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Private Fund Adviser Exemptions

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On June 22, 2011, the US Securities and Exchange Commission (the " SEC") issued Release IA-3222 (the "Final Release") adopting rules 203(l) and 203(m) (individually a "Final Rule" and collectively the "Final Rules") under the US Investment Advisers Act of 1940 (the "Advisers Act") that define and implement the private fund adviser exemptions. In this Briefing Note we will summarize the most significant aspects of these Final Rules and highlight where they differ significantly from the SEC's original proposals (the "Proposed Rules").

Background

The Dodd-Frank Act amends the Advisers Act by, among other things, repealing the so-called "Private Adviser Exemption" that exempts advisers with fewer than 15 clients from SEC registration and regulation. In place of the Private Adviser Exemption, the Dodd-Frank Act creates several new exemptions, including an exemption for advisers solely to venture capital funds and an exemption for mid-sized investment advisers to private funds. The Final Rules define the term "venture capital fund" for purposes of the exemption for advisers solely to venture capital funds and provide standards for determining what constitutes an adviser to a private fund with assets under management of less than $150 million in the US.

Transition Period

Repeal of the current Private Adviser Exemption becomes effective on July 21, 2011. However, if an adviser will not qualify for any exemption from registration after the repeal of the Private Adviser Exemption, the adviser will not be required to register with the SEC until March 30, 2012, although the SEC recommends completing the requisite application no later than February 14, 2012.

Reporting by Exempt Advisers

Advisers that qualify for an exemption from registration under the Final Rules will nonetheless be required to report a limited amount of information on a modified Form ADV, as more fully described below. Advisers must file an initial Form ADV with the SEC within 60 days of relying on an exemption.

Final Rules

While a primary purpose of the Dodd-Frank Act was to require advisers to private funds (*i.e.* hedge funds, private equity funds and other pooled investment vehicles exempt from registration as investment companies under Section 3©(1) and/or Section 3©(7) of the Investment Company Act of 1940 (the "Company Act")) to register under the Advisers Act, it identified certain fund advisers that it did not intend to subject to registration. Section 407 of the Dodd-Frank Act exempts from registration advisers solely to venture capital funds. Section 408 of the Dodd-Frank Act exempts from registration advisers solely to private funds, so long as such advisers have less than $150 million in assets under management in the US. The SEC adopted the Final Rules to define "venture capital funds" for purposes of Section 407 and to specify both the method for calculation of assets under management and the definition of "in the United States," for purposes of Section 408, among other things.

It is important to note that advisers exempt from registration under the Final Rules will still be required to maintain specified records and file annual reports using Form ADV.

Definition of Venture Capital Fund

Section 407 of the Dodd-Frank Act exempts venture capital fund advisers from registration under the Advisers Act. Final Rule 203(l) defines a venture capital fund as a private fund that:

- Immediately after acquiring any assets (not including "qualifying investments" or "short-term holdings"), holds no more than 20% of the fund's aggregate capital contributions and uncalled committed capital in assets (other than "short-term holdings") that are not "qualifying investments;"
- Represents to investors that it pursues a venture capital strategy;
- Does not borrow, issue debt obligations, provide guarantees or otherwise utilize leverage, in excess of 15 percent of the fund's capital contributions and uncalled committed capital, and any such borrowing, indebtedness, guarantee or leverage is for a non-renewable term of no longer than 120 calendar days;
- Does not provide its investors with the right to redeem their interests in the fund except under extraordinary circumstances; AND

- Is not registered under the Company Act and has not elected to be treated as a business development company.

The Final Rule also provides a grandfathering provision that allows existing funds that cannot meet the definition above to be treated as venture capital funds. To be grandfathered, a fund must (i) have represented to investors at the time it offered securities that it would pursue a venture capital strategy, (ii) have sold securities to investors prior to December 31, 2010, and (iii) not have sold securities to or accepted capital commitments from any investor after July 21, 2011.

The Final Release notes that the Final Rule does not specify that a venture capital fund must be advised by a US adviser. In fact, a non-US adviser may rely on the exemption if all of its clients (US and non-US) are venture capital funds.

In the most significant shift from the Proposed Rules, a private fund may still qualify as a venture capital fund under the Final Rules while holding as much as 20% of its capital in non-"qualifying investments," net of "short-term holdings" including cash and cash equivalents with a remaining maturity of 60 days or less.

In adopting the 20% basket for non-qualifying investments, the SEC eliminated provisions that had appeared in the Proposed Rules imposing a 20% limit on secondary market transactions defined "qualifying investment" as any equity security (i) issued by a qualifying portfolio company (a "QPC") and received in exchange for directly acquired equities issued by the same QPC, (ii) issued by a QPC and acquired directly by the private fund from the QPC, and (iii) issued by a company of which a QPC is a majority-owned subsidiary or a predecessor, and acquired by the private fund in exchange for an equity security.

A QPC is defined under the Final Rules as any company that (i) is not reporting or "foreign traded," (ii) does not incur leverage in connection with the investment in it made by the private fund and distribute the proceeds of borrowing to the private fund in exchange for its investment, and (iii) is an operating company and not a fund. A company need not be a US company to qualify as a QPC. Further, a fund's status as a venture capital fund under the Final Rules is not affected if the securities of any of its QPCs become publicly traded following the date of the fund's investment.

The Final Rules, unlike the Proposed Rules, do not require a venture capital fund (i) to offer or provide significant managerial or operational assistance to a QPC or (ii) to control the QPC.

Private Fund Adviser Exemption

The SEC adopted Final Rule 203(m) substantially as proposed, providing an exemption from Advisers Act registration for investment advisers that advise only private funds and that have less than $150 million in aggregate assets under management in the US. The private fund adviser exemption permits an investment adviser to advise an unlimited number of private funds so long as the aggregate value of the adviser's private fund assets under management in the US is less than $150 million. Non-US advisers would not lose the ability to rely on this exemption if they have non-fund clients outside of the US -so long as all of their US clients are private funds. The Final Rules incorporate the definition of US persons used in Regulation S for purposes of determining if a non-US adviser has advised any US client that is not a private fund. The definition of US Person used in Regulation S is discussed in detail in our separate Briefing Note devoted exclusively to the foreign private adviser exemption.

With respect to private fund advisers whose principal place of business and office is in the US, Final Rule 203(m)-1 counts all assets under management (even those attributable to persons residing outside of the US and serviced from offices outside of the US) by such private fund advisers as "assets under management in the United States." However, private fund advisers whose principal place of business and office is located outside the US would only be required to count those assets managed from a US place of business towards the $150 million threshold.

Determining whether a private fund adviser has "assets under management" at a US place of business will turn on the question of whether the adviser provides "continuous and regular supervisory or management services" in respect of certain securities portfolios from such US place of business. A "place of business," for purposes of Final Rule 203(m)-1, includes any office where an adviser regularly meets with or otherwise communicates with clients. Notably, the Final Release also indicates that any location where an adviser simply conducts research, including research used to produce non-public information relevant to investment decisions and recommendations, will be deemed a "place of business."

For purposes of satisfying the private fund adviser exemption, advisers must report annually on a Form ADV certain information about the private funds they manage. The Form ADV, which up to now has been used exclusively as an SEC registration statement for investment advisers, has been modified to require limited disclosure by advisers who rely on the exemptions provided in the Final Rules ("exempt reporting advisers") with respect to items such as their form of organization and other identifying information, control persons, information on financial industry affiliations, other business activities of the adviser, and the asset values of their private funds, inclusive of uncalled capital commitments (which values must be calculated based on the assets' market value or on the fair value where market value is unavailable).

We note that Final Rule 203(m)-1 provides a transition period of 90 days after filing an annual update to the Form ADV for registration with the SEC by a private fund adviser who determines it is no longer eligible for the private fund adviser exemption because its assets under management in the US exceed $150 million. To qualify for the 90-day transition period, the adviser must be in compliance with all applicable SEC reporting requirements.

Finally, the SEC has indicated that it does not intend to conduct routine examinations of exempt reporting advisers, citing scarcity of resources, even though the Dodd-Frank Act gives the SEC authority to do so. However, the SEC has noted that it has the authority to conduct on-site examinations of exempt reporting advisers if there are indications that such examinations are necessary.

Conclusion

The Final Rules provide much-needed clarity for advisers who had been unsure whether they would qualify for an exemption from Advisers Act registration. We think that the 20% "basket" for non-qualifying investments adds welcome flexibility for true venture capital fund advisers who otherwise may have been ineligible for the benefits of the venture capital fund adviser exemption if the Proposed Rules had been adopted unaltered. However, even those advisers who satisfy the exemptions from registration provided by the Final Rules will need to comply with other applicable SEC requirements (such as reporting obligations). Further, even though the Final Rules clarify registration requirements at the federal level, exempt reporting advisers must wait for action by state regulators to determine whether similar requirements will apply at the state level.

We urge all private fund managers that have their principal place of business in the US or that are located outside of the US and accept investments from US investors to consult with counsel regarding the effects of the Final Rules.

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