Proskauer

SEC Adopts Final Rules for Advisers to Private Investment Funds and Amendments to Form ADV

July 11, 2011

On June 22, 2011, pursuant to Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), the Securities and Exchange Commission (the "SEC") adopted final rules to implement new exemptions from the registration requirements of the Investment Advisers Act of 1940 (the "Advisers Act"). The final rules also significantly expand registration and disclosure requirements for advisers to private investment funds under the Advisers Act. The final rules set forth the following:

- a definition of "venture capital fund" for purposes of the venture capital fund adviser exemption;
- an adviser's eligibility under the $150 million "private fund adviser" exemption;
- definitions of a number of terms related to the "foreign private adviser" exemption;
- new reporting and disclosure requirements for certain "exempt reporting advisers" to private funds;
- expanded information requirements for registered investment advisers on Form ADV; and
- a new definition of assets under management.

The SEC also delayed the registration deadline for private fund advisers required to register with the SEC until March 30, 2012. Exempt reporting advisers will also not be required to make their initial filings with the SEC until March 30, 2012.

Below is a summary of the final rules and other amendments implementing the Dodd-Frank Act. The SEC's adopting releases may be found at http://www.sec.gov/rules/final/2011/ia-3221.pdf and http://www.sec.gov/rules/final/2011/ia-3222.pdf.

Extension for Registration

Effective July 21, 2011, the Dodd-Frank Act eliminates the so-called “private adviser exemption” under Section 203(b)(3) of the Advisers Act, which exempted any investment adviser from registration if the adviser had less than 15 clients, was not an adviser to a registered investment company, and did not hold itself out to the public as an investment adviser. Most advisers to private funds have historically relied on this exemption and thus will be required to register with the SEC unless one of the exemptions described below is available. The final rules adopted by the SEC provide that advisers that were relying on the private adviser exemption as of July 20, 2011, and that do not advise more than 14 clients, do not need to register with the SEC until March 30, 2012. Registration applications may take up to 45 days to be approved, and therefore the SEC specifically stated in the adopting release that advisers planning to register should file a complete application on Form ADV no later than February 14, 2012.

New Exemptions from Registration

The Dodd-Frank Act created three new exemptions from registration under the Advisers Act:

- an exemption for advisers solely to private funds with less than $150 million in assets under management in the United States (the “Private Fund Adviser Exemption”);
- an exemption for advisers solely to venture capital funds (the “Venture Capital Fund Exemption”); and
- an exemption for certain non-U.S. advisers with no place of business in the United States, less than $25 million in assets under management attributable to U.S. clients and investors and fewer than 15 U.S. clients and investors in private funds (the “Foreign Private Adviser Exemption”).

The final rules for each of the three exemptions are summarized below.

Private Fund Adviser Exemption

U.S. Advisers

Rule 203(m)-1 provides that a U.S. adviser (*i.e.*, an adviser with its principal office and place of business in the United States) solely to "private funds" is exempt from registration under the Advisers Act if the aggregate value of the adviser's assets under management in the United States is less than $150 million. A U.S. adviser must aggregate the value of all assets of the private funds it manages, regardless of where the funds are organized, to determine whether the adviser remains below the $150 million limitation. Generally speaking, a "private fund" means a fund that is not an "investment company" required to register under the Investment Company Act of 1940 (the "ICA"). The calculation of assets under management for this purpose is discussed in more detail below under the subject heading "Assets Under Management."

Under the final rule, an adviser must calculate and report its total assets under management to the SEC on an annual basis. The proposed rule would have required quarterly calculation.

Advisers exempt from registration pursuant to the Private Fund Adviser Exemption will be deemed "Exempt Reporting Advisers" by the SEC and required to submit an abbreviated version of Part 1 of Form ADV to the SEC within 90 days of each fiscal year end. If an adviser reports in its Form ADV that is has $150 million or more in assets under management (and therefore becomes ineligible to rely on the Private Fund Adviser Exemption), the adviser will have an additional 90 days to register as an investment adviser with the SEC (unless it is exempt from registration pursuant to another exemption). This 90-day grace period is only available to advisers that have complied with all applicable SEC reporting requirements.

Advisers exempt from registration pursuant to the Private Fund Adviser Exemption will also be subject to examination oversight by the SEC. However, the SEC has stated that it does not anticipate conducting compliance examinations of Exempt Reporting Advisers on a regular basis, but reserves the right to conduct "for cause" examinations if there are indications of wrongdoing (*e.g.*, tips, complaints, or referrals).

In the release adopting the final rule, the SEC stated that single?investor funds that do not serve any purpose other than to avoid registration will not be respected by the SEC as “private funds” for purposes of applying the Private Fund Adviser Exemption. The SEC did state, however, that there are circumstances in which it may be appropriate for an adviser to treat a single-investor fund as a private fund, such as where a private fund seeks to raise capital from multiple investors but has only one initial investor for a period of time or where all but one of a fund’s investors have redeemed their interests.

Non-U.S. Advisers

Under Rule 203(m)-1, non-U.S. advisers (defined as advisers that have their principal office and place of business outside of the United States) are exempt from registration if:

- the adviser has no clients that are U.S. persons, except for private funds; and
- all assets managed by the adviser at a place of business in the United States are private fund assets, the total value of which is less than $150 million.

The same method for calculating assets under management applies to non-U.S. advisers (see “Assets Under Management” below). Non-U.S. advisers with no place of business in the United States and whose only U.S. clients are private funds will not be required to register under the Advisers Act, regardless of the amount of private fund assets under management attributable to U.S. private funds. An investment adviser will be regarded as managing assets at a U.S. place of business if it provides “continuous and regular supervisory or management services” from the United States. Whether or not “continuous and regular supervisory or management services” are conducted in the United States will depend on the particular facts and circumstances. The release specifically stated that conducting due diligence or providing research from the United States does not necessarily cause the assets to be managed from the United States if a person outside of the United States makes the independent investment decisions and implements those decisions.

Non-U.S. advisers relying on the Private Fund Adviser Exemption are Exempt Reporting Advisers and are therefore subject to reporting requirements and examination oversight by the SEC as described below. It is expected that many non-U.S. advisers will rely on the Private Fund Adviser Exemption to exempt themselves from registration with the SEC as an investment adviser.

Venture Capital Fund Exemption

Rule 203(l)-1 of the Advisers Act exempts advisers solely to "venture capital funds" from registration with the SEC under the Advisers Act. For purposes of the exemption, a venture capital fund is defined as a private fund that:

- represents itself as pursuing a venture capital strategy to its investors and prospective investors;
- holds no more than 20 percent of its aggregate capital contributions and uncalled committed capital in assets (other than short-term holdings) that are not qualifying investments;
- does not borrow or otherwise incur leverage, other than limited short-term borrowing;
- does not offer its investors redemption or other similar liquidity rights except in extraordinary circumstances; and
- is not registered under the ICA and has not elected to be treated as a business development company.

In addition, certain funds formed prior to 2011 may qualify as venture capital funds under a grandfathering provision discussed below under "Grandfathering Provision."

Venture Capital Strategy Requirement

Under Rule 203(l)-1, a qualifying venture capital fund must represent to its investors and potential investors that it is pursuing a venture capital strategy. While there is little guidance on what "pursuing a venture capital strategy" specifically entails, the release states that an adviser to a venture capital fund that is otherwise relying on the exemption could not identify the fund as a multi-strategy fund (*i.e.*, venture capital is one of several investment strategies along with, for example, a hedge fund strategy). Among other statements, the SEC release stated that a venture capital strategy is typified by investing capital directly in portfolio companies for the purpose of funding the expansion and development of the company's business. This element of the final rule marks a change from the proposed rule, which required that the fund represent itself as being a venture capital fund to its investors and potential investors. Accordingly, failure to use the words "venture capital" or use of the words "growth capital" or even "private equity" would not automatically preclude a qualifying fund from satisfying the definition.

Qualifying Investment Requirement

Under Rule 203(l)-1, the definition of a venture capital fund requires that immediately after the acquisition of an asset, other than qualifying investments or short-term holdings, the fund holds no more than 20 percent of the amount of its aggregate capital contributions and uncalled committed capital in assets that are not qualifying investments or permissible short-term holdings. Although non-qualifying investments may be valued at historical cost or fair value for purposes of measuring the 20 percent threshold, the method must be applied consistently during the term of the fund; accordingly, it is assumed most funds will use cost to attain certainty. A venture capital fund must calculate its total percentage of non-qualifying investments at the time it acquires a non-qualifying investment for purposes of determining whether it continues to fall within the 20 percent threshold. As a result, space in the basket will "free up" if earlier non-qualifying investments are disposed. The inclusion of the 20 percent basket for non-qualifying investments provides significant flexibility in comparison to the proposed rule.

Rule 203(l)-1 defines a "qualifying investment" as (i) an equity security issued by a qualifying portfolio company that has been acquired directly by the fund from the qualifying portfolio company, (ii) any equity security issued by a qualifying portfolio company in exchange for an equity interest issued by the qualifying portfolio company described in (i) above, or (iii) any equity security issued by a company of which a qualifying portfolio company is a majority-owned subsidiary (as defined in the ICA) or a predecessor and is acquired by the fund in exchange for an equity security described in (i) or (ii) above. Accordingly, the SEC has provided venture capital advisers with flexibility to participate in certain capital restructurings and mergers and acquisitions without running afoul of the requirement that a security be directly acquired from the issuer. Moreover, although direct secondary purchases of stock from existing shareholders must be included in the 20 percent non-qualifying basket, unlike the initial proposal, the final rule would seemingly provide portfolio companies with flexibility to issue new securities to a venture capital fund and simultaneously redeem out existing shareholders in connection with a venture capital fund's investment without including such a transaction in the 20 percent non-qualifying basket.

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

- ???at the time of any investment by the fund, the company is not itself "reporting or foreign traded" (*i.e.*, it is not subject to the reporting requirements of the Securities

Exchange Act of 1934 and does not have securities listed or traded in a foreign jurisdiction) and does not control, is not controlled by and is not under common control with, a "reporting or foreign traded" company. Because of the requirement that all of the fund's securities be equity securities of qualified portfolio companies, a "private investment in public equity" (PIPE) transaction or other purchase of listed company securities would need to be included in the 20 percent basket. 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 as "qualifying investments," but any follow-on investments made in that company after the initial public offering would need to be included in the 20 percent non-qualifying basket;

- the company does not borrow or issue debt obligations in connection with the fund's investment in the company and distribute to the fund the proceeds of such borrowing or issuance in exchange for the fund's investment; and
- the company is not itself a "private fund."

Accordingly, a traditional venture capital fund of funds would not meet the definition of venture capital fund and therefore advisers to funds of funds would not qualify for the Venture Capital Exemption. However, in response to many comments on the proposed rules, the SEC specifically noted that investments made through a "wholly owned intermediate holding company" formed solely for tax, legal or regulatory reasons to hold investments in a qualifying portfolio company would be disregarded for purposes of the "private fund" test. This interpretation would permit investments to be made through traditional alternative investment vehicles ("AIVs") that are wholly owned by a venture capital fund and not require such investments to be counted toward the 20 percent non-qualifying basket. The SEC also indicated that AIV structures used to address the particular needs of venture capital funds or their investors are not intended to circumvent the final rule's general limitation on investing in other investment vehicles.

No Borrowing Requirement

In order to qualify as a venture capital fund, a fund may not borrow, issue debt obligations, provide guarantees or otherwise incur leverage in excess of 15 percent of the fund's capital contributions and uncalled committed capital. In addition, any such borrowing, indebtedness, guarantees or leverage must have a non-renewable term of no longer than 120 days. However, a guarantee by the fund of a qualifying portfolio company's obligations up to the value of the fund's investment in the qualifying portfolio company is not subject to the 120 day limit.

No Redemptions Requirement

Pursuant to Rule 203(l)-1, the fund may not permit its investors to withdraw or redeem their interests, except in extraordinary circumstances. The SEC indicated that the question of whether regulatory "opt-out" rights would be considered extraordinary circumstances (and therefore permitted by the exemption) would depend on the particular facts and circumstances. However, a fund with periodic withdrawal rights or that regularly identifies potential investors on behalf of existing fund investors seeking to transfer or redeem interests in the fund would not comply with the exemption. Accordingly, under the final rules, advisers seeking to rely on the Venture Capital Fund Exemption would be unable to regularly identify potential transferees to fund investors.

Private Fund Requirement

For purposes of the exemption, the venture capital fund determination is limited to limited partnerships or other pooled investment vehicles excluded from the definition of "investment company" under Section 3 of the ICA.

Grandfathering Provision

The definition of "venture capital fund" includes any private fund that: (i) represented to investors and potential investors at the time of the offering of its interests that it was pursuing a venture capital strategy, (ii) issued 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.*, the fund held its initial closing prior to 2011 and its final closing prior to the effective date of the repeal of the private adviser exemption). Funds that satisfy the "grandfathering" criteria would not be required to satisfy the other elements of the definition of venture capital fund outlined above.

Reporting Requirement

As discussed in more detail below under “Exempt Reporting Adviser Reporting Requirements,” advisers relying on the Venture Capital Fund Exemption remain subject to certain SEC reporting requirements and examination oversight, including a requirement to file a limited subset of the items found in Part 1A of Form ADV. A venture capital fund adviser that seeks to rely on the Venture Capital Fund Exemption would need to affirm that it can rely on the exemption in its annual updating amendment to Form ADV. The deadline for filing the initial subset of Part 1 of Form ADV applicable to an Exempt Reporting Adviser is March 30, 2012.

Exemption for Foreign Private Advisers

Section 403 of the Dodd-Frank Act added a new exemption from registration under the Advisers Act for a “foreign private adviser.” Unlike the Venture Capital Fund Exemption and the Private Fund Adviser Exemption, foreign private advisers are not Exempt Reporting Advisers and therefore are not subject to the related reporting requirements and examination oversight described under the subject heading “Exempt Reporting Adviser Reporting Requirements.”

To qualify for the Foreign Private Adviser Exemption, an adviser must: (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 (in the aggregate); (iii) have less than $25 million in assets under management attributable to United States clients and investors; and (iv) not hold itself out to the United States public as an investment adviser.

In the final rule's adopting release, the SEC clarified how to count clients of foreign private advisers for purposes of the Foreign Private Adviser Exemption. The SEC stated that advisers should use the counting rules previously required by Advisers Act Rule 203(b)(3)-1. However, advisers must also include clients from which they receive no compensation. Under Rule 203(b)(3)-1, the following may be treated as a single client: (i) a natural person; (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. Also, (i) a corporation, partnership or limited liability company to which an adviser provides investment advice based on its investment objectives rather than the individual investment objectives of the organization's owners and (ii) two or more organizations that have identical owners, can be treated as a single client.

The final rule also contains provisions on how to count investors in private funds and specifies that advisers need not double-count private funds and their investors. A non-U.S. adviser is not required to count a private fund as a client if the non-U.S. adviser is counting any investor (as discussed below) in that private fund as a United States investor. Finally, a non-U.S. adviser is not required to count a person as an investor if the adviser separately counts such person as a client of the adviser. Therefore, a client who is also an investor in one or more private funds advised by the adviser would only be counted once.

An "investor" is any person that 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 ICA, or whether the outstanding securities of a private fund are owned exclusively by qualified purchasers under Section 3(c)(7) of the ICA. "Investor" also includes any beneficial owner of short-term paper issued by the fund.

The definition of foreign private adviser uses the term “in the United States” in several contexts. The final rule defines the phrase “in the United States” by incorporating the definition of a “U.S. person” and “United States” under Regulation S of the Securities Act of 1933 (the “Securities Act”). The final 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 a private fund, at the time the investor acquired the private fund securities. 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.

“Assets under management” is defined in the final rule by reference to the requirements of revised Form ADV described below.

Importantly, unlike a non-U.S. adviser relying on the private adviser exemption, non-U.S. advisers relying on the Foreign Private Adviser Exemption are not given any transition time to register with the SEC after becoming ineligible to rely on this exemption due to an increase in the value of private assets attributable to U.S. clients and investors in the United States (*i.e.*, the adviser would need to register prior to exceeding the 15 client/investor or $25 million limitations).

In the adopting release, the SEC also noted that although it would generally treat as a single adviser two or more affiliated advisers that are separately organized but operationally integrated, the new rules are not intended to withdraw any prior statement of the SEC or its staff expressed in the *Unibanco* line of no-action letters. The SEC indicated that further guidance on the applicability of *Unibanco* to the newly available Dodd-Frank Act registration exemptions may be forthcoming.

Assets Under Management

Generally, the amount of “regulatory assets” that an adviser has under management must be disclosed on Form ADV, and will determine whether the adviser must be registered with the SEC or the states. Form ADV requires an adviser to report the amount of its regulatory assets under management as determined not more than 90 days prior to the filing.

The SEC will use the following method of calculating assets under management for purposes of determining whether an adviser must register with the SEC:

- include the value of any securities portfolios (*i.e.*, any portfolio at least 50 percent of the total value of which consists of securities) or any private fund for which it provides continuous and regular supervisory or management services, regardless of whether the assets are proprietary assets, assets managed without receiving compensation, or assets of foreign clients;
- include the amount of any uncalled capital commitments;
- do not subtract any outstanding indebtedness; and
- use market value, or fair value when market value is unavailable.

Because advisers are required to assess their eligibility for registration on an annual basis, advisers will not be required to switch between state and SEC registration as a result of mid-year changes in the value of an adviser's regulatory assets under management. As is the case under the previous rules, if an adviser is no longer eligible for SEC registration at the end of its fiscal year, the rule provides a 180-day grace period from the adviser's fiscal year-end to allow it to switch to state registration.

Exempt Reporting Adviser Reporting Requirements

Section 203(1) and Section 203(m) of the Advisers Act permit the SEC to require Exempt Reporting Advisers (*i.e.,* advisers relying on the Venture Capital Exemption or the Private Fund Adviser Exemption) to maintain certain records and submit regular reports to the SEC. While an Exempt Reporting Adviser is exempt from registration with the SEC and generally does not need to comply with most aspects of the Advisers Act, it will be required to submit responses to certain questions in Part 1 of Form ADV with the SEC on an annual basis within 90 days of its fiscal year end (with the first filing due on March 30, 2012). An Exempt Reporting Adviser will only need to respond to the following questions on Part 1 of Form ADV (the responses to which would be publicly available via the SEC's website):

- Item 1 (Identifying Information)
- Item 2.B (Basis for SEC exemption)
- Item 3 (Form of Organization)
- Item 6 (Other Business Activities)
- Item 7 (Financial Industry Affiliations and Private Fund Reporting)
- Item 10 (Control Persons)

- Item 11 (Disciplinary Information)
- Schedules A, B, C and D (including information about certain private funds on Schedule D)

In addition to annual filings, an Exempt Reporting Adviser will be required to file prompt amendments for any change to Items 1 or 3, or if there are any material inaccuracies/changes to Item 11 or Schedule A. Exempt reporting advisers are not required to file Part 2 of Form ADV.

Also, as discussed above, Exempt Reporting Advisers are technically subject to limited examination oversight by the SEC, although the SEC has stated that it does not anticipate conducting compliance examinations of Exempt Reporting Advisers on a routine basis.

The SEC stated that new recordkeeping requirements for Exempt Reporting Advisers will be addressed in a future release.

Eligibility for Registration with the SEC

Section 203A of the Advisers Act prohibits an adviser regulated by the state in which it maintains its principal office from registering with the SEC unless the adviser has at least $25 million in assets under management. The Dodd-Frank Act generally raises the floor for SEC registration to $100 million by creating a new category of advisers called “mid-sized advisers” that have assets under management between $25 million and $100 million, but are still generally required to register with the states.

Importantly, the SEC adopted a new registration “buffer” which provides that (i) advisers with greater than $100 million in assets under management but less than $110 million are permitted, but not required, to register with the SEC and (ii) advisers that are registered with the SEC and have at least $90 million in assets under management do not need to withdraw their SEC registrations.

Rule 203A-5 will require any adviser registered with the SEC as of January 1, 2012, to file an amendment to its Form ADV no later than March 30, 2012. In such amendment, each investment adviser must report whether it is eligible to remain registered. Revisions to Item 2 of Part 1A of Form ADV reflect the new $100 million floor and will require each adviser to state that it is eligible to register with the SEC because it has $100 million or more in assets under management, or $90 million or more if the adviser is already registered with the SEC or has its principal office and place of business outside the United States or in Minnesota, New York or Wyoming (which either do not regulate advisers or do not perform inspections of state-registered advisers). The limitations on mid-size investment advisers registering with the SEC does not go into effect until January 1, 2012 and mid-sized advisers registered with the SEC as of July 21, 2011 that are prohibited from remaining registered with the SEC must withdraw their registrations between January 1, 2012 and June 28, 2012.

Section 203A(a)(2) of the Advisers Act prohibits mid-sized advisers from registering with the SEC if: (i) the adviser is required to be registered as an investment adviser with the securities commissioner (or any agency or office performing like functions) of the state in which it maintains its principal office and place of business and (ii) if registered, the adviser would be subject to examination as an investment adviser by such commissioner, agency, or office. The SEC has determined that advisers registered in Minnesota, New York and Wyoming are not subject to such requirements. Accordingly, all New York based advisers (unless there is another applicable exemption) will be required to register with the SEC if they have at least $25 million in assets under management.

Amendments to Form ADV

The final rules amend Form ADV to require advisers to provide the SEC with additional information about their business and the private funds they advise.

In response to numerous comments, the SEC eliminated the reporting of certain proprietary information regarding private funds that had been included in the proposal. However, an adviser is still required to provide, with respect to each such private fund that it advises, information regarding:

- ???the organization of the fund;

- the fund's regulatory status (*i.e.*, exemption from registration under the ICA and Securities Act);
- the name of the fund;
- gross assets;
- the type of investment strategy employed;
- the number of beneficial owners; and
- information concerning auditors, prime brokers, custodians, administrators, and marketers.

Conclusion

Clients of Proskauer should contact their assigned lawyer at the firm to discuss the implications of these new rules or any of these matters.

Related Professionals

- **Bruce L. Lieb**
- **Amanda H. Nussbaum**
  Partner
- **Scott S. Jones**
  Partner
- **Charles (Chip) Parsons**
  Partner
- **Jamiel E. Poindexter**
  Partner
- **Marc A. Persily**
  Partner
- **Ira G. Bogner**
  Managing Partner
- **Sarah K. Cherry**
  Partner
- **Stephen T. Mears**
  Partner

???Arnold P. May

Partner

???Mary B. Kuusisto

Partner

???Malcolm B. Nicholls III

Partner

???David W. Tegeler

???Howard J. Beber

Partner

???Robin A. Painter