SEC Proposes Rules to Implement Exemptions to Registration Under the Investment Advisers Act and Make Other Changes to Registration and Reporting Requirements

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I. Introduction

On November 19, 2010, the Securities and Exchange Commission proposed rules ("Proposed Rules") to implement amendments to the Investment Advisers Act of 1940 effected by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act").[1] The Proposed Rules define venture capital funds; define key terms used in determining who is an exempt "foreign private adviser"; change the reporting requirements for both registered and unregistered investment advisers, including advisers to hedge funds and other private funds; implement a new exemption for advisers to private funds with less than $150 million in assets under management; and define terms used in determining whether an adviser is eligible for SEC or state registration.[2] Although the Proposed Rules will affect many different types of investment advisers, they are most significant for (1) venture capital advisers, (2) offshore investment advisers that currently are exempt from SEC registration, and (3) advisers to hedge funds and other private funds.

II. Analysis

A. Dodd-Frank Act Provisions

The Dodd-Frank Act effects several major changes to the Advisers Act, effective July 21, 2011.

First, it eliminates the private adviser exemption of section 203(b)(3) of the Advisers Act, which exempts from registration an investment adviser who during the preceding 12 months had fewer than 15 clients and who neither holds itself out generally to the public as an investment adviser nor acts as an investment adviser to any investment company registered under the Investment Company Act of 1940 or a company that elected to be a business development company.

Second, the Dodd-Frank Act provides an exemption from registration for investment advisers that solely advise venture capital funds. The SEC is required to define a venture capital fund for purposes of this exemption and is authorized to prescribe reporting requirements for such investment advisers.

Third, the Dodd-Frank Act provides a new (but very narrow) exemption for a "foreign private adviser," defined generally as an adviser that (1) has no place of business in the U.S.; (2) has fewer than 15 clients in the U.S. and investors in the U.S. in private funds advised by the investment adviser; (3) has less than $25 million in assets under management attributable to clients in the U.S. and investors in the U.S. in private funds managed by the adviser; (4) does not hold itself out generally to the public in the U.S. as an investment adviser; and (5) does not act as an adviser to any registered investment company or business development company ("BDC").

Fourth, the Dodd-Frank Act authorizes the SEC to prescribe reporting requirements for registered investment advisers as to the private funds they advise.

Fifth, the Dodd-Frank Act directs the SEC to create a new exemption for registration for any investment adviser solely advising private funds with under $150 million in assets under management in the U.S.

Sixth, the Dodd-Frank Act creates a new category of "midsized advisers," defined as investment advisers that have between $25 million and $100 million in assets under management, and shifts the primary responsibility of oversight of these advisers to state securities authorities.

B. Venture Capital Adviser Matters

1. Definition of Venture Capital Fund

The Proposed Rules define a "venture capital fund" quite narrowly, providing very little flexibility. A venture capital fund would be required to meet all of the following requirements.

- **Private Fund.** Any venture capital fund would have to be a "private fund." In this regard, the Dodd-Frank Act amends the Advisers Act to define a private fund as an entity that would be an "investment company" under the Investment Company Act, but for the exceptions provided by sections 3(c)(1) or 3(c)(7) of that Act.

- **Investments and Qualifying Portfolio Companies.** The fund must own (i) solely equity securities issued by one or more qualifying portfolio companies ("QPC") and at least 80% of each QPC's securities owned by the fund must have been acquired directly from the QPC; and (ii) cash, cash equivalents, and U.S. Treasuries with a remaining maturity of 60 days or less.[3] In other words, a venture capital fund could not invest in debt securities issued by a QPC, even by making a bridge loan, nor could it invest in another venture capital fund.

- **Management Involvement.** The fund must control the QPC, or, directly or through its investment advisers, offer or provide significant guidance and counsel concerning the management, operations, or business objectives and policies of the QPC.

- **Limit on Fund Leverage and Guarantees.** The 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. Any such borrowing, indebtedness, guarantee, or leverage must be for a non-renewable term of no more than 120 calendar days.

- **No Redemption Rights.** The fund must not offer its investors redemption or similar liquidity rights except in extraordinary circumstances. The SEC did not define "extraordinary circumstances."

- **Fund Holds Itself Out as a Venture Capital Fund.** The fund must hold itself out as a venture capital fund to investors.

- **Not a Registered Investment Company or a BDC.** The fund cannot be registered under the Investment Company Act or have elected to be treated as a BDC.

Alternatively, the Proposed Rules also provide a grandfathering provision that extends the venture capital fund exemption. To fall within the grandfathering provision, the fund must: (i) have represented to its investors and potential investors at the time of the offering of its securities that it is a venture capital fund; (ii) sold securities before December 31, 2010, to one or more investors that are not related to its investment advisers; and (iii) not sell any securities to any person after July 21, 2011.

Investment advisers that are exempt from registration under the venture capital fund exemption are exempt reporting advisers and are required to electronically file reports with the SEC on Form ADV Part 1A, discussed in more detail below, and to update such reports periodically. The Proposed Rules provide that each exempt reporting adviser will be required to file its initial report no later than August 20, 2011.

C. Foreign Advisers

As noted above, the Dodd-Frank Act greatly narrows the exemption for any foreign investment adviser, by (1) including U.S. investors in funds advised by the adviser as counting towards the 15 client limit of the exemption and (2) by imposing a limit of $25 million on assets under management attributable to U.S. clients and U.S. investors in funds managed by the adviser. The Proposed Rules would define two of the terms in this exemption. The SEC proposes to (i) define persons who qualify as a single "client"; and (ii) define the phrase "in the United States."

First, the Proposed Rules provide that the following will be considered a single client:

- A natural person, and:
  - any minor child of the natural person;
  - any relative, spouse, or relative of the spouse of the natural person who has the same principal residence;
  - all accounts of which the natural person and/or the persons referred to in this paragraph are the only primary beneficiaries; and
  - all trusts of which the natural person and/or the persons referred to in this paragraph are the only primary beneficiaries.
- A corporation, general partnership, limited partnership, limited liability company, trust (other than a trust referred to above), or other legal organization (any of which are referred to hereinafter as a "legal organization") to which an adviser provides investment advice based on its investment objectives rather than the individual investment objectives of its shareholders, partners, limited partners, members, or beneficiaries (any of which are referred to as an "owner"); and two or more legal organizations that have identical owners.
- In contrast to its existing rule on client counting, a person who receives advice without paying compensation would be counted as a client.

Second, notwithstanding the plain English reading of the statutory phrase "in the United States," the Proposed Rules would define that phrase solely by reference to the definition of "U.S. person" in Rule 902(k) of Regulation S.

- Specifically, "in the United States" as to any client would mean "any person that is a 'U.S. person' as that term is defined in § 230.902(k)."
- The following, however, would be excluded from this definition: any discretionary account or similar account that is held for the benefit of a person in the U.S. by a dealer or other professional fiduciary who is in the U.S. if the dealer or professional fiduciary is a related

person of the investment adviser relying on this section and is not organized, incorporated, or (if an individual) resident in the U.S.

- A person who is in the U.S. may be treated as *not being in the U.S.* if the person was not in the U.S. 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).

D. New Reporting Requirements

The Proposed Rule will require exempt reporting advisers (defined to include venture capital fund advisers and advisers solely to private funds with less than $150 million in assets under management) to file electronic reports with the SEC using Form ADV and to periodically update such reports. Exempt reporting advisers will also be subject to the existing recordkeeping and compliance requirements that SEC registered advisers must follow.[4] To facilitate the new reporting requirements for exempt reporting advisers, the SEC proposes to revise Form ADV. Most notably, Item 2 of Part 1A will be amended to require advisers to demonstrate their eligibility for registration by identifying any exemptions relied on to report to, rather than register with, the SEC. Significantly, two SEC Commissioners expressed concern that the use of Form ADV may increase excessively the costs to exempt reporting advisers and require provision of too much information.[5]

Exempt reporting advisers will be required to complete the following Items in Part 1A of Form ADV: 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"). Exempt reporting advisers must complete corresponding sections of Schedules A, B, C, and D, but disclosure such as a client brochure is not required, although the SEC warned that exempt advisers are still subject to the antifraud provision of section 206 of the Advisers Act.[6]

Form ADV also will be generally revised to require all investment advisers to disclose additional information about three areas of operations: (i) private funds advised; (ii) data on advisory business, including types of clients, employees, advisory activities, and business practices that may result in conflicts of interest, in the SEC's view; and (iii) non-advisory activities and financial industry affiliations.

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 filing. This will allow the SEC to determine which investment advisers are subject to the prohibition on registration. An adviser no longer eligible to register with the SEC would have to withdraw its registration by October 19, 2011.

The SEC said that it would address recordkeeping requirements for exempt reporting advisers in a future release.

E. Exemption for Private Fund Adviser with Less than $150 Million in Assets Under Management

As noted above, the Dodd-Frank Act creates a new exemption for private fund advisers with less than $150 million in assets under management. Under the exemption, a U.S. adviser with its principal office and place of business in the U.S. must act solely as an investment adviser to qualifying private funds and manage private fund assets of less than $150 million, including assets managed from a place of business outside the U.S.[7] The Proposed Rules define "principal office and place of business" as the executive office of the investment adviser from which the officers, partners, or managers direct, control, and coordinate the activities of the investment adviser.

For non-U.S. advisers with a principal office and place of business outside the U.S., the analysis is somewhat more complicated. A non-U.S. adviser will be exempt from registration if all of the adviser's clients that are U.S. persons are qualifying private funds, and all of the assets managed by the adviser from a place of business in the U.S. are solely attributable to private fund assets with a total value of less than $150 million. A non-U.S. adviser that does not have a place of business in the U.S. would qualify for the exemption regardless of the amount of its assets under management if all of the adviser's clients that are U.S. persons are qualifying private funds. A non-U.S. adviser with a place of business in the U.S. could qualify for this exemption if (i) all of the assets managed by the adviser from its place of business in the U.S. are solely attributable to private fund assets (formed within or outside the U.S.), (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 U.S. persons other than qualifying private funds.

The value of private fund assets is calculated by reference to Form ADV and generally is equal to the fair market value of the assets of a qualifying private fund plus the amount of uncalled capital commitments of the qualifying private fund.

An investment adviser would have three months to register with the SEC after losing eligibility to use the exemption due to an increase in the value of its private fund assets.

F. Midsized Advisers

The Dodd-Frank Act creates a new category of "midsized advisers" and shifts the primary responsibility of oversight of these advisers to state securities authorities. The Proposed Rule prohibits from SEC registration an adviser that is registered in the state in which it maintains its principal office and place of business and that has assets under management of between $25 million and $100 million. A midsized adviser may choose to register with the SEC if (i) the adviser is not required to be registered in the state in which it maintains its principal office and place of business; (ii) if registered in its home state, the adviser would not be subject to examination in its home state; or (iii) the adviser would be required to register in 15 more states as a result of not registering with the SEC.[8] Eligibility for SEC registration must be affirmed upon application for registration and annually thereafter.

The SEC proposes to revise the definition of "assets under management," not just for eligibility for SEC registration, but also for a variety of purposes under the Advisers Act. Under this revised definition, an adviser's assets under management include (i) 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 proprietary assets, managed without receiving compensation, or assets of foreign clients; and (ii) for 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.

G. Pay to Play Rules

Earlier this year, 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.[9] The Proposed Rules amend the scope of the Pay to Play Rule, applying it to exempt reporting advisers and foreign private advisers. Additional changes would amend Rule 206(4)-5 to let an adviser pay any "regulated municipal advisor" to solicit government entities on its behalf. A regulated municipal advisor is a person that is registered under section 15B of the Exchange Act and also subject to pay to play rules adopted by the Municipal Securities Rulemaking Board. In this regard, a "municipal advisor" is a new definition created by the Dodd-Frank Act.

III. Next Steps

The Proposed Rules are subject to a public comment period of 45 days from the date of publication in the Federal Register, meaning that comments will be due in early January. Given the controversial nature of these roles, it is likely that the SEC will receive many comments recommending significant changes before the rules are adopted.

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[1] Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[2] Rules Implementing Amendments to the Investment Advisers Act of 1940, Advisers Act Release No. 3110 (Nov. 19, 2010); Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers, Advisers Act Release No. 3111 (Nov. 19, 2010).

[3] According to the Proposed Rule, in general, a QPC is any company that (i)

at the time of the fund's investment in the company is not publicly traded; (ii) does not borrow or otherwise incur leverage in connection with the fund's investment in such company (although borrowing in the ordinary course of the company's business is permitted); (iii) does not redeem, exchange, or repurchase any securities of the company (or otherwise distribute cash or other assets to preexisting security holders) in connection with the private fund's investment in such company; and (iv) is not itself a fund (*i.e.*, it must be an operating company).

[4] Release No. 3110 at 150.

[5] *See* Kathleen L. Casey, Commissioner, SEC, Statement at SEC Open Meeting: Meeting Proposals to Implement Investment Adviser Provisions of the Dodd-Frank Act (Nov. 19, 2010), *available at*www.sec.gov/news/speech/2010/spch111910klc-items1-2.htm; Troy A. Parades, Commissioner, SEC, Statement at SEC Open Meeting: Meeting Proposals to Implement Investment Adviser Provisions of the Dodd-Frank Act (Nov. 19, 2010), *available at*www.sec.gov/news/speech/2010/spch111910tap-items1-2.htm.

[6] *See* Advisers Act Release No. 3111 at 7 n.9 (Nov. 19, 2010) (antifraud provisions continue to apply to exempt reporting advisers).

[7] A "place of business" is 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.

[8] There are six exemptions from the prohibition on registration for: (i) nationally recognized statistical rating organizations; (ii) pension

consultants; (iii) investment advisers that are affiliated and share a principal place of business with advisers registered with the SEC; (iv) investment advisers anticipating eligibility for SEC registration within 120 days of filing Form ADV; (v) multistate investment advisers; and (vi) internet advisers. These exemptions are generally unaffected by the Dodd-Frank Act and the Proposed Rules, other than the change in the exemption for multistate investment advisers, where the SEC reduced the number of states in which one would have to register from 35 to 15.

[9] Pay to Play Rules address campaign contributions by an investment adviser or its employees to public officials. Advisers Act Release No. 3043 (July 1, 2010).

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