WILMERHALE

SEC Proposes Definition of "Venture Capital Fund" and Other Rules to Implement the Private Fund Adviser Registration Provisions of the Dodd-Frank Act

2010-11-24

In General. On November 19, 2010, the SEC issued Proposed Rules (the "Proposed Rules") implementing the amendments to the Investment Advisers Act of 1940 (the "Advisers Act") that were effected by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). The following is a summary of the aspects of the Proposed Rules which are most material to our Fund Formation Group clients.

Venture Capital Exemption. The Dodd-Frank Act provided an exemption from registration for investment advisers that advise solely venture capital funds. The Proposed Rules define "venture capital fund" for purposes of this exemption, and provide for a grandfathering rule for certain private funds.

Definition of Venture Capital Fund. The definition of "venture capital fund" under the Proposed Rules contains the following elements:

- **Fund Must Be a "Private Fund":** The fund must be a "private fund," which is defined in the Advisers Act as an entity that would be an "investment company" under the Investment Company Act of 1940 (the "Investment Company Act") but for the exceptions provided under sections 3(c)(1) or 3(c)(7) of the Investment Company Act.

- **Private Fund Represents as Venture Capital Fund to Investors:** The fund must hold itself out as a venture capital fund to investors and potential investors (for example, by describing its investment strategy as venture capital investing).

- **Fund Investments and Qualifying Portfolio Companies:** The private fund must own solely (i) *equity securities*[1] issued by one or more "qualifying portfolio companies," and at least 80% of each such company's securities owned by the fund must have been acquired directly from the qualifying portfolio company (rather than on a secondary basis), and (ii) cash, cash equivalents and U.S. Treasuries with a remaining maturity of 60 days or less. In

general, a "qualifying portfolio company" is any company that (a) at the time of the private fund's investment in the company is not publicly traded, (b) does not borrow or otherwise incur leverage in connection with the private fund's investment in such company (although borrowing in the ordinary course of the company's business is permitted), (c) does not redeem, exchange or repurchase any securities of the company (or otherwise distribute cash or other assets to pre-existing security holders) in connection with the private fund's investment in such company, and (d) is not itself a fund (i.e., it must be an operating company).

- **Management Involvement:** With respect to each qualifying portfolio company, the private fund must either (a) directly, or through its investment advisers, offer or provide significant guidance and counsel concerning the management, operations or business objectives and policies of the qualifying portfolio company, or (b) control the qualifying portfolio company.

- **Limitation on Fund Leverage and Guarantees:** The private fund must not borrow, issue debt obligations, provide guarantees or otherwise incur leverage, in excess of 15% of the private fund's aggregate capital contributions and uncalled committed capital, and any such borrowing, indebtedness, guarantee or leverage must be for a non-renewable term of no longer than 120 calendar days.

- **No Redemption Rights:** The private fund must not offer its investors redemption or other similar liquidity rights except in extraordinary circumstances.

Grandfathering Provision: The Proposed Rules also provide that the definition of a "venture capital fund" also includes any private fund that (a) has represented to its investors and potential investors at the time of the offering of the private fund's securities that it is a venture capital fund, (b) has sold securities prior to December 31, 2010, to one or more investors that are not related to the fund's investment advisers, and (c) does not sell any securities to any person after July 21, 2011.

Fund of Funds and Venture Debt Funds Don't Qualify: It is worth noting that a fund of funds that itself only invests in venture capital funds would not qualify as a venture capital fund under the Proposed Rules because of the requirement that venture capital funds invest only in equity securities of "qualifying portfolio companies," which excludes an entity that is itself a fund. In addition, a venture debt fund would also likely not qualify as a venture capital fund because such a fund would typically invest in debt securities of its portfolio companies.

Private Fund Adviser Exemption. The Dodd-Frank Act directed the SEC to exempt from registration any investment adviser solely to private funds that has less than $150 million in assets under management in the United States. The SEC's proposal for implementing this so-called "private fund adviser exemption" includes the following key components:

US Advisers: The Proposed Rules provide that in order to qualify for the exemption, an adviser with

its "principal office and place of business"[2] in the United States must (a) act solely as an investment adviser to "qualifying private funds"[3] and (b) manage private fund assets of less than $150 million (including, for purposes of this calculation, any private fund assets managed from a place of business outside the United States).

Non-US Advisers: The Proposed Rules take a jurisdictional approach in applying the exemption to an investment adviser with its principal office and place of business outside of the United States (a "Non-US Adviser"). A Non-US Adviser will be exempt from registration under the private fund adviser exemption if (a) all of the adviser's clients that are "United States persons"[4] are qualifying private funds, and (b) all of the assets managed by the adviser from a "place of business"[5] in the United States are solely attributable to private fund assets, the total value of which is less than $150 million. It appears that a Non-US Adviser that does not have a place of business in the United States would qualify for this exemption regardless of the amount of its assets under management so long as the adviser does not have any clients that are United States persons other than qualifying private funds. A Non-US Adviser that has a place of business in the United States would seem to qualify for this exemption if (i) all of the assets managed by such adviser from such place of business in the United States are solely attributable to private fund assets (regardless of whether the private funds holding such assets are formed within or outside the United States), (ii) the total value of such private fund assets is less than $150 million, and (iii) the adviser does not have any clients that are United States persons other than qualifying private funds.

Calculating Private Fund Assets: Under the Proposed Rules, the value of private fund assets is calculated by reference to Form ADV and is generally equal to the fair market value of the assets of a qualifying private fund plus the amount of uncalled capital commitments of a qualifying private fund. Each investment adviser is required to determine the value of the private fund assets managed by such investment adviser on a quarterly basis. Notwithstanding these quarterly valuations, investment advisers would generally only be required to report these values to the SEC on an annual basis.

Transition Rule: The Proposed Rules provide an investment adviser three months to register with the SEC after becoming ineligible to rely on the private fund adviser exemption due to an increase in the value of its private fund assets.

Foreign Private Adviser Exemption. Under the so-called "foreign private adviser exemption" contained in the Dodd-Frank Act, an investment adviser qualifies as a "foreign private adviser" and is exempt from registration (and reporting) if it (a) has no place of business in the United States, (b) has fewer than 15 clients in the United States and investors in the United States in private funds advised by the investment adviser, (c) has less than $25 million in assets under management attributable to clients in the United States and investors in the United States in private funds managed by the adviser, (d) does not hold itself out generally to the public in the United States as an investment adviser, and (e) does not act as an adviser to any registered investment company or business development company. The Proposed Rules provide the following rules to implement this exemption:

Counting Clients and Investors in the United States: In counting the number of an adviser's clients and investors in the United States, the following rules generally apply: (a) one or more private funds that have identical equity owners or beneficiaries can be counted as a single client so long as the adviser provides investment advice based on the investment objectives of the private fund(s); (b) in the event the investment adviser provides investment advisory services to an owner of an interest in a private fund separate and apart from the private fund, the investment adviser must count such owner as a separate client; (c) an "investor" in a private fund is generally defined as any person who would be included in determining the number of beneficial owners of the private fund under section 3(c)(1) of the Investment Company Act, or whether the outstanding securities of the private fund are owned exclusively by "qualified purchasers" under section 3(c)(7) of the Investment Company Act; (d) an adviser need not count a private fund as a client if the adviser already counted any "investor" in that private fund; (e) 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; and (f) in counting the number of clients and investors in the United States for purposes of determining the availability of the foreign private adviser exemption, only clients and investors that are "United States persons"[6] at the time of becoming a client or investor in a private fund are counted.

Place of Business in the United States: The Proposed Rules provide that the term "place of business" in the United States means any office in the United States where the investment adviser regularly provides advisory services, solicits, meets with, or otherwise communicates with clients, and any location in the United States held out to the public as a place where the adviser conducts any such activities.

Assets Under Management: For purposes of determining whether an adviser qualifies as a foreign private adviser, only the adviser's assets under management[7] attributable to clients and investors in the United States would be counted.

Reporting Obligations of Advisers Relying on Venture Capital Exemption and Private Fund Adviser Exemption. Under the Proposed Rules, investment advisers that are exempt from registration under either the venture capital exemption or the private fund adviser exemption are referred to as "exempt reporting advisers," and are required to electronically file reports with the SEC on Form ADV Part 1A, and to update such reports on a periodic basis. The information that is required to be reported by an exempt reporting adviser will cover (a) basic identification details, such as the adviser's name, address, contact information and form of organization, as well as the identity of the owners of the adviser, (b) details regarding the other business activities of the adviser and its affiliates, which the SEC believes is important to collect in order to identify potential conflicts of interest between the adviser and its clients, and (c) information regarding the disciplinary history of the adviser and its employees. It is important to note that these reports would be publicly available on the SEC website. The Proposed Rules provide that each exempt reporting adviser will be required to file its initial report no later than August 20, 2011 (i.e., within 30 days after the effective date of the Dodd-Frank Act).

Rules Implementing Limitations on SEC Registration by Mid-Size Advisers. The Dodd-Frank Act prohibits an investment adviser with less than $100 million in assets under management[8] from registering with the SEC unless (a) the adviser is not required to be registered in the state in which it maintains its principal office and place of business, (b) if registered in its home state, the adviser would not be subject to examination in its home state, or (c) the adviser would be required to register in 15 more states as a result of not registering with the SEC. The Proposed Rules address the following issues with respect to this prohibition:

Required Amendment to Form ADV: The Proposed Rules 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 fair market value of its assets under management within 30 days of such filing. This will allow the SEC to determine which investment advisers are subject to this prohibition on SEC registration. Under the Proposed Rules, an adviser no longer eligible to register with the SEC would have to withdraw its registration no later than October 19, 2011.

Revisions to Form ADV: The Proposed Rules would amend Form ADV to cause each registered investment adviser to indicate the basis for its registration with the SEC in light of the revised registration requirements effected by the Dodd-Frank Act and to report annually whether it is eligible to remain so registered.

Subject to State Examination: Under the Proposed Rules, each state must certify to the SEC if such state subjects investment advisers registered in such state to examination. Based on these certifications, the SEC will maintain a list of those states that do not subject advisers to examination.

Amendment to SEC Pay-to-Play Rule. On June 30, 2010, the SEC adopted Rule 206(4)-5, which generally prohibits registered and certain unregistered advisers from engaging directly or indirectly in "pay-to-play" activity (i.e., contributions by an investment adviser or its employees to public officials in order to influence their selection of investment advisers). The SEC has proposed certain technical revisions to the pay-to-play rule which, among other things (a) clarify that the pay-to-play rule applies to exempt reporting advisers and foreign private advisers; and (b) provide that an investment adviser covered by the rule may not compensate a third-party marketer to solicit an investment by a governmental entity unless the marketer is a "regulated municipal advisor" (which is defined under the Proposed Rules as any person registered with the SEC under section 15B of the Securities Exchange Act of 1934 and which is subject to the pay-to-play rules of the MSRB).

Next Step: Public Comment Period. The Proposed Rules are subject to a public comment period of 45 days from the date the Proposed Rules were published in the Federal Register.

If you have any questions about the matters addressed in this alert, or if the WilmerHale Fund Formation Group can be of assistance to you in determining whether you are required to register or in the registration process, please contact your WilmerHale Fund Formation Group attorney.

[1] The Proposed Rules provide that the term "equity securities" has the same meaning as set forth in

section 3(a)(11) of the Securities Exchange Act of 1934.

[2] Defined under the Proposed Rules as the executive office of the investment adviser from which the officers, partners, or managers of the investment adviser direct, control, and coordinate the activities of the investment adviser.

[3] Defined under the Proposed Rules as any private fund that is not registered under the Investment Company Act and has not elected to be treated as a business development company under the Investment Company Act.

[4] Under the Proposed Rules, a "United States person" is generally defined by reference to the definition of a "U.S. person" in Regulation S under the Securities Act of 1933, and includes (a) a natural person resident in the United States, (b) any partnership or corporation organized under the laws of the United States, (c) any estate of which any executor or administrator is a U.S. person under Regulation S, and (d) any trust of which any trustee is a U.S. person under Regulation S.

[5] The Proposed Rules define a "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.

[6] See footnote 4 above for a description of the meaning of "United States person" under the Proposed Rules.

[7] The Proposed Rules provide a uniform method of calculating an adviser's "assets under management" for a variety of purposes under the Advisers Act. Under such method, an adviser's assets under management includes (a) the fair market value of any securities portfolios for which the adviser provides continuous and regular supervisory or management services, regardless of whether the assets are (i) proprietary assets, (ii) managed without receiving compensation or (iii) assets of foreign clients, and (b) with respect to any private fund managed by the adviser, the fair market value of the assets of such private fund plus the amount of uncalled capital commitments of such private fund.

[8] Id.

Authors

Sarah Rothermel

RETIRED PARTNER

+1 617 526 6000