INSIGHTS

THE CORPORATE & SECURITIES LAW ADVISOR

ASPEN PUBLISHERS Volume 25 Number 1, January 2011

INVESTMENT MANAGEMENT

SEC Implements Advisers Act Provisions of Dodd-Frank Act

Recently proposed SEC rules would implement the provisions of the Dodd-Frank Act that address the registration and reporting requirements under the Investment Advisers Act for several categories of investment managers, including those that advise private equity funds.

By Kenneth Muller and Seth Chertok

On November 19, 2010, the SEC proposed two releases that implement different aspects of the "Dodd-Frank Wall Street Reform and Consumer Protection Act" (Dodd-Frank Act) applicable to investment advisers. The first release (Implementing Release)[1] for the most part concerns the mechanics of investment advisers registering and reporting following the Dodd-Frank Act. The second release (Exemptions Release)[2] implements new exemptions from the registration requirements of the Investment Advisers Act of 1940 (Advisers Act). The new exemptions generally can be relied upon by investment advisers who are no longer able to rely upon the fewer than 15 client exemption in Section 203(b)(3) of the Advisers Act and who have assets under management in excess of the applicable floor following the enactment of the Dodd-Frank Act.

Kenneth Muller is a partner, and Seth Chertok is a senior associate, at Morrison & Foerster LLP in San Francisco, CA.

The Rules Implementing Amendments to the Advisers Act

Eligibility for Federal Registration of Investment Advisers

The Dodd-Frank Act generally defines a covered mid-sized investment adviser as an investment adviser with between \$25 and \$100 million in assets under management, and that is subject to registration and examinations as an investment adviser with the state in which it maintains its principal office and place of business.[3] Following the enactment of the Dodd-Frank Act, new Section 203A(a)(2) of the Advisers Act provides that no covered mid-sized investment adviser shall register federally unless: (1) the adviser advises a registered investment company; (2) the investment adviser advises an electing "business development company"; or (3) the adviser is required to register with 15 or more states. As a result of the Dodd-Frank Act, private equity mid-sized investment advisers that desire federal registration will have to structure their investment operations so that they would be required to register with 15 or more states, or advise only business development companies (BDCs). Alternatively, it would be possible for private equity mid-sized investment advisers to register federally if the investment adviser were not subject to registration and examinations in the state where it maintains its principal office and place of business.

The above changes will frequently raise the federal floor for registration to $100 million, which generally bars smaller and mid-sized investment advisers from choosing federal registration over state registration. It will relieve some of the federal congestion that would have resulted from the narrowing of several Advisers Act exceptions in the Dodd-Frank Act, including, without limitation, the most commonly relied upon exemption in Section 203(b)(3) of the Advisers Act, which is the private advisers exemption for investment advisers that advise fewer than 15 clients. The SEC noted that as a consequence of Section 410 of the Dodd-Frank Act, the SEC estimated that approximately 4,100 SEC-registered advisers will be required to withdraw their registrations and register with one or more state securities authorities.[4]

Transition to State Registration

The SEC proposed Rule 203A-5, which would require each investment adviser registered with the SEC on July 21, 2011, to file an amendment to its Form ADV no later than August 20, 2011, and to report the market value of its assets under management determined within 30 days prior to the filing.[5] The SEC noted that if an adviser failed to file this amendment, it would cancel the adviser's registration.

An adviser registered with the SEC on July 21, 2011, but no longer eligible for Commission registration as a result of being a covered mid-sized investment adviser, unless exempt from the prohibition on registration by virtue of Rule 203A-2, would have to withdraw its registration by filing Form ADV-W no later than October 19, 2011 (60 days after the required refiling of Form ADV).[6] By the end of that 60 day period, the withdrawing investment adviser would have to register in the states and arrange for its associated persons to qualify for investment adviser representative registration. Some investment advisers may believe that the 90 day grace period (the 30 day plus the 60 day period) is too short, as it contrasts with the 180 day period in the SEC's current rule that applies to SEC registered advisers switching to state registration.[7]

Definition of "Assets Under Management"

The concept of "assets under management" has a significant impact on whether an investment adviser must register federally or with the states. The concept of "assets under management," in particular, is relevant to determining whether the applicable floor for federal registration is met as well as to determining whether the new private funds exemption in Section 203(m) is available.[8] The term "assets under management" additionally appears in Section 202(a)(30) of the Advisers Act, which defines a "foreign private adviser," in part, as having "assets under management" attributable to U.S. clients and private fund investors of less than $25 million.

Section 203A(a)(2) of the Advisers Act currently defines "assets under management" as the "securities portfolios" with respect to which an adviser provides "continuous and regular supervisory or management services." In the Implementing Release, the SEC proposed a uniform calculation of "assets under management" that can be used for all purposes under the Advisers Act. The SEC also intended to eliminate the choices in the calculation of "assets under management" that currently exist in Item 5(b) of the instructions to Part 1A of Form ADV, to create more consistency and to make sure that assets that potentially generated systemic risk were included in the calculation.

In order to achieve consistency, the SEC would require an adviser to include in its assets under management the value of any "securities portfolios" (including private funds) over which the adviser exercises continuous and regular supervisory or management services as of the date of filing the Form ADV, regardless of whether these assets are family or proprietary assets, accounts managed without receiving compensation, or assets of clients who are not U.S. persons, all of which an adviser currently may (but is not required to) exclude.[9] For “private funds,” an adviser would include in the calculation of regulatory assets under management all the assets of the private fund, including the amount of any uncalled capital commitments made to the fund.[10] Note that the proposed rule is not clear about whether all assets of exempt funds other than “private funds” would be included. Proposed item 5.F directs the adviser to exclude the portion of an account (a) under management by another person; or (b) that consists or real estate or businesses whose operations the adviser manages on behalf of a client but not as an investment.[11] The SEC would not allow an adviser to subtract outstanding indebtedness and other accrued but unpaid liabilities from assets under management, since they remain in a client’s account and are managed by the adviser.[12]

The SEC proposed to modify the valuation instructions to add an instruction that requires advisers to use the fair value of private fund assets.[13] The SEC would not require such fair value calculation to be made in accordance with GAAP.[14] It appears that by fair value, the SEC would mean market value, since Instruction 5.b.(4) of the Instructions for Part 1A requires the calculation to be based on market value. That instruction notes that the adviser would determine market value using the same method it used to report account values to clients or to calculate fees for advisory services. The SEC also noted that it would permit the general partner to calculate market value,[15] but even while this would be permitted for purposes of calculating assets under management, we think it could potentially give rise to a conflict of interest.

It should be noted that the above calculation of “assets under management” generally tends to include potential assets in “assets under management.” Many private equity fund advisers may actually find this type of calculation to be advantageous, since it will generally more easily allow private equity fund advisers to reach the applicable floor required for federal registration, which will allow such advisers to avoid the complexities of state regulation. However, “foreign private advisers” seeking to rely upon new Section 203(b)(3) may find this type of calculation burdensome.

Registered advisers would only need to update assets under management on Form ADV annually, although the proposed Exemptions Release discussed in Part II notes how for purposes of the “private funds” exemption in Section 203(m), the adviser would need to calculate assets under management on a quarterly basis.

Switching Between Federal and State Registration

Rule 203A-1(b) provides the framework for investment advisers with fluctuating assets that may have to switch between federal and state registration.

Rule 203A-1(b)(1) currently provides that if an investment adviser is registered with a state securities authority, it must apply for registration with the Commission within 90 days of filing an annual updating amendment to its Form ADV reporting that it has at least $ 30 million of assets under management. Proposed Rule 203A-1(a) would provide that if the investment adviser is registered with a state securities authority, it must apply for registration with the Commission within 90 days of filing an annual updating amendment to its Form ADV reporting that it is eligible for SEC registration and is not relying on an exemption from registration under Sections 203(l) (the new venture capital exemption) or 203(m) (the new private funds exemption) of the Advisers Act.

It is unclear why the rule suggests that an adviser eligible for federal registration would have to apply for federal registration in the event it relied on an exemption other than Section 203(l) (the new venture capital exemption) or Section 203(m) (the new private funds exemption). For example, an adviser that relied upon the new SBIA exemption in Section 203(b)(7) presumably should not have to register federally. Another problem with the proposed rule is that switching should be triggered not when the adviser is eligible to register federally, but when the adviser is required to register federally. This is because the floor for non-covered mid-sized investment advisers remains at $25 million under Section 203A, while registration for such advisers would only be required under Rule 203A-1 at $30 million. Thus, the rule should be potentially changed to require that switching will occur when the adviser must register federally and when the adviser is unable to rely upon any exemptions.

Rule 203A-1(b)(2) currently provides that if an investment adviser is registered with the Commission and files an annual updating amendment to its Form ADV reporting that it no longer has $25 million of assets under management (or is not otherwise eligible for SEC registration), it must file Form ADV-W (17 C.F.R. 279.2) to withdraw its SEC registration within 180 days of its fiscal year end (unless it then has at least $25 million of assets under management or is otherwise eligible for SEC registration). Proposed Rule 203A-1(b) would provide that if the investment adviser is registered with the Commission and files an annual updating amendment to its Form ADV reporting that it is not eligible for SEC registration and is not relying on an exemption from registration under Section 203(l) (the new venture capital exemption) or Section 203(m) (the new private funds exemption) of the Advisers Act, it must file Form ADV-W to withdraw its SEC registration within 180 days of its fiscal year end (unless it then is eligible for SEC registration). Note that it is probably not necessary to include in the rule that the adviser not be relying upon Section 203(l) or Section 203(m), since, to the extent an adviser was ineligible for federal registration, it is difficult to fathom why it would need to rely upon an exemption.

Exemptions with Respect to Prohibited Registrations

The SEC previously adopted six exemptions from the prohibition on registration in Rule 203A-2, permitting certain types of advisers to register with the Commission if they meet certain conditions. The SEC proposed to amend three of the exemptions in Rule 203A-2 to reflect recent developments since their adoption, including the enactment of the Dodd-Frank Act.

First, the SEC proposed to delete the exemption for nationally recognized statistical rating organizations (NRSROs), since there is currently only one Advisers Act registered NRSRO and it has more than $100 million in assets under management. Note that Congress has provided for a separate regulatory regime for NRSROs under the Securities Exchange Act of 1934 (Exchange Act).

Second, the SEC proposed to change the exemption for pension consultants. Currently, this exemption applies to investment advisers that are "pension consultants" with respect to assets of plans having an aggregate value of at least $50 million. The SEC proposed to increase the minimum value of plan assets from $50 million to $200 million.[16] Essentially, the SEC proposed to retain the same proportion with respect to the new $100 million floor as previously existed with respect to the $25 million floor.

Third, the SEC proposed to change the multistate adviser exemption. Under Rule 203A-2(e), the prohibition on registration with the Commission does not apply to an investment adviser that is required to register in 30 or more states. The SEC proposed to amend Rule 203A-2(e) to permit all investment advisers required to register as an investment adviser with 15 or more states to register with the Commission if its conditions are met.[17] This provision will particularly benefit smaller investment advisers with interstate operations that seek to avoid the complexities of a myriad of state regulations. The case of mid-sized investment advisers with similar operations is already addressed by new Section 203A(a)(2), which, as discussed above, already provides that mid-sized investment advisers can register with the SEC if they are required to register with 15 or more states.

Elimination of Safe Harbor

Rule 203A-4 currently provides a safe harbor that protects against enforcement actions in connection with SEC registration for an investment adviser that is registered with the state securities authority of the state in which it has its principal office and place of business, based on a reasonable belief that it is prohibited from registering with the Commission because it does not have sufficient assets under management. The SEC has proposed completely eliminating this exemption due to the fact that the Dodd-Frank Act generally requires a higher threshold for registration under the theory that advisers would be more likely to be aware of crossing these higher thresholds. This logic probably does not apply in the case of non-covered mid-sized investment advisers within the meaning of Section 203A(a)(2), since, with respect to non-covered mid-sized investment advisers, the Dodd-Frank Act generally retains the old $25 million floor for federal registration.

Mid-Sized Investment Advisers

As discussed above, new Section 203A(a)(2) of the Advisers Act will generally prohibit (subject to certain exceptions) covered mid-sized advisers (defined above) from registering with the SEC. The SEC proposed changes to Form ADV to require a mid-sized adviser filing with the SEC to affirm, upon application and annually thereafter, that it is not required to be registered as an adviser with the state securities authority in the state where it maintains its principal office and place of business.[18] The SEC also stated that it would identify for advisers the states in which the securities commissioner did not certify that advisers are subject to examination.

Reports by "Exempt Reporting Advisers"

The Dodd-Frank Act provides that the SEC will require investment advisers meeting the conditions for the venture capital or the private fund exemptions (Exempt Reporting Advisers) to submit to certain record keeping and reporting requirements.

Reporting Through Form ADV. Proposed Rule 204-4 would require Exempt Reporting Advisers to file reports with the Commission electronically on Form ADV.[19] The reports filed by Exempt Reporting Advisers would be publicly available on the SEC's website. Investment advisers may object to such public disclosure, although confidentiality concerns are mitigated by the fact that the SEC would only use sub-sets of items currently required by Form ADV. Such disclosure may be more limited than what would be required under applicable state law. The SEC also noted that advisers could easily transition from Exempt Reporting Advisers to applying for registration simply by amending Form ADV.

Information in reports. The SEC proposed several amendments to Form ADV to facilitate filings by Exempt Reporting Advisers. Among other proposals, the SEC proposed to require Exempt Reporting Advisers to complete only 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). In addition, Exempt Reporting Advisers would have to complete corresponding sections of Schedules A, B, C, and D. The SEC would not require Exempt Reporting Advisers to complete and file with the SEC other Items in Part 1A or prepare a client brochure (Part 2). Note that these investment advisers will usually have to prepare the client brochure under state law regardless of whether the SEC requires it. The SEC noted that the items that it has proposed would provide the

SEC with information as to whether these advisers or their activities might present sufficient concerns as to warrant the SEC's further attention in order to protect their clients, investors and other market participants.

Updating requirements. The SEC proposed to amend Rule 204-1 to propose the same updating requirements for Exempt Reporting Advisers with respect to Form ADV as are applicable to registered advisers. The SEC also proposed to require an Exempt Reporting Adviser to file an amendment to its Form ADV when it ceases to be an Exempt Reporting Adviser.[20] The SEC noted that an Exempt Reporting Adviser that had to register would file an amendment on Form ADV simultaneously indicating that the filing will be its final "report" on Form ADV and applying for registration with the SEC.

Transition. The SEC proposed requiring each Exempt Reporting Adviser to file its initial report with the SEC on Form ADV no later than August 20, 2011, 30 days after the July 21, 2011, effective date of the Dodd-Frank Act.

Form ADV

The SEC noted the importance of Form ADV, which the SEC uses to efficiently allocate its examination resources based on the risks it discerns or the identification of common business activities from information provided by advisers. To enhance its ability to oversee investment advisers, the SEC proposed to rquire advisers to provide it with additional information about certain areas of their operations, such as information about the private funds they advise, their advisory business, their conflicts of interest and their non-advisory activities and financial industry affiliations. The SEC also proposed certain additional changes intended to improve its ability to assess compliance risks and also to identify advisers that are subject to the Dodd-Frank Act's requirements concerning certain incentive-based compensation arrangements.[21]

Private Fund Reporting: Item 7.B

Currently, Item 7 requires each adviser to complete Section 7.B of Schedule D for any investment-related limited partnership that the adviser or a related person advises. The SEC proposed to expand the information it required advisers to provide the SEC about the private funds they advise.

The SEC proposed to modify the scope of Item 7 by requiring completion of Section 7.B only about "private funds," rather than only about limited partnerships that they advise. The SEC stated that it would no longer require an adviser to report to it funds that are advised by affiliates. Note that real estate funds relying upon Section 3(c)(5)(C) of the Investment Company Act and investment companies not relying upon Section 3(c)(1) or Section 3(c)(7) would not fall within the definition of "private funds" and therefore would not be subjected to such expanded information requirements.

The SEC proposed certain exceptions that permit an investment adviser not to have to complete Section 7.B with respect to certain private funds that it advises, which could potentially apply with respect to sub-advisers, master-feeder structures and advisers with a principal office and place of business outside the U.S. operating foreign funds that are not organized in the U.S. and are not offered to "U.S. persons."

Furthermore the SEC proposed a new Section 7.B.1 for private fund reporting that would expand on the identifying information currently required to be reported in order to provide the SEC with basic organizational, operational and investment characteristics of the fund; the amount of assets held by the fund; the nature of the investors in the fund; and the fund's service providers. The SEC stated that it believed that such information will help the SEC identify potential compliance risks and inform its regulatory activities.

Investment advisers may object to the proposed requirement that the adviser break down the assets and liabilities held by the fund by class and categorization in the fair value hierarchy established by U.S. GAAP, as this could communicate proprietary portfolio characteristics to other advisers. Note how this differs from the discussion of the calculation of "assets under management," which did not require GAAP.

Advisory Business Information: Employees, Clients, and Advisory Activities: Item 5

Item 5 of Part 1A requires an adviser to provide basic information regarding the business of the adviser that allows the SEC to identify the scope of the adviser's business, the types of services it provides, and the types of clients to whom it provides those services. The SEC proposed to modify Item 5 to enable it to better understand the operations of advisers. First, the SEC proposed to seek additional information about the adviser's employees. Second, the SEC proposed to add some questions to help it better understand an adviser's business by reference to the types of clients the adviser services. Third, the SEC proposed to expand the list of advisory activities that an adviser provides to include portfolio management for pooled investment vehicles and educational seminars or workshops. The SEC also proposed new Item 5.J. that would require advisers to select from a list the types of investments about which they provided advice during the fiscal year for which they are reporting. These changes would provide the SEC with more details regarding the services an adviser provides.

Other Business Activities and Financial Industry Affiliations: Items 6 and 7

Items 6 and 7 of Part 1A require advisers to report those financial services the adviser or a related person is actively engaged in providing from lists of financial services set forth in the items. The SEC proposed several changes to these Items that would provide it with a more complete picture of the activities of an adviser and its related persons, which would allow the SEC to assess the conflicts of interest and risks that may be created by those relationships and to identify affiliated financial service businesses.

Participation in Client Transactions: Item 8

Item 8 requires an adviser to report information about its transactions, if any, with clients, including whether the adviser or a related person engages in transactions with clients as a principal, sells securities to clients, or has discretionary authority over client assets. This item also currently requires an adviser to indicate if it has discretionary authority to determine the brokers or dealers for client transactions and if it recommends brokers or dealers to clients. The SEC proposed to further ask whether any of the brokers or dealers are related persons of the adviser.[22] An adviser that indicates that it receives "soft dollar benefits" would also report whether all those benefits qualify for the safe harbor under Section 28(e) of the Exchange Act for eligible research or brokerage services.[23] Finally, the SEC would add a new question requiring an adviser to indicate whether it or its related person *receives* direct or indirect compensation for client referrals to complement the existing question concerning whether the adviser compensates any person for client referrals.[24] The SEC stated that the amendments the SEC proposed would enhance its ability to identify additional conflicts of interest that advisers may face that the SEC has identified through its experience administering the Advisers Act.

Reporting $1 Billion in Assets: Item 1

Section 956 of the Dodd-Frank Act requires the SEC, jointly with certain other federal regulators, to adopt rules or guidelines addressing certain excessive incentive-based compensation arrangements, including those of investment advisers with $1 billion or more in assets. To enable the SEC to identify those advisers that would be subject to Section 956, the SEC proposed to require each adviser to indicate in Item 1 whether or not the adviser had $1 billion or more in assets as of the last day of the adviser's most recent fiscal year.[25] The SEC proposed that for purposes of this reporting requirement, the amount of assets would be the adviser's total assets determined in the same manner as the amount of "total assets" is determined on the adviser's balance sheet for its most recent fiscal year end.[26] The SEC did not address whether affiliates of adviser would be counted for these purposes.

Amendments to Form ADV Not Related to the Dodd-Frank Act

The proposed amendments also include a number of additional changes unrelated to the Dodd-Frank Act that are intended to improve the SEC's ability to assess compliance risks. First, the SEC proposed changes to improve certain identifying information it obtained from other items of Part 1A of Form ADV. For example, the SEC proposed to amend Item 1 to require an adviser to provide contact information for its chief compliance officer. In addition, the SEC proposed amending Item 1 to require an adviser to indicate whether it or any of its control persons is a public reporting company under the Exchange Act, thereby providing a signal that there is additional public information available. Second, the SEC proposed to add an additional custody question to Item 9 to require advisers 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 in order to provide a more complete picture of an adviser's custodial practices.[27] Finally, the SEC proposed certain technical changes with respect to the reporting of disciplinary events.

Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers, and Foreign Private Advisers

Exemptions Under the Dodd-Frank Act

Prior to the enactment of the Dodd-Frank Act, Section 203(b)(3) exempted investment advisers who during the course of the preceding twelve months had fewer than 15 clients and who did not hold themselves out to the public as investment advisers, and who also did neither act as an investment adviser to any registered investment company registered, nor to a company which has elected to be a "business development company."

The Dodd-Frank Act struck Section 203(b)(3) in its entirety and replaced it with a provision that provides that the Advisers Act will not apply to "any investment adviser that is a foreign private adviser."[28] The revisions to Section 203(b)(3) closed the Advisers Act exemption most frequently relied upon by investment advisers, except with respect to "foreign private advisers."

However, while the Dodd-Frank Act narrowed Section 203(b)(3), it created several new Advisers Act exemptions, including, without limitation, Section 203(l) (the venture capital exemption) and Section 203(m) (the private funds exemption). Section 203(l) provides that "no investment adviser that acts as an investment adviser solely to 1 or more venture capital funds shall be subject to the registration requirements of this title with respect to the provision of investment advice relating to a venture capital fund."[29] Section 203(m) provides that the SEC shall provide an exemption from the registration requirements to any investment adviser of "private funds," if each of such investment adviser acts solely as an adviser to private funds and has assets under management in the United States of less than $150 million.[30] The SEC proposed rules that would implement these new exemptions.

Definition of "Venture Capital Fund"

The SEC proposed a definition of "venture capital fund" for purposes of the new exemption for investment advisers that advise solely venture capital funds in Section 203(l). The SEC stated that its general view of a venture capital was an unleveraged long-term investor fund in early-stage or small companies that are privately held, as distinguished from other types of private equity funds, which may invest in businesses at various stages of development including mature, publicly held companies. In drafting the venture capital exemption rules, the SEC sought to give effect to this general understanding of venture capital funds.

The SEC proposed to define a venture capital fund as a private fund that:

(1) invests solely in equity securities of qualifying portfolio companies and at least 80 percent of each company's securities owned by the fund were acquired directly from the qualifying portfolio company,[31] cash (and cash equivalents) and U.S. Treasuries with a remaining maturity of 60 days or less;
(2) directly, or through its investment advisers, offers or provides significant managerial assistance to, or controls, the qualifying portfolio company;
(3) does 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, and any such borrowing, indebtedness, guarantee or leverage is for a non-renewable term of no longer than 120 calendar days;
(4) does not offer its investors securities with redemption or other similar liquidity rights except in extraordinary circumstances (but the fund may entitle holders to receive distributions made to all holders pro rata);
(5) represents itself as a venture capital fund to investors;[32] and
(6) is not registered under the Investment Company Act and has not elected to be treated as a BDC.

The SEC noted that the above 80 percent threshold in (1) above was designed to allow for angel investors who may seek liquidity from their investment. The 80 percent threshold also gives some latitude to obtain favorable tax treatment with respect to directly acquired equity securities of issuers that, among other things, devote at least 80 percent of their assets to the conduct of their business as specified in IRC Section 1202.

Note that venture capital funds could potentially satisfy (2) above by either providing managerial assistance or exercising control. Under Section 202(a)(12) of the Advisers Act, "control" is defined to mean "the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of an official position with such company." Control could be established, for example, through voting rights. The fact that control is included in the definition of managerial assistance means that venture capital funds will not have to actively offer assistance to operating companies, and in certain cases, venture capital funds without the resources to assist operating companies could find relief. Note that venture capital funds that invest as a group would each have to offer managerial assistance or have control in order to qualify as a venture capital fund.

The term "extraordinary circumstances" in (4) above is not defined, but the SEC suggested that it could include extraordinary rights for an investor to withdraw from the fund under foreseeable but unexpected circumstances, such as, for example, an owner's death or disability, a merger or reorganization of the fund, ERISA reasons or a key person provision trigger, or rights to be excluded from particular investments due to regulatory or other legal requirements. Future no-action guidance will determine the precise scope of "extraordinary circumstances," but a general definition is preferable in order to provide flexibility.

The SEC also proposed to grandfather an existing private fund as a venture capital fund if it satisfies certain criteria under the grandfathering provision in Proposed Rule 203(l)-1(b): (1) the fund represented to investors and potential investors at the time the fund offered its securities that it is a venture capital fund; (2) the fund has sold securities to one or more investors that are not related persons of any investment adviser of the fund prior to December 31, 2010; and (3) the fund does not sell any securities to, including accepting any additional capital commitments from, any person after July 21, 2011. The SEC stated that the grandfathering provision would include any fund that has accepted capital commitments by the specified dates even if none of the commitments has been called. The SEC noted that it did not expect funds identifying themselves as "private equity" or "hedge" to be able to rely on the grandfathering exemption.

The SEC noted that it believed that its definition of venture capital funds captured funds with a comparatively small amount of aggregate assets under management, thereby not raising systemic risk concerns.

Finally, the SEC noted that it was unclear under the Dodd-Frank Act to what extent Section 203(l) should apply to advisers that operate principally outside of the United States but that invest in U.S. companies or solicit U.S. investors. The SEC stated that Section 203(l) would clearly apply if all of the clients of the non-U.S. adviser were venture capital funds. However, the SEC requested comment on whether an adviser with its principal office and place of business outside the U.S. that advised foreign funds that were non-U.S. person clients that did not qualify as venture capital funds could still rely upon the venture capital exemption with respect to U.S. venture capital funds that it advised. At a minimum, we think that the SEC should not count foreign funds with no U.S. investors, which would parallel the revised counting mechanism under the amended Section 203(b)(3) following the enactment of the Dodd-Frank Act.

Qualifying Portfolio Companies

The SEC defined "qualifying portfolio companies" as any company that: (1) at the time of any investment by the private fund, is not publicly traded and does not control, is not controlled by or under common control with another company, directly or indirectly, that is publicly traded; (2) does not borrow or issue debt obligations, directly or indirectly, in connection with the private fund's investment in such company; (3) uses the capital provided by the fund for operating or business expansion purposes rather than to buy out other investors;[33] and (4) is not itself an investment company, a private fund, an issuer that would be an investment company but for the exemption provided by Rule 3a-7 of the Investment Company Act or a commodity pool.[34] Note that the definition of "qualifying portfolio companies" would likely not allow investments in venture capital fund of funds.

With regard to (1) above, a venture capital fund could continue to hold securities of a portfolio company that subsequently becomes public. The reasoning behind this is that venture capital funds traditionally may exit their investments in the public markets once the portfolio company has matured. Although the public markets may involve some level of systemic risk, the SEC noted that venture capital funds managed significantly less assets than hedge funds, thereby diminishing the possibility for systemic risk as they exit mature investments.

It should also be noted that (2) above would only exclude companies that borrow in connection with a venture capital fund's investment, but would not exclude companies that borrow in the ordinary course of their business (*e.g.*, to finance inventory or capital equipment, manage cash flows, and meet payroll). The SEC stated that it would generally view, without limitation, any financing or loan (unless it met the definition of equity security) to a 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 investments as being a type of financing that is "in connection with" the fund's investment.

The intent of (4) above is designed to make sure that a qualifying portfolio company is in fact an operating company, rather than an intermediate fund. The definition of fund in (4), however, does not capture every type of fund.

Finally, investment advisers will probably find it advantageous that the SEC proposed not to require that qualifying portfolio companies be early-stage or small companies, which likely will expand the types of companies that will fit within the definition of qualifying portfolio companies.

Equity Securities

"Equity securities" would be defined in the same manner as in Section 3(a)(11) of the Exchange Act. This definition is broad, and includes common stock as well as preferred stock, warrants, and other securities convertible into common stock in addition to limited partnership interests. The proposed definition would not generally include investments in debt unless they met the definition of "equity security." The SEC's belief was that venture capital funds typically invest in equity, rather than debt.

As proposed, equity securities would generally not include bridge loans. Venture capital funds typically make bridge loans in anticipation of a future round of venture capital investment. Note that to the extent the venture capital fund receives equity securities in exchange for the bridge loan, such as preferred equity or convertible equity, the definition of equity securities would be satisfied.

Private Funds

The SEC proposed to require that exempt venture capital funds be "private funds," which is defined by the Dodd-Frank Act as investment funds that would be an investment company but for the exemptions in Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act of 1940.[35] Note that the "private fund" requirement could preclude real estate funds relying upon Section 3(c)(5)(C) and other exempt investment companies not relying upon Section 3(c)(1) or Section 3(c)(7) under the Investment Company Act from fitting within the definition of venture capital fund.

Proposed new Rule 203(m)-1 would provide for the private funds exemption created by new Section 203(m) of the Advisers Act. It would limit an adviser relying on the exemption to advising "private funds" with aggregate assets of less than $150 million.[36] Proposed Rule 203(m)-1 would require advisers to calculate the value of private fund assets by reference to Form ADV (discussed above in Part I).[37] Under proposed Rule 203(m)-1, each adviser relying upon Section 203(m) 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.[38] As a result, interim fluctuations between quarters would not affect the availability of proposed Rule 203(m)-1.

Under proposed Rule 203(m)-1, all of the private fund assets of an adviser with a principal office and place of business in the United States would be included within the $150 million threshold, even if the adviser has offices outside of the United States.[39] For most advisers, this approach would avoid difficult attribution determinations. In addition, such advisers would be required to act as an investment adviser solely to one or more "qualifying private funds." "Qualifying private fund" would mean any private fund that is not registered under Section 8 of the Investment Company Act and has not elected to be treated as a BDC pursuant to Section 54 thereof.

An adviser with its principal office and place of business outside the U.S., however, would need only count private fund assets it manages from a place of business in the United States toward the $150 million asset limit under the exemption.[40] An adviser with its principal office and place of business outside the United States could not rely on the exemption if it advised any client that is a United States person other than a "qualifying private fund."[41] 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.[42] The SEC proposed to define a "United States person" generally by incorporating the definition of a "U.S. person" in Regulation S promulgated under the Securities Act.[43] Under the proposed rule, an adviser must treat a discretionary or other fiduciary account held by a dealer or other professional fiduciary as a United States person if the account is held for the benefit of a United States person by a non-U.S. dealer or professional fiduciary who is a related person of the adviser. Unless the adviser solely advised qualifying private funds, an adviser could therefore not rely on Rule 203(m)-1 if it established discretionary accounts for the benefit of U.S. clients with an offshore affiliate that would then delegate the actual management of the account back to the adviser. This result may be a drafting mistake as the SEC may have intended to prohibit this type of arrangement even if the adviser advises solely qualifying private funds.

The SEC proposed to include in proposed Rule 203(m)-1 a provision giving an adviser one calendar quarter to register with the Commission after becoming ineligible to rely on the private funds exemption due to an increase in the value of its private fund assets.[44] It would be available only to an adviser that has complied with all applicable Commission reporting requirements.[45]

Foreign Private Advisers

Section 403 of the Dodd-Frank Act replaces the old private adviser exemption from registration in Section 203(b)(3) under the Advisers Act with a new exemption that can be used only by "foreign private advisers," as defined in new Section 202(a)(30). The new exemption is codified as new Section 203(b)(3) of the Advisers Act. The new exemption provides that a "foreign private adviser" will require, among other things, that the investment adviser have, in total, fewer than 15 clients and investors in the United States in private funds advised by the investment adviser.

For purposes of the definition of "foreign private adviser," proposed Rule 202(a)(30)-1 would generally include the safe harbor for counting clients currently in Rule 203(b)(3)-1, as modified to account for its use in the foreign private adviser context, but would eliminate a provision allowing advisers not to count those clients from which they receive no compensation. The SEC proposed to add a provision that would avoid double-counting private funds and their investors by advisers.

The SEC proposed generally to define "investor" in a private fund 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 that Act.[46] 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 investment adviser.[47] In addition, under the proposed rule, holders of both equity and debt securities could be counted as investors.

The definition of investor would be read in conjunction with Section 208(d) of the Advisers Act, which prohibits doing indirectly what cannot be done directly. Thus, an adviser relying on the exemption would have to count as an investor a person who is not the nominal owner of a private fund's securities. For example, the adviser to a master fund in a master-feeder arrangement would have to treat as investors the holders of the securities of any feeder fund formed or operated for the purpose of investing in the master fund rather than the feeder funds, which act as conduits. In addition, an adviser would need to count as an investor any holder of an instrument, such as a total return swap, that effectively transfers the risk of investing in the private fund from the record owner of the private fund's securities.

The SEC also proposed 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; and (ii) beneficial owners 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), and knowledgeable employees are not required to be qualified purchasers under Section 3(c)(7).

The definition of "foreign private adviser" utilizes the term "in the United States" in several contexts. For example, it requires that the adviser not have a place of business in the United States. It requires that the adviser have fewer than 15 clients and investors in the United States in private funds advised by the investment adviser. It also requires that the adviser have aggregate assets under management attributable to clients in the United States and investors in the United States in private funds advised by the investment adviser of less than $25 million. Furthermore, it requires that an adviser not hold itself out generally to the public in the United States as an investment adviser.

The SEC would define "in the United States" in proposed Rule 202(a)(30)-1(c)(2) to mean: (1) with respect to any place of business located "in the United States," as that term is defined in Regulation S; (2) with respect to any client or investor in the United States, any person that is a "U.S. person" as defined in Regulation S, except that any discretionary account or similar account that is held for the benefit of a person "in the United States" by a non-U.S. dealer or other professional fiduciary is deemed "in the United States" if the dealer or professional fiduciary is a related person of the investment adviser relying on the exemption; and (3) with respect to the public in the "United States," as that term is defined in Regulation S. In addition, the SEC proposed to add a note to paragraph (c)(2)(i) specifying that for purposes of that definition, 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.

Proposed Rule 203(a)(30)-1, by reference to proposed Rule 222-1, defines "place of business" to mean 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.

Subadvisory Relationships

The SEC generally interprets advisers as including subadvisers and therefore believes it is appropriate to permit subadvisers to rely on each of the new exemptions, provided that subadvisers satisfy all terms and conditions of the applicable proposed rules.

Advisory Affiliates

The SEC requested comment on whether any proposed rule should provide that an adviser must take into account the activities of its advisory affiliates when determining eligibility for an exemption. Note that if the SEC does not address this issue explicitly, there is a risk that Section 208(d) under the Advisers Act, which prohibits doing indirectly what cannot be done directly, could interfere with an adviser's ability to use the new exemptions when their affiliates do not qualify for them.

Ability to Combine Exemptions

Section 203(l) (the venture capital exemption) and Section 203(m) (the private funds exemption) each provide that they will only apply if the investment adviser advises solely that type of fund. We think that the SEC will need to consider whether hybrid exemptions could be combined so that, for example, an investment adviser could simultaneously rely upon the venture capital exemption and the private funds exemption.

NOTES

1. Release No. IA-3110, Rules Implementing Amendments to the Investment Advisers Act of 1940.
2. Release No. IA-3111, Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less than $150 Million in Assets under Management and Foreign Private Advisers.
3. Dodd-Frank Act, Section 203A(a)(2)(B).
4. *See* Rules Implementing Amendments to the Investment Advisers Act of 1940, Release No. IA-3110.
5. Proposed Rule 203A-5(a).
6. Proposed Rule 203A-5(b).
7. Rule 203A-1(b)(2).
8. Many investment advisers falling above the applicable floor for federal registration with a choice between an Advisers Act exemption and state registration and regulation may in fact prefer federal registration under the Advisers Act due to the fact that it can be administratively more efficient.
9. Proposed Form ADV: Instructions for Part 1A, instr. 5.b.(1).
10. *Id*.
11. Proposed Form ADV: Instructions for Part 1A, instr. 5.b.(2).
12. Proposed Form ADV: Instructions for Part 1A, instr. 5.b.(2).
13. *See* proposed Form ADV: Instructions for Part 1A, instr. 5.b.(4).
14. Release No. IA-3110, Rules Implementing Amendments to the Investment Advisers Act of 1940.
15. Release No. IA-3110, Rules Implementing Amendments to the Investment Advisers Act of 1940, fn. 55.
16. Proposed Rule 203A-2(a).
17. Proposed Rule 203A-2(d)(1).
18. *See* proposed Form ADV, Part 1A, Item 2.A.(2)(a).
19. Proposed Rule 204-4(a).
20. Proposed Rule 204-4(f).
21. Dodd-Frank Act, Section 956.
22. Proposed Form ADV, Part 1A. Items 8.F.
23. Proposed Form ADV, Part 1A, Item 8.G.(2).
24. Proposed Form ADV, Part 1A, Item 8.I.
25. Proposed Form ADV, Part 1A. Item 1.O.
26. Proposed Form ADV: Instructions for Part 1A, instr. 1.b.
27. Proposed Form ADV, Part 1A, Item 9.F.
28. Dodd Frank Act, Section 403.
29. Dodd-Frank Act, Section 407.
30. Dodd-Frank Act, Section 408.
31. This element reflects the distinction between venture capital funds that provide capital to portfolio companies for operating and business purposes (in exchange for an equity investment) and leveraged buyout funds, which acquire controlling equity interests in operating companies through the "buy out" of existing security holders.
32. The SEC stated that a private fund could satisfy this definitional element by, for example, describing its investment strategy as venture capital investing or as a fund that is managed in compliance with the elements of the SEC's proposed rule.
33. The SEC stated that a company that achieved an indirect buyout of its security holders such as through as a recapitalization would not be a qualifying portfolio company. The SEC noted that only recapitalizations that resulted in redemptions, subordinations or other changes in rights with respect to existing security holders would be considered a buyout.
34. Proposed Rule 203(l)-1(c)(4).
35. Proposed Rule 203(l)-1(a)(6).
36. Proposed Rule 203(m)-1(a) and (b).
37. See Proposed Rules 203(m)-1(a)(2); 203(m)-1(b)(2); 203(m)-1(e)(1).
38. Proposed Rule 203(m)-1(c).
39. Proposed Rule 203(m)-1(a).
40. Proposed Rule 203(m)-1(b)(2).
41. Proposed Rule 203(m)-1(b)(1).
42. Proposed Rule 203(m)-1(e)(8).
43. Proposed Rule 203(m)-1(e)(8).
44. Proposed Rule 203(m)-1(d).
45. Proposed Rule 203(m)-1(d).
46. Proposed Rule 202(a)(30)-1(c)(1).
47. Proposed Rule 202(a)(30)-1(c)(1), at note to paragraph (c)(1).