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SEC Proposes Rules Implementing New Exemptions from Advisers Act Registration Under the Dodd-Frank Act

On November 19, 2010, the SEC issued a release (the "**Exemptions Release**") proposing rules to implement certain provisions of Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**") that exempt certain advisers from registration under the Investment Advisers Act of 1940 (the "**Advisers Act**"). Among other things, the SEC's proposal:

- defines "venture capital fund" for the purposes of the new Advisers Act exemption for advisers to venture capital funds;
- proposes a new rule that would exempt from registration certain private fund advisers with less than $150 million in assets under management in the United States; and
- clarifies the meaning of certain terms used in the new exemption for foreign private advisers.

On the same day, the SEC also issued a companion release proposing rules to implement amendments to the Advisers Act effected by the Dodd-Frank Act, including the increased assets under management threshold for adviser registration with the SEC, modified reporting requirements for registered and unregistered advisers (including with respect to their private funds), conforming and other amendments to Form ADV and amendments to the SEC's "pay-to-play" rule in response to changes made by the Dodd-Frank Act, a summary of which is available in the Davis Polk Client Memorandum ***SEC Issues Proposal Implementing Advisers Act Registration and Reporting Amendments Under the Dodd-Frank Act***.

Venture Capital Fund Advisers

New section 203(l) of the Advisers Act provides that an adviser that solely advises venture capital funds is exempt from registration under the Advisers Act and directs the SEC to define "venture capital fund." The SEC is proposing new rule 203(l)-1 under the Advisers Act to provide a definition of "venture capital fund." The exemption, like the other new exemptions for private fund advisers with less than $150 million in assets under management in the United States and foreign private advisers, is not mandatory, and an adviser that qualifies under this exemption could still choose to register with the SEC if it has sufficient assets under management.

The SEC drafted the proposed definition of venture capital fund to implement Congress's intent in establishing the exemption. The SEC states that Congress intended to distinguish advisers to "venture capital funds" from advisers to "private equity funds," for which Congress did not provide an exemption. In contrast to private equity funds, according to the SEC, venture capital funds typically make long-term investments in smaller companies or early-stage companies that are held privately with the goal of eventually selling the companies or taking them public. Venture capital funds, the SEC stated, generally are not leveraged and contribute capital to companies that are not leveraged and thus do not contribute to systemic risk.

The definition of a "venture capital fund" in the SEC's proposed rules will likely influence and, indeed, could become the definition of venture capital fund used for purposes of a possible exemption under the Volcker Rule, codified in the Bank Holding Company Act but requiring coordination with the SEC. As a result, those interested in that area should also be interested in this definition.

Definition of Venture Capital Fund

To effect the congressional understanding of venture capital funds, the SEC proposes to define a venture capital fund as a fund that:

- invests in "equity securities" of "qualifying portfolio companies" for the purpose of providing business expansion and operating capital (and may invest in certain cash items and short maturity U.S Treasuries), provided that at least 80 percent of the fund's interest in each of its portfolio companies was acquired directly from the company;
- offers or provides significant managerial assistance to (either directly or through its investment advisers) the qualifying portfolio company or controls the qualifying portfolio company;
- does not borrow or otherwise incur leverage apart from a limited amount of short-term borrowing;
- except in extraordinary circumstances, does not offer investors redemption or other liquidity rights;
- represents itself as a venture capital fund to investors; and
- is a private fund.

The definition includes a grandfathering provision that would allow an adviser to one or more existing venture capital funds to rely on the exemption, provided such existing funds satisfy the grandfathering requirements.

***Qualifying Portfolio Companies*.** The SEC proposes to define a "qualifying portfolio company" as any company that:

- is not publicly traded (or in a control relationship with a public company) at the time of the investment;
- does not incur leverage in connection with the investment by the venture capital fund;
- uses capital provided by the venture capital fund for business expansion or operating purposes, as opposed to buying out other investors; and
- is not itself a fund.

Private Companies at Time of Investment. At the time of each investment by a venture capital fund, a qualifying portfolio company cannot be publicly traded (or in a control relationship with a public company), but the venture capital fund could continue holding securities of a portfolio company that goes public after its investment.

***Portfolio Company Leverage*.** To be a qualifying portfolio company, a portfolio company may not incur leverage in connection with the investment by a venture capital fund. The definition is not intended to exclude companies that borrow in the ordinary course of business.

Non-U.S. Portfolio Companies. An eligible venture capital fund is not limited to investing in U.S. companies. Instead, qualifying portfolio companies include non-U.S. companies.

80% Test; Fund Capital Used for Operating and Business Purposes. To satisfy the proposed definition, a venture capital fund must acquire 80% of its interest in a qualifying portfolio company from the qualifying portfolio company itself. Further, to be a qualifying portfolio company, a portfolio company must use the capital invested by the venture capital fund for operating and business purposes, not to return capital to other owners of the company. These elements are designed to exclude private equity funds, according to the SEC, which typically undertake transactions designed to "buy out" existing owners. As an eligible venture capital fund could acquire 20% of its interest in a qualified portfolio company from other investors, venture capital funds have some flexibility to acquire securities from a company founder or "angel" investor seeking liquidity.

Equity Securities. Under the proposed rule, "equity securities" is defined by reference to the definition of "equity security" in section 3(a)(11) of the Securities Exchange Act of 1934 and rule 3a11-1 thereunder, and would include common stock, preferred stock, warrants, other securities convertible into equity and limited partnership interests.

Other Investments. In addition to equity securities of qualifying portfolio companies, an eligible venture capital fund may hold cash and cash equivalents (as defined in Rule 2a51-1(b)(7)(i) under the Investment Company Act of 1940 (the "**Investment Company Act**")) and U.S. Treasuries with a remaining maturity of 60 days or less.

***Management Involvement*.** An eligible venture capital fund would be required to:

- have an arrangement under which it (or its investment adviser) offers to provide significant guidance and counsel on the management, operations or business objectives and policies of the qualifying portfolio company; or
- control the portfolio company.

According to the SEC, managerial assistance typically entails active involvement in the business or management of the qualifying portfolio company, or involvement through board representation or similar voting rights. The SEC notes that managerial assistance under the proposed rule does not have a "fixed character" and is flexible to accommodate the evolving managerial needs of a qualifying portfolio company.

Limitation of Leverage. An eligible venture capital fund could not borrow funds, issue debt obligations, provide guarantees or otherwise incur leverage in excess of 15 percent of the Fund's contributed capital and uncalled capital commitments. Further, any permitted borrowing must be for a non-renewable term of no longer than 120 calendar days. The SEC states that the requirement that loans be non-renewable is intended to prevent a fund from transforming its short-term debt into long-term debt by continually rolling it over.

***No Redemption Rights*.** An eligible venture capital fund could only provide investors with redemption rights in exceptional circumstances. Investors, however, could receive pro rata distributions from time to time.

***Represents Itself as a Venture Capital Fund*.** An eligible venture capital fund must represent itself to investors as a venture capital fund. The SEC notes that one way a private fund could satisfy this requirement is by describing its investment strategy as venture capital investment. According to the SEC, this element is necessary to ensure that only funds that engage in typical venture capital activities will be treated as eligible venture capital funds.

***Is a Private Fund*.** An eligible venture capital fund must be a private fund that relies on the 3(c)(1) or 3(c)(7) exemption from the Investment Company Act (including, the SEC indicated, offshore funds that rely on 3(c)(1) or 3(c)(7) with respect to their U.S. investors). Registered investment companies ("**RICs**") and funds regulated as business development companies ("**BDCs**") under the Investment Company Act are explicitly excluded from the proposed definition.

***Application to Non-U.S. Advisers*.** A non-U.S. adviser may rely on the venture capital exemption if all of its clients, whether U.S. or non-U.S., are venture capital funds as defined.

***Grandfathering Provision*.** The SEC proposes to include in the definition of "venture capital fund" any private fund that:

- represented to its investors and potential investors at the time it offered its securities that it was a venture capital fund;
- sold securities to one or more investors prior to December 31, 2010; and

- does not sell any securities to, or accept additional capital commitments from, any person after July 21, 2011.

Private Fund Adviser Exemption

The Dodd-Frank Act directs the SEC to provide an exemption from registration for any investment adviser that:

- acts solely as an adviser to private funds;
  - a private fund is defined as an issuer that relies on Section 3(c)(1) or 3(c)(7) of the Investment Company Act;
- has assets under management in the United States of less than $150 million (the "**private fund adviser exemption**").

The Dodd-Frank Act requires, however, that such advisers maintain such records and provide to the SEC such annual or other reports as the SEC determines necessary or appropriate in the public interest or for the protection of investors.

Proposed Private Fund Adviser Rule

The release proposes a new rule 203(m)-1 (the "**private fund adviser rule**"), which implements this provision of the Dodd-Frank Act. The requirements of the exemption depend on whether an adviser has its principal office and place of business in the United States (a "**U.S. adviser**") or outside the United States (a "**non-U.S. adviser**").

Exemption for U.S. Advisers. The proposed private fund adviser rule would provide an exemption from registration under the Advisers Act for any U.S. adviser that acts solely as an adviser to private funds and has private fund assets under management in the United States of less than $150 million. All of the U.S. adviser's private fund assets would be considered to be "in the United States" for purposes of the proposed rule if its principal office and place of business is in the United States, even if the adviser has offices outside of the United States. The proposal notes that the 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.

Application to Non-U.S. Advisers. For a non-U.S. adviser, the private fund adviser exemption would be available so long as:

- the adviser has no client that is a U.S. person (generally as defined in Regulation S) except for private funds; and
- all assets managed by the adviser from a place of business in the United State are solely attributable to private fund assets, the value of which is less than $150 million.

For a discretionary or other fiduciary account maintained outside of the United States for the benefit of a U.S. person, an adviser must treat such an account as a U.S. person if the account is held by a non-U.S. fiduciary who is a related person of the adviser. As opposed to U.S. advisers, non-U.S. advisers would need only to count those private fund assets managed from a place of business in the United States toward the exemption's $150 million asset limit.

Assets Under Management. For purposes of the rule, advisers would be required to calculate on a quarterly basis their assets under management in private funds in the same manner as they are calculated for Form ADV reporting purposes, which method the SEC proposed revising in the companion release. Among other changes, the proposed method would require advisers to calculate their "regulatory assets under management" based on the fair value of the assets and include the value of proprietary assets, assets managed without compensation and, in the case of private funds, uncalled capital commitments. Note that, even though the rule requires advisers relying on the exemption to value their assets on a quarterly basis, advisers would need only to report on Form ADV their regulatory assets under management on an annual basis.

Transition Period. An adviser that becomes ineligible to continue relying on the private fund adviser exemption because the value of its private fund assets under management has exceeded $150 million would have a three-month transition period from the end of the calendar quarter at which its private fund assets equaled or exceeded $150 million to register with the SEC. The proposal notes that the transition safe harbor would only be available to an adviser that has complied with the applicable reporting requirements of the exemption.

Foreign Private Advisers

The Dodd-Frank Act eliminated (effective July 21, 2011) the "private investment adviser" exemption contained in section 203(b)(3) of the Advisers Act, which, in the case of foreign advisers, provided an exemption from registration for foreign investment advisers that, among other things, have had fewer than 15 U.S. clients over the preceding 12 months and that do not hold themselves out generally to the U.S. public as investment advisers. The Dodd-Frank Act, however, provides a narrow registration exemption for any "foreign private adviser," which under the Dodd-Frank Act is defined as any investment adviser who:

- has no place of business in the United States;
- has, in total, fewer than 15 clients and investors in the United States in private funds advised by the adviser;
- has aggregate assets under management attributable to clients in the United States and investors in the United States in private funds advised by the investment adviser of less than $25 million, or such higher amount as the SEC may, by rule, deem appropriate in accordance with the purposes of the Advisers Act; and
- does not:
  - hold itself out generally to the U.S. public as an investment adviser;
  - act as an investment adviser to any RIC; or
  - act as a BDC.

The Dodd-Frank Act defines the term "private fund" to mean an issuer that relies on Section 3(c)(1) or 3(c)(7) of the Investment Company Act.

Proposed Foreign Private Adviser Rule

The Exemptions Release proposes a new rule 202(a)(30)-1 (the "**foreign private adviser rule**") to implement the foreign private adviser exemption and to propose definitions for certain undefined terms used in the definition.

Place of Business. "Place of business" as used in the foreign private adviser rule means any office where the investment adviser regularly provides investment advisory services, solicits, meets with, or otherwise communicates with clients, and any other location that is held out to the general public as a location at which the adviser conducts any such activities.

"Clients and Investors." Like the current private adviser exemption, eligibility for the new foreign private adviser exemption is determined in part by the number of clients of an adviser. The proposed foreign private adviser rule would incorporate the safe harbor rules and many of the client counting rules of rule 203(b)(3)-1 currently in effect for the private adviser exemption.

Definition of Clients. Under the proposed rule, an adviser would be allowed to treat the following as a single client:

- A natural person and:
  - that person's minor children;
  - any relative, spouse, or relative of the spouse of that person who has the same principal residence;
  - all accounts of which that person and/or the person's minor child or relative, spouse, or relative of the spouse who has the same principal residence are the only primary beneficiaries; and
  - all trusts of which that person and/or the person's minor child or relative, spouse, or relative of the spouse who has the same principal residence are the only primary beneficiaries;
- A corporation, general partnership, limited partnership, limited liability company, trust, or other legal organization to which the adviser provides investment advice based on the organization's investment objectives; and
- Two or more legal organizations that have identical shareholders, partners, limited partners, members, or beneficiaries.

The definition of client would also incorporate certain "special" client counting rules currently in effect under rule 203(b)(3)-1, such as counting investors in a fund if the adviser provides advisory services to the investors separate and apart from the fund. However, unlike the current definition, the proposed definition would require advisers to count those for whom the adviser does not receive compensation for advisory services (such as knowledgeable employees). In addition, the proposed rule would avoid double-counting of clients and investors by providing that an adviser need not count a private fund as a client if the adviser counts any investor in that private fund for purposes of the foreign private adviser exemption.

Definition of Investors. Under the proposed foreign private adviser rule, the definition of "investor" would incorporate the counting methods required by sections 3(c)(1) and 3(c)(7) of the Investment Company Act. As such, any person who would be included in the number of beneficial owners of a 3(c)(1) fund, or included in the determination of whether all of a 3(c)(7) fund's investors were qualified purchasers, would be deemed on investor. Thus, the definition of "investors" for purposes of the foreign private adviser exemption would generally incorporate the look-through rules applicable to counting investors in 3(c)(1) and 3(c)(7) funds. To avoid double-counting, an adviser would be able to treat as a single investor any person who is an investor in two or more private funds advised by the adviser. The proposal notes that knowledgeable employees (and certain related persons) as described in rule 3c-5 under the Investment Company Act, as well as beneficial owners of "short-term paper" (as defined in section 2(a)(38) of the Investment Company Act) issued by a private fund, would also count as investors.

What it means to be "in the United States." In general, the proposed foreign private adviser rule defines "in the United States" by reference to the definitions of "U.S. person" and "United States" in Regulation S under the Securities Act. For determining whether an investor or client was "in the United States," an adviser would generally only be required to look to the point in time when the person either became a client or an investor. Investors that were not "in the United States" at the time of becoming a client or an investor, but later became a person "in the United States," would *not* need to be treated as being "in the United States."

As with the approach utilized to determine eligibility under the private fund adviser rule, the foreign private adviser rule would treat a discretionary account owned by a U.S. person, but managed by a non-U.S.

affiliate of the adviser, as a person "in the United States," even though such person would not be considered a "U.S. person" under Regulation S.

Assets Under Management. For purposes of the foreign private adviser rule, as with the exemption of private fund advisers rule discussed above, foreign advisers would be required to calculate their regulatory assets under management as they are calculated for Form ADV reporting purposes.

Subadvisers and Advisory Affiliates

In general, subadvisers are permitted to rely on each of the new exemptions provided they satisfy the requirements of such exemptions. The release notes that interpretive questions exist as to whether an adviser with advisory affiliates would be able to rely on these new exemptions without taking into account the activities of its affiliates. According to the SEC, whether an adviser would need to take into account the activities of an affiliate generally depends on the degree of separateness between the adviser and the affiliate, which is a question of facts and circumstances.

- See the Exemptions Release containing the full text of the proposed rules
- See the press release and fact sheet issued by the SEC

The SEC has requested public comment on the proposed rules. Comments are due to the SEC within 45 days after publication in the Federal Register. Assuming Federal Register publication by November 29, the Monday after Thanksgiving, comments would be due the first week of January.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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