that the outstanding securities of a private fund are owned exclusively by qualified purchasers under Section 3(c)(7) of the Company Act. However, unlike under the Company Act attribution rules, “knowledgeable employees” and owners of short-term paper issued by a fund will also count as “investors.” For purposes of the 15 client threshold, (i) identical investors in two or more funds only need to be counted once and (ii) if an adviser has already counted a U.S. investor in a non-U.S. fund, it does not need to “double count” the fund.

Finally, the rule defines “in the United States” generally by incorporating the definition of a “U.S. person” and “United States” under Regulation S.

Form ADV Reporting and Examinations for Exempt Reporting Advisers

Under the proposed rules, all registered investment advisers and Exempt Reporting Advisers will be required to file Form ADV Part 1 no later than August 20, 2011 and report the value of their assets under management, determined within 30 days of the filing. Similar to registered investment advisers, Exempt Reporting Advisers would be required to file updating amendments to Form ADV Part 1 on at least an annual basis. Exempt Reporting Advisers would only be required to respond to a limited number of Form ADV inquiries, including detailed information about the adviser’s ownership structure and comprehensive information about each private fund that it advises, including information about the gross and net asset values of the fund, a breakdown of assets and liabilities held by the fund (by class and categorization in the fair valuation hierarchy established by GAAP), Form D filing information, and detailed information regarding placement agents, custodians, administrators, and prime brokers. All information filed with the SEC via Form ADV would be publicly available.

Importantly, the SEC also stated that it has authority to conduct examinations with respect to the books and records of Exempt Reporting Advisers. The SEC indicated that Exempt Reporting Adviser recordkeeping requirements will be addressed in a subsequent SEC release.

Following the August 20 filing, a registered investment adviser that is no longer eligible for SEC registration under the new Dodd-Frank Act legislation and related SEC rules (e.g., an adviser that has less than $100 million in assets under management and is required to register in the state in which it maintains its principal office and place of business) would be required to withdraw its SEC registration and register with the appropriate state authorities by October 19, 2011. Advisers that may be required to withdraw from SEC registration should be aware that state registration (and in particular, potential investment adviser representative examination and licensing requirements) can be a lengthy process in certain circumstances.

Should you have any questions about this alert or complying with the new regulations, please contact your Proskauer relationship lawyer or any Proskauer lawyer listed in this alert.

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