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SEC Proposes Exemptions for Private Fund Advisers and Certain Foreign Advisers

Certain fund advisers that fit narrow definitions would be exempt from registration requirements imposed by the Dodd-Frank Act.

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Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), referred to as the Private Fund Investment Advisers Registration Act of 2010, effected fundamental changes in the Investment Advisers Act of 1940 (Advisers Act) that will result in many previously unregistered advisers, such as advisers to private funds, having to register with the U.S. Securities and Exchange Commission (SEC) or one or more state regulators absent an exemption from registration. When the Dodd-Frank Act was signed into law on July 21, 2010, most of its impact had not yet been determined, as the implementation was left in the hands of industry regulators.

Now the SEC has spoken. At an open meeting on November 19, 2010, the SEC voted to propose rules that would implement registration exemptions and reporting requirements for certain advisers, as required by the Dodd-Frank Act. In its proposing release, the SEC sets forth proposals to adopt registration exemptions for private fund advisers and foreign private advisers (Exemptions Release).[1] Comments on the proposal must be submitted to the SEC by January 24 and may be submitted online at the SEC's website.

EXEMPTION FOR PRIVATE FUND ADVISERS

As amended by the Dodd-Frank Act, Section 203(m) of the Advisers Act requires the SEC to provide an exemption from registration to any investment adviser that acts solely as an adviser to private funds and has assets under management in the United States of less than $150 million. In the Exemptions Release, the SEC issued Proposed Rule 203(m)-1, which would bring this private fund adviser exemption into effect.

Section 202(a)(29) of the Advisers Act, as amended by the Dodd-Frank Act, defines a "private fund" as an issuer that would be an investment company under Section 3 of the Investment Company Act of 1940 (1940 Act) but for Section 3(c)(1) or 3(c)(7). This definition of "private fund" would also include a private fund that invests in other private funds. The SEC explained in the Exemptions Release that a fund organized under the laws of the United States or a state is a "private fund" if it is excluded from the

1. *See* 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 Rel. No. 3111 (Nov. 19, 2010), *available at* http://www.sec.gov/rules/proposed/2010/ia-3111.pdf.

definition of "investment company" pursuant to Section 3(c)(1) or 3(c)(7) of the 1940 Act, and that a non-U.S. fund that offers its securities in the United States and relies on Section 3(c)(1) or 3(c)(7) of the 1940 Act would be a "private fund" under Section 202(a)(29) of the Advisers Act. Thus, a non-U.S. fund may conduct a private offering of its securities in the United States without first obtaining an order permitting registration under Section 7(d) of the 1940 Act if the fund complies with either Section 3(c)(1) or 3(c)(7) with respect to its U.S. investors.[2]

Assets Under Management

A private fund adviser may advise an unlimited number of private funds and still qualify for the exemption from registration under Proposed Rule 203(m)-1, provided that the adviser's U.S. assets under management are less than $150 million. Any uncalled capital commitments would be counted toward this $150 million threshold. An adviser would have to determine its private fund assets under management quarterly, using fair-value and not cost-basis accounting.[3] If an adviser exceeds the $150 million threshold, it will be given a one-calendar-quarter period to register with the SEC. This one-calendar-quarter grace period would ease the burden of registration and the corresponding requirement to adopt and implement compliance policies and procedures, but would only be available to advisers that otherwise complied with SEC reporting requirements during the period in which they were exempt from registration.

Due to the exemption, an adviser solely to private funds that would otherwise need to register with the SEC once it had reached $100 million of assets under management[4] would in fact not need to register with the SEC until it has acquired an additional $50 million of U.S. assets under management. Advisers to private funds with less than $150 million of U.S. assets under management will still need to comply with applicable state investment adviser registration requirements. Private fund advisers based in states where they would not be required to register with and be supervised by a state securities authority will still need to register with the SEC if they manage private funds with $25 million or more of assets.[5]

U.S. and Non-U.S. Advisers

The exemption would count U.S. assets under management differently for advisers with a principal office and place of business in the United States (U.S. advisers) versus advisers with a principal office and place of business outside the United States (non-U.S. advisers).[6] For U.S. advisers, all of the private

2. Section 7(d) of the 1940 Act prohibits a non-U.S. fund from using U.S. jurisdictional means to make a public offering, absent an order from the SEC permitting registration.

3. Proposed Rule 203(m)-1 would not require private fund advisers to determine fair value in accordance with U.S. generally accepted accounting principles (GAAP).

4. The Dodd-Frank Act amended Section 203A(a)(2) of the Advisers Act to increase the assets-under-management threshold for mandatory registration with the SEC to $100 million.

5. Currently, Rule 203A-1(a) under the Advisers Act permits an adviser with between $25 million and $30 million in assets under management to not register with the SEC if the state in which the adviser maintains its principal office and place of business has enacted an investment adviser statute. Rule 203A-1(a) also includes a $5 million "buffer" that does not require a registered adviser to de-register with the SEC until its assets under management, as annually reported, decrease below $25 million. In its companion reporting release, the SEC proposed to amend Rule 203A-1 to remove the $5 million "buffer." Combined with the Dodd-Frank Act's amendment to Section 203A(a)(2) of the Advisers Act, Proposed Rule 203A-1 would essentially make registration for investment advisers with between $25 million and $100 million optional so long as the adviser is regulated or required to be regulated as an investment adviser in the state in which it maintains its principal office and place of business.

6. The SEC noted that, similar to the approach taken under Rules 203A-3(c) and 222-1 under the Advisers Act, an adviser's principal office and place of business would be the location where the adviser controls, or has ultimate

fund assets managed by an adviser would be counted toward its U.S. assets under management, even if the adviser has offices outside the United States. Non-U.S. advisers would only need to count those assets managed from a location within the United States toward the $150 million threshold.

A non-U.S. adviser may rely on the exemption if all of its clients that are U.S. persons[7] are "qualifying private funds,"[8] regardless of the type or number of the adviser's non-U.S. clients. In other words, non-U.S. advisers may advise clients that are not "qualifying private funds" so long as those clients are not U.S. persons. In addition, a non-U.S. adviser could still rely on the exemption from registration if it advised U.S. funds (such as a U.S. master fund in a master-feeder structure) so long as all of the funds are "qualifying private funds." Further, a non-U.S. adviser would only be required to count private fund assets managed from a place of business in the United States toward the $150 million threshold. Any assets managed by a non-U.S. adviser outside the United States (whether investment funds or managed accounts) would not count toward the $150 million limit. However, if the non-U.S. adviser manages any assets from a U.S. place of business for clients that are not qualifying private funds, the non-U.S. adviser would be disqualified from the exemption.

Because Proposed Rule 203(m)-1 would deem all assets managed by a U.S. adviser to be managed in the United States, a U.S. adviser may rely on the exemption only if all of its clients are qualifying private funds. If a U.S. adviser has any client that is not a qualifying private fund, it would be disqualified from the exemption, even if the client is a non-U.S. person.

Offshore Discretionary Accounts

Proposed Rule 203(m)-1 would also require that a non-U.S. adviser's discretionary or other fiduciary account be treated as a U.S. person if it is held for the benefit of a U.S. person by a non-U.S. fiduciary that is a related person of the adviser. That is, a non-U.S. adviser will not qualify for the exemption if it establishes offshore accounts for the benefit of U.S. clients held by an offshore affiliate of the adviser, where the offshore affiliate then delegates the management of the account back to the adviser, unless the aggregate amount of assets under management by the adviser in such accounts and other accounts of U.S. persons is less than $150 million. This aspect of Proposed Rule 203(m)-1 is aimed at curtailing attempts by non-U.S. advisers to circumvent the exemption. This treatment would not affect U.S. advisers because all assets managed by a U.S. adviser, regardless of client location, would already be counted toward the adviser's $150 million threshold.

EXEMPTION FOR FOREIGN PRIVATE ADVISERS

The Dodd-Frank Act amended Section 203(b)(3) of the Advisers Act to provide an exemption from registration for "foreign private advisers," as defined in Section 202(a)(30) of the Advisers Act. As a practical matter, this exemption would apply only to foreign advisers that do not otherwise qualify for the private fund adviser exemption set forth in Section 203(m) of the Advisers Act and Proposed Rule 203(m)-1. An adviser with no place of business in the United States will nonetheless be required to register with the SEC if, among other things, (i) it holds itself out to the public in the United States as an investment adviser, or (ii) (a) it has 15 or more clients and private fund investors in the United States or

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responsibility for, the management of private fund assets, even if day-to-day management of certain assets takes place at another location.

7. Proposed Rule 203(m)-1 would use the definition of "U.S. Person" set forth in Rule 902(k) of Regulation S under the Securities Act of 1933.

8. Rule 203(m)-1(e)(5) would define "qualifying private fund" as any private fund that is not registered under Section 8 of the 1940 Act and has not elected to be treated as a business development company under Section 54 of the 1940 Act.

(b) it has $25 million or more of assets under management from clients/investors in the United States regardless of the number of its clients/investors.[9] In the Exemptions Release, the SEC issued Proposed Rule 202(a)(30)-1, which would define certain terms used in the definition of "foreign private adviser" set forth in Section 202(a)(30).

Counting Investors

Proposed Rule 202(a)(30)-1 would implement certain client counting rules, similar to those that currently appear in Rule 203(b)(3)-1 under the Advisers Act. Under Proposed Rule 202(a)(30)-1 , a foreign private adviser could treat as a single person a natural person combined with any of the following: (1) the natural person's minor children (regardless of principal residence); (2) any relative, spouse, or relative of the spouse of the natural person (with the same principal residence); and (3) all accounts or trusts of which the natural person and/or the natural person's minor child, spouse, relative, or relative of the spouse are the only primary beneficiaries. Proposed Rule 202(a)(30)-1 would also permit a foreign private adviser to count a corporation, general partnership, limited partnership, limited liability company, trust, or other legal organization as a single client. Two or more legal organizations with identical shareholders, partners, limited partners, members, or beneficiaries could also be treated as a single client under the Proposed Rule 202(a)(30)-1.

Unlike Rule 203(b)(3)-1, Proposed Rule 202(a)(30)-1 would require foreign private advisers to count clients that do not pay compensation to the foreign private adviser. In addition, Proposed Rule 202(a)(30)-1 would specify that a foreign private adviser would not need to count a private fund as a client if the foreign private adviser counted any investor in the private fund when determining whether it qualifies for the exemption.

Proposed Rule 202(a)(30)-1 would also define "investor" as any person who would be included in determining the number of beneficial owners of a private fund's outstanding securities under Section 3(c)(1) of the 1940 Act or any person who would be included in determining whether a private fund's outstanding securities are owned exclusively by qualified purchasers under Section 3(c)(7) of the 1940 Act. The proposed rule would permit a foreign private adviser to count an investor in two or more private funds advised by the foreign private adviser as a single investor. These definitions would prevent foreign private advisers from using nominee accounts to circumvent the registration requirement. Further, because Sections 3(c)(1) and 3(c)(7) of the 1940 Act refer to beneficial owners and owners, respectively, of "securities," holders of both equity and debt securities would be counted as "investors" under Proposed Rule 202(a)(30)-1.[10]

The SEC in the Exemptions Release also sets forth certain examples in which a foreign private adviser would have to "look through" nominal owners to count the number of investors. A foreign private adviser to a master fund in a master-feeder fund structure would have to count holders of securities of any feeder fund as investors. If the record owner of private fund shares has transferred the risk of investment in the private fund to a third party (i.e., through a total return swap), then the third party would be counted as an investor. Beneficial owners who are "knowledgeable employees" of the private fund would also be counted as investors, as would beneficial owners of short-term paper issued by the

9. A person that is "in the United States" would not be treated as such if the person was not in the United States at the time the person became a client of the foreign private adviser or at the time the person acquired securities issued by the private fund.

10. Citing Section 2(a)(36) of the 1940 Act, the SEC noted in the Exemptions Release that "securities" is broadly defined to include both debt and equity securities.

private fund. In the aggregate, these inclusions of "investors" have the effect of significantly narrowing the foreign private adviser exemption from registration with the SEC.

It would appear from the Dodd-Frank Act and Proposed Rule 202(a)(30)-1 that the foreign adviser only has to look through the adviser's funds that constitute "private funds." Therefore, the adviser's funds that are not offered in the United States and do not need to rely on exemptions from the 1940 Act may continue to have U.S. investors (assuming the admission of the investors was otherwise in compliance with the 1940 Act), without those investors being counted against the adviser's 14-U.S.-investor limit.

It is also worth noting that, in accordance with longstanding SEC interpretations, the investors in a foreign adviser's offshore private funds will not be considered "clients" of the adviser (even though they must be counted in determining whether the adviser must register with the SEC) unless there is a direct contractual relationship between the adviser and the investor. Accordingly, as further explained below under "Practical Considerations," many of the substantive provisions of the Advisers Act will not apply to the relationship between such investors and the adviser, even after the adviser registers with the SEC.

PRACTICAL CONSIDERATIONS

For U.S. Private Fund Advisers

Hedge fund and private equity fund managers in the United States will now have to register with the SEC if they meet the assets-under-management threshold, and thus will become subject to the Advisers Act—just as if they managed separate accounts of individuals or institutions. Managers in the United States that have less than $150 million in assets under management must register with their state regulators if such registration is so required.

Many states, such as Florida and New York, have broad exceptions that will allow managers to operate without registering. However, advisers in such states would not satisfy the requirement under Section 203A(a)(2)(B)(i) of the Advisers Act that they be "required to be registered as an investment adviser" in their state. As a result, when such advisers reach $25 million in assets under management, they would have to either register with the SEC or register with the state to avoid SEC registration. Arguably, even if such an adviser registered with its state, it would not satisfy the requirement under Section 203A(a)(2)(B)(i) because the registration was not required and the adviser would still be required to register with the SEC. Over time, state regulators may adopt new regulations to eliminate these gaps in registration requirements.

It is also unclear whether the general partners of private funds will also need to register with the SEC or state regulators when they meet the definition of adviser because they provide limited advice to the fund and are affiliated with the registered adviser to the fund. We presume that the SEC will develop an exception for these general partners—perhaps by viewing them as "persons associated with an investment adviser" under Section 202(a)(17) of the Advisers Act, which would obviate their need to register separately as advisers.

For Foreign Investment Advisers

Foreign investment advisers would gain substantially from the adoption of the rules set forth in the Exemptions Release because Proposed Rule 203(m)-1 would permit foreign advisers to rely on the private fund adviser exemption. For those foreign advisers, or "non-U.S. advisers," that cannot meet the requirements of the private fund adviser exemption, the foreign private adviser exemption may still apply.

In determining how many U.S. clients it has, a foreign adviser that manages a U.S. feeder fund will have to include the feeder fund. The foreign adviser will also have to take into account all of the investors in the U.S. feeder fund, not just the U.S. resident investors, in determining how many U.S. fund investors the adviser has (although such feeder fund investors will still not need to be treated as clients of the adviser).

We understand from speaking with the SEC that the "regulation lite" regime will be preserved. This concept was first articulated in an SEC rule release in 2004 (and later reconfirmed by no-action letters) and provides that foreign advisers that voluntarily register or are required to register with the SEC must comply with the substantive provisions of the Advisers Act only with respect to their U.S. "clients." Under this regime, a foreign adviser will not need to treat U.S. investors in the adviser's offshore funds as "clients in the U.S." because the fund is not a U.S. client (and the investors are not clients), but will have to treat stand-alone funds and feeder funds as U.S. clients if the funds are organized under U.S. law. This may create an incentive for organizing U.S.-targeted funds in offshore jurisdictions.

In determining whether it will classify itself as a private fund adviser or a foreign private adviser, an adviser should consider that foreign private advisers will not be subject to the reporting requirements set forth in a companion proposing release issued by the SEC on the same day as the Exemptions Release, nor would they be subject to SEC examination or the recordkeeping requirements that the SEC plans to propose in 2011. The reporting requirements that accompany private fund adviser status may serve as a disincentive to many foreign advisers, but in order to remain outside of the reporting requirements, foreign advisers would have to limit their U.S. subscriptions to fewer than 15 investors and less than $25 million in assets under management.

One item that remains open is the treatment of foreign advisers with affiliates that are registered as investment advisers with the SEC. The SEC has not yet clearly resolved this issue, but has stated that whether a foreign adviser would have to register would be determined on a facts-and-circumstances basis. We believe that the *Unibanco* line of no-action letters issued by the SEC staff will survive, but in a narrower framework.[11] Currently, the *Unibanco* line of no-action letters generally states that the SEC will not recommend enforcement action if (a) neither a foreign bank nor certain of its affiliates register under the Advisers Act if they share certain personnel with, and provide certain services to, a U.S.-registered adviser; or (b) the foreign bank or its unregistered affiliates provide investment advisory services to their clients who are not residents of the United States solely in accordance with the laws of their home jurisdiction (or other applicable foreign law) without also complying with the provisions of the Advisers Act.

ADDITIONAL INFORMATION

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11. *Uniao de Banco de Brasileiros S.A.*, SEC No-Action Letter, 1992 SEC No-Act. LEXIS 817 (July 29, 1992).

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