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SEC Proposes Exemptions for Certain Private Fund Advisers

Certain fund advisers that fit narrow definitions would be exempt from registration requirements imposed by the Dodd-Frank Act, but would still be required to comply with extensive recordkeeping and reporting obligations.

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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 two companion releases, the SEC sets forth proposals to adopt registration exemptions for venture capital fund advisers, private fund advisers, and foreign private advisers (Exemptions Release),[1] and also proposes a new rule requiring exempt private fund advisers to file public reports on an expanded version of Form ADV (Reporting Release).[2] Comments on the proposals must be submitted to the SEC by January 24 and may be submitted online at the SEC's website.

EXEMPTION FOR VENTURE CAPITAL FUND ADVISERS

The Dodd-Frank Act amended Section 203(l) of the Advisers Act to provide an exemption from SEC registration requirements for any investment adviser that acts as an investment adviser solely to one or more venture capital funds. There is no limit on the number of venture capital funds a venture capital fund adviser may advise and still qualify for the exemption. In general, venture capital funds, according to the SEC, are a subset of private equity funds and are typically unleveraged long-term investors in

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.

2. *See* Rules Implementing Amendments to the Investment Advisers Act of 1940, Advisers Act Rel. No. 3110 (Nov. 19, 2010), *available at* http://www.sec.gov/rules/proposed/2010/ia-3110.pdf.

early-stage or small privately held companies, thereby limiting their ability to contribute to systemic risk.

The Dodd-Frank Act also directed the SEC to issue final rules to define the term "venture capital fund" for the purposes of the exemption by July 21, 2011, and further directed the SEC to require venture capital fund advisers to maintain records and provide the SEC with annual or other reports as the SEC determines necessary or appropriate in the public interest or for the protection of investors.

In the Exemptions Release, the SEC sets forth Proposed Rule 203(l)-1 under the Advisers Act, which would define the term "venture capital fund," sets forth a grandfathering provision for existing venture capital funds, and defines additional terms used in the definition of "venture capital fund."

Proposed Definition

Under Proposed Rule 203(l)-1(a), a fund would have to meet *all* of the following criteria in order to be considered a "venture capital fund."

1. ***The fund must be a private fund.***

In order to meet the definition of "venture capital fund" set forth in Proposed Rule 203(l)-1(a), the fund must be a "private fund," as defined in Section 202(a)(29) of the Advisers Act, as revised by the Dodd-Frank Act. Under Section 202(a)(29), a "private fund" is an issuer that would be an investment company, as defined in Section 3 of the Investment Company Act of 1940 (1940 Act), but for the exemptions from the definition of "investment company" set forth in Section 3(c)(1) or 3(c)(7) of the 1940 Act.[3] The fund cannot be an investment company registered under Section 8 of the 1940 Act or elect to be treated as a business development company under Section 54 of the 1940 Act.

2. ***The fund must represent to investors and potential investors that it is a venture capital fund.***

In order to meet the definition of "venture capital fund," a fund must represent itself to the investing public as a venture capital fund. In the Exemptions Release, the SEC indicated that a fund that describes its investment strategy as "venture capital investing" or "investing in compliance with Rule 203(l)-1" would be deemed to be representing itself to investors and potential investors as a venture capital fund. The SEC further stated that a fund could not identify itself as a hedge fund or a multistrategy fund (i.e., a fund where venture capital is one of several investment strategies) and still fulfill this requirement. Further, the fund's adviser would not be able to include the fund in a hedge fund database or index of hedge funds.

3. ***The fund must own solely (i) equity securities issued by one or more "qualifying portfolio companies" (QPCs), at least 80% of which were acquired directly from the QPCs; and (ii) cash, cash equivalents, or U.S. Treasury instruments with a remaining maturity of 60 days or less.***

In order to be defined as a "venture capital fund," a fund can only own equity securities of QPCs and cash, cash equivalents, or U.S. Treasury instruments with a remaining maturity of 60 days or less.

3. In general, the exemptions provided in Sections 3(c)(1) and 3(c)(7) of the 1940 Act apply to private funds with fewer than 100 investors or investors who are qualified purchasers.

A fund cannot invest in debt instruments of a QPC unless such instruments can be considered "equity securities" under Section 3(a)(11) of the Securities Exchange Act of 1934 (1934 Act) and Rule 3a11-1 thereunder.[4] Eligible securities offered by a QPC in which a fund may invest are common or preferred stock, warrants, convertible securities, or interests in a limited partnership. Further, the SEC noted that a fund could provide a QPC with "bridge financing" in anticipation of future investment in exchange for instruments that are ultimately convertible into stock of the QPC. Any bridge financing by a fund to a QPC in exchange for an instrument that is not an "equity security" would disqualify the fund from the definition of "venture capital fund" and thereby disqualify the fund's adviser from the exemption from registration. A fund may also invest in cash and cash equivalents, as defined in Rule 2a51-1(b)(7)(i) under the 1940 Act.[5]

Under Proposed Rule 203(l)-1(c)(4), a company would have to meet *all* of the following criteria in order to be considered a QPC.

a. At the time of any investment by the fund, the company was not publicly traded and did not control, was not controlled by, and was not under common control with another company, directly or indirectly, that is publicly traded.

A fund may continue to hold securities of a company that goes public after the fund's investment, but the fund cannot make additional investments in the company after it goes public and still qualify as a "venture capital fund." In the Exemptions Release, the SEC acknowledged that a fund's portfolio could consist entirely of publicly traded securities and the fund could still qualify as a "venture capital fund" under Proposed Rule 203(l)-1 so long as the fund acquired all of the securities prior to their being publicly traded. The SEC noted that although venture capital funds typically invest in small, startup companies, these concepts were not built into the proposed definition of "venture capital fund" because the SEC was concerned that too many companies would be eliminated from possible investment by venture capital funds as a result. The SEC also did not include any length-of-existence, number-of-employees, or revenue thresholds under the definition of QPC. Finally, the SEC considered, but did not adopt, the definitions of "venture capital fund" used by the California Corporations Commission and U.S. Department of Labor, both of which permit a fund to invest in publicly traded companies and permit a fund to invest up to 50% of its assets in nonoperating companies (i.e., investment funds). In rejecting this approach, the SEC referenced Congress's concern that fund-of-funds structures present systemic risk concerns.

b. The company does not borrow or issue debt obligations, directly or indirectly, in connection with the fund's investment.

A company will not meet the definition of a QPC if it borrows money, issues debt, or otherwise incurs leverage in connection with the fund's investment. A company may, however, borrow money as part of its normal course of business (i.e., to invest in infrastructure or make payroll) and still qualify as a QPC.

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4. Under Section 3(a)(11) of the 1934 Act, "equity security" is defined as "any stock or similar security; or any security future on any such security; or any security convertible, with or without consideration, into such a security, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right; or any other security which the Commission shall deem to be of similar nature and consider necessary or appropriate, by such rules and regulations as it may prescribe in the public interest or for the protection of investors, to treat as an equity security."

5. "Cash and cash equivalents" are defined under Rule 2a51-1(b)(7)(i) as "[b]ank deposits, certificates of deposit, bankers acceptances and similar bank instruments held for investment purposes." The SEC noted that cash and cash equivalents must be held for "investment purposes" as required by Rule 2a51-1(b)(7)(i), and that a fund may also invest in short-term obligations of the U.S. Treasury that mature in 60 days or less, which are not included in the definition of "cash and cash equivalents" under Rule 2a51-1(b)(7)(i).

This "in connection with the fund's investment" requirement is aimed at preventing advisers to leveraged-buyout funds from relying on the venture capital fund advisers exemption since, according to the SEC, leveraged-buyout funds present a greater systemic risk than venture capital funds. The SEC noted that any financing or loan to a company that is provided by a fund that invests in the company or is a condition of a contractual obligation with the fund (or adviser) would be viewed as a loan in connection with the fund's investment and would thus disqualify the company from the definition of a QPC and the fund from the definition of a venture capital fund.

c. The company does not redeem, exchange, or repurchase any of its securities, or distribute to pre-existing security holders cash or other assets, directly or indirectly, in connection with the fund's investment.

In order to qualify as a QPC, a company must use the fund's investment for operating and business purposes and for facilitating the expansion and development of the company. The definition of "venture capital fund" requires that at least 80% of a QPC's securities held by the fund must have been acquired directly from the QPC and not from existing shareholders, either directly or indirectly. This 80% test is aimed at preserving the existing rights, priority, and economic terms of the QPC's beneficial owners while still permitting the QPC to benefit from the fund's investment. The 80% test would prohibit a company from using the capital inflow from the fund's investment to buy out all existing shareholders or reconstitute its capital structure to subordinate the rights of its existing shareholders. The SEC noted that Proposed Rule 203(l)-1 would permit a fund to acquire up to 20% of the securities of a QPC from shareholders, which would allow a QPC to use a fund's investment to redeem a certain number of its outstanding securities, thus providing some liquidity to its angel investor(s), if any. Further, the SEC stated that the 80% test is not intended to preclude capital reorganizations by a company that would not change the rights, priority, or economic terms of existing beneficial owners. The SEC also noted that the 80% threshold is consistent with certain tax treatment typically relied on by venture capital funds.[6]

d. The company is not an investment company, a private fund, an issuer that would be an investment company but for the exemption provided by Rule 3a-7 under the 1940 Act, or a commodity pool.

In order to meet the definitional requirements of a QPC, a company cannot be a private fund or other pooled investment vehicle, including an investment company, an investment company relying on Rule 3a-7 under the 1940 Act, or a commodity pool. The SEC noted that Congress provided no indication that the venture capital fund exemption was meant to apply to funds-of-funds. There is no requirement that the QPC be a U.S. company.

4. The fund must, with respect to each QPC (either directly or indirectly through its adviser), either (i) have an arrangement whereby the fund or the adviser offers to provide, and if accepted, does so provide, significant guidance and counsel concerning the management, operations, or business objectives and policies of the QPC; or (ii) control the QPC.

For each QPC in which the fund invests, the fund (or its adviser) must either control the QPC or offer to provide significant guidance and counsel to the QPC regarding its management, operations, or business

6. In general, Section 1202 of the Internal Revenue Code provides a partial exclusion from a taxpayer's gross income for gain from the sale or exchange of qualified small business stock held for more than five years. In order to be "qualified," the small business must be an "active business." Section 1202(e)(1)(A) of the Internal Revenue Code notes that if at least 80% of a company's assets are used by the company in the active conduct of one or more qualified trades or businesses, then the company meets the "active business" requirement.

objectives and policies.[7] If the QPC accepts the fund's (or adviser's) offer to provide such guidance and counsel, the fund (or adviser) must actually provide guidance and counsel to the QPC. The Exemptions Release states that the fund's (or adviser's) guidance and counsel must be more than a mere contribution of capital and instead must entail active involvement in the business, operations, or management of the QPC or less active "control" through board representation or similar voting rights. The SEC also stated that the extent of the fund's (or adviser's) managerial assistance may evolve over time as the QPC expands and develops. On the assumption that if control exists it will likely be exercised, Proposed Rule 203(l)-1 does not require a fund (or adviser) that controls a QPC to offer to provide managerial assistance. Proposed Rule 203(l)-1, however, does not provide any direct guidance on the meaning of "control." Additionally, if the fund invests as a group of funds, each fund (or its adviser) would have to either exercise control over the QPC or offer to provide managerial assistance to the QPC and, if accepted, actually provide managerial assistance to the QPC.

5. ***The fund cannot borrow, issue debt obligations, provide guarantees, or otherwise incur leverage in excess of 15% of its aggregate capital contributions and uncalled committed capital, and any such borrowing, indebtedness, guarantee, or leverage must be for a nonrenewable term of no longer than 120 calendar days.***

In order to meet the definition of "venture capital fund," a fund cannot borrow, issue debt obligations, provide guarantees, or otherwise incur leverage in excess of 15% of its aggregate capital contributions and uncalled committed capital. If the fund does conduct such leveraging activities, it must be for a nonrenewable term of no longer than 120 calendar days. The SEC noted that a fund may issue short-term debt, such as commercial paper, and still be considered a "venture capital fund." Because the 15% threshold is calculated as 15% of the fund's aggregate capital contributions and uncalled capital commitments, it would be possible for the fund to leverage an acquisition of QPC securities up to 100% so long as the invested amount does not exceed 15% of the fund's total capital commitments. All such leverage would still be limited to 120 days or less. The SEC noted that a fund cannot avoid the prohibition on QPC borrowing by incurring debt at the fund level.

6. ***The fund must only issue securities that do not provide investors with any right (except in extraordinary circumstances) to withdraw, redeem, or require the repurchase of such securities.***

Outside of extraordinary circumstances, a fund cannot require investors to sell securities back to the fund or grant investors the right to redeem or withdraw their securities. Extraordinary circumstances could include changes in the law that would affect investors' tax treatment or ability to invest in particular countries and industries, or foreseeable but unexpected corporate events, such as mergers. If the fund offers quarterly or periodic withdrawal rights, it cannot qualify as a "venture capital fund," even if the fund has a temporary initial lock-up period or other restriction on the right to redeem. Proposed Rule 203(l)-1 does not set forth any specific time period for which fund interests must be held, though the SEC noted that industry practice is usually 10 years.

Grandfathering

7. In the Exemptions Release, the SEC noted that the concept of providing guidance and counsel to the QPC regarding management, operations, or business objectives and policies is intended to be a more streamlined version of the concept of "managerial assistance" defined in Section 2(a)(47) of the 1940 Act, which applies to investment in business development companies. The SEC noted that Congress's discussions of business development companies in the 1980s are instructive to the concepts in Proposed Rule 203(1)-1, though not directly considered by Congress in passing the Dodd-Frank Act.

Proposed Rule 203(l)-1 also exempts an adviser to a fund that does not meet the definition of "venture capital fund," but that is a private fund that (1) represented to investors and potential investors at the time it offered its securities that it was a venture capital fund, (2) sold securities to one or more investors prior to December 31, 2010, and (3) does not sell securities (including additional capital commitments) to any person after July 21, 2011. The SEC specified that in order to meet the grandfathered exemption, capital commitments from the fund's investors need not be called by July 21. Further, the SEC noted that it does not expect that advisers to private equity or hedge funds will be able to rely on the grandfathering exemption.

Other Items

The SEC noted that Proposed Rule 203(l)-1 does not require an adviser to provide a capital contribution to its fund, does not specify a minimum investment term, and does not exclude funds that permit investment by retail investors. The SEC also stated that an adviser with its principal place of business outside the United States may rely on the exemption if all of its clients—whether U.S. or non-U.S. clients—are venture capital funds.

The exemption provided to advisers to venture capital funds under Proposed Rule 203(l)-1 is not mandatory and such advisers may voluntarily register. Unregistered venture capital fund advisers may still be subject to state registration requirements, as Section 203A(b)(1) of the Advisers Act only provides an exemption from state registration requirements to advisers that are registered with the SEC.

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 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 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.[8]

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

8. 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.

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.[9] 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[10] 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.[11]

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).[12] For U.S. advisers, all of the private 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[13] are "qualifying private funds,"[14] 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

9. 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).

10. 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.

11. 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 the 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.

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

13. 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.

14. 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.

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 (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.[15] 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

15. 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.

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 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.[16]

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 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.

16. 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.

NEW REPORTING AND EXAMINATION REQUIREMENTS

Sections 203(l) and 203(m)(2) of the Advisers Act, as amended by the Dodd-Frank Act, mandate that the SEC require venture capital fund advisers and private fund advisers exempted from registration to maintain records and provide the SEC with reports as the SEC determines necessary or appropriate in the public interest or for the protection of investors. In the Reporting Release, the SEC issued Proposed Rule 204-4 under the Advisers Act, which would require those advisers exempt from registration to complete and electronically file reports on certain items set forth in Form ADV, which would be publicly available on the SEC's website.

The items in Form ADV on which exempt advisers would have to report are the following:

- **Item 1 – Identifying Information.** An exempt adviser would be required to disclose information such as its business name, principal place of business, mailing address, and website address.

- **Item 2C – Identification of Exemption.** An exempt adviser would be required to identify the exemption that it is relying on to report to, rather than register with, the SEC. This would be a new section that was proposed to be added to Part 1A of Form ADV in the Reporting Release.

- **Item 3 – Form of Organization.** An exempt adviser would be required to disclose its corporate form (e.g., limited liability company, trust), the state under which the adviser is organized, and its fiscal year.

- **Item 6 – Other Business Activities.** An exempt adviser would be required to disclose other businesses in which it is actively engaged (broker-dealer, futures commission merchant, etc.) and whether the adviser sells products or provides services other than investment advice to its advisory clients.

- **Item 7 – Financial Industry Affiliations.** An exempt adviser would have to provide information about whether its related persons are financial industry participants (e.g., investment company, other investment adviser) or otherwise engaged in financial activities. In the Reporting Release, the SEC also proposed to expand the scope of Item 7B and Schedule D of Form ADV to include additional information about private funds advised by a reporting adviser. Under the revised disclosure requirements, a reporting adviser would be required to disclose the organizational, operational, and investment characteristics of each of the private funds it manages; the amount of assets held by such private fund; the nature of such private fund's investors; and the identity of and other information about five of such fund's service providers that typically act as a "gatekeepers" of each fund (i.e., auditor, prime broker, custodian, administrator, or marketer). Currently, an adviser is required to disclose any "investment-related limited partnership" that either the adviser or a related person of the adviser advises. Under the Reporting Release, an adviser would be required to disclose any private fund (regardless of whether the private fund is organized as a limited partnership) it advises, but would not have to disclose private funds advised by related persons. In addition, under the Reporting Release, sub-advisers of an adviser would not have to disclose private funds that the adviser has already disclosed. Finally, a non-U.S. adviser would not have to disclose private funds organized outside the United States that are not offered to, or owned by, U.S. persons.

- **Item 10 – Control Persons.** An exempt adviser would be required to disclose the identity of every person who directly or indirectly controls the adviser or its management policies. Form ADV defines "control" as the power, directly or indirectly, to direct the management or policies of a ***person***, whether through ownership of securities, by contract or otherwise, and presumes control upon ownership of 25% of the adviser's voting interests.

- **Item 11 – Disclosure Information.** An exempt adviser would have to disclose its disciplinary history as well as that of its employees.

A reporting adviser would be required to amend its Form ADV annually within 90 days of its fiscal year-end. Proposed Rule 204-4 would require the adviser's initial Form ADV to be filed by August 20, 2011.

In the Exemptions Release, the SEC noted that because venture capital fund advisers and private fund advisers are not "specifically exempt" from the registration requirement under Section 203(b) of the Advisers Act, their books and records are all still subject to SEC examination under Section 204(a). The books and records of foreign private advisers, on the other hand, which are specifically exempt from registration under Section 203(b)(3), would not be subject to SEC examination.

The Reporting Release did not address other recordkeeping requirements for exempt advisers, but the SEC indicated at its open meeting on November 19 that it expects to propose implementing rules during the first quarter of 2011.[17]

PRACTICAL CONSIDERATIONS

For U.S. Venture Capital Fund Advisers

The combination of the elimination of the *de minimis* exemption (the 15-client rule), upon which many venture capital fund managers currently rely, and the new explicit carveout from any registration requirements for venture capital fund advisers means that a venture capital fund adviser will no longer be limited to fewer than 15 clients (i.e., 15 venture capital funds). Consequently, venture capital fund advisers that are self-constrained by the 15-client rule so as to avoid registration will no longer be limited by the number of funds they can manage, so long as all of the funds they manage meet the definition of "venture capital fund." Nonetheless, although still not registered, such managers will be subject to the additional reporting requirements and will continue to be subject to the antifraud provisions of the Advisers Act.

Venture capital fund advisers should consider altering practices and limiting activities so as to conform to the proposed definition of "venture capital fund." For example, advisers may want to make their representations to the public more explicit so as to meet the requirement that they represent themselves as venture capital funds. Advisers will also have to install policies and procedures to determine that the companies they invest in are QPCs and that they acquire at least 80% of the securities they own of each QPC from the QPC itself. Advisers may want to consider building into their purchase agreements for shares that the QPC will use the funds for operating and business purposes and not to buy out

17. Section 204(b) of the Advisers Act, as amended by the Dodd-Frank Act, states that the SEC may require registered investment advisers to maintain records and file reports regarding the amount of assets under management, use of leverage (including off-balance-sheet leverage), counterparty credit risk exposure, trading and investment positions, trading practices, valuation policies and practices, types of assets held, and side arrangements.

shareholders. If an individual QPC does intend to use a portion of its funds to provide liquidity to an angel investor, this should be noted by the adviser and the QPC during the purchase of the QPC's securities. Advisers will also have to ensure that QPCs do not borrow money outside of the normal course of business or issue any debt securities. Advisers should also make a record of their offers to provide managerial assistance and, if applicable, the QPCs' acceptance or rejection of such offers.

Regardless of whether an adviser qualifies for exemption from registration with the SEC, all venture capital fund advisers will be subject to the reporting requirements set forth in the Reporting Release, including the proposed revisions to Item 7B and Schedule D of Form ADV, which would require advisers to provide identifying information about each of their private funds, such as each fund's name and domicile, ownership, service providers, and assets. Venture capital fund advisers, as discussed above, would also be subject to examination by the SEC. In the Reporting Release, the SEC noted that such increased disclosure of private funds would help the SEC target its examinations.

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 the Reporting 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.[18] 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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18. *Uniao de Banco de Brasileiros S.A.*, SEC No-Action Letter, 1992 SEC No-Act. LEXIS 817 (July 29, 1992).

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In addition, Morgan Lewis's multidisciplinary Financial Regulatory Reform resource team is available to assist with a wide range of issues and areas of concern related to the reform effort. You can access a complete collection of the firm's updates and alerts on the subject on our website's Financial Regulatory Reform page.

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