The SEC Proposes Registration Exemptions For Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers

On November 19, 2010, the Securities and Exchange Commission ("SEC") issued proposed rules to implement new exemptions from the registration requirements of the Investment Advisers Act of 1940 ("Advisers Act") for certain advisers of private investment funds, as enacted in the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[1] The Dodd-Frank Act repealed the section of the Advisers Act that exempts "any investment adviser from registration if the investment adviser (i) has had fewer than 15 clients in the preceding 12 months, (ii) does not hold itself out to the public as an investment adviser and (iii) does not act as an investment adviser to a registered investment company or a company that has elected to be a business development company" (the "private adviser exemption").[2] Congress repealed this provision primarily to require advisers to private funds to register under the Advisers Act, since the exemption allowed investment advisers with large amounts of assets under management and significant numbers of investors to avoid SEC oversight. In place of the private adviser exemption, Congress created three new exemptions, which apply to:

"(i) advisers solely to venture capital funds . . .

(ii) advisers solely to private funds with less than $150 million in assets under management in the United States . . . and

(iii) non-U.S. advisers with less than $25 million in aggregate assets under management from U.S. clients and private fund investors and fewer than 15 such clients and investors."[3]

These amendments to the Advisers Act will take effect July 21, 2011, unless otherwise noted in the Dodd-Frank Act.

The new exemptions for venture capital funds and advisers with less than $150 million in assets under management in the United States provide that the SEC shall require advisers relying on them to provide the SEC with reports and keep records as the SEC determines necessary or appropriate in the public interest or for the protection of investors. These new exemptions do not limit the statutory authority of the SEC to examine the books and records of advisers relying upon these exemptions.[4]

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1 The Dodd-Frank Act is available at http://www.govtrack.us/congress/billtext.xpd?bill=h111-4173.

2 *See Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers*, Release No. IA-3111; File No. S7-37-10 (Nov. 19, 2010), available at http://www.sec.gov/rules/proposed/2010/ia-3111.pdf, at 4 (citing Advisers Act § 203(b)(3)).

3 *Id*. at 6-7. These exemptions are not mandatory; a qualifying adviser could choose to register with the SEC unless it is barred from doing so by Section 203A of the Advisers Act, which generally does not allow the registration of most advisers that do not have at least $100 million in assets under management. *Id*. at 9-10.

4 *Id.* at 8.

The exemptive rules proposed by the SEC are drafted with great particularity and are narrow in scope. As a result, it does not seem likely that they will afford relief from registration for many U.S. investment advisers that are not presently required to register under the Advisers Act.

The SEC is seeking comment on the proposed rules within 45 days of publication in the Federal Register.

I. Exemption for Advisers of Venture Capital Funds

In conjunction with the new statutory exemption for investment advisers that advise only venture capital funds, the SEC proposes to define "venture capital fund" in accordance with Congress' apparent understanding of the nature of investments in a venture capital fund and "in light of other provisions of the federal securities laws that seek to achieve similar objectives."[5] By basing its proposed definition on what the SEC perceives as the key characteristics of venture capital funds, the SEC has excluded other types of private funds, such as leveraged buy-out funds and hedge funds, from the coverage of the venture capital fund exemption. This focused approach is consistent with the SEC's understanding of the intention of Congress to legislate regulatory oversight over advisers to other types of funds which Congress concluded operate in a manner that may give rise to systemic risk primarily due to their use of significant leverage to execute their investment strategies.[6]

In general, venture capital funds tend to be long-term investors that contribute substantial capital to early-stage companies or small, privately held companies, and these funds are generally not leveraged. Specifically, the SEC proposes to define "venture capital fund" as a private fund that:

- invests in equity securities of private companies in order to provide operating business expansion capital (*i.e.*, "qualifying portfolio companies") and at least 80 percent of each company's securities owned by the fund were acquired directly from the qualifying portfolio company;
- directly, or through its investment advisers, offers or provides significant managerial assistance to, or controls, the qualifying portfolio company;
- does not borrow or otherwise incur leverage (other than limited short-term borrowing);
- does not offer its investors redemption or other similar liquidity rights except in extraordinary circumstances;
- represents itself as a venture capital fund to investors; and
- is not registered under the Investment Company Act of 1940 ("Investment Company Act") and has not elected to be treated as a business development company ("BDC").[7]

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[5] *Id*. at 10, 12.

[6] *Id.* at 42-44.

[7] *Id*. at 13.

A. Qualifying Portfolio Companies

To come within the SEC's definition of "venture capital fund," a fund must invest in equity securities of "qualifying portfolio companies" and/or cash (and cash equivalents) and U.S. Treasuries with a remaining maturity of 60 days or less. Under the SEC's proposed rule, "qualifying portfolio companies" are companies that:

- are not publicly traded;
- do not incur leverage in connection with investments by the private funds;
- use the capital provided by the fund for operating or business expansion purposes rather than to buy out other investors; and
- are not themselves funds (*i.e.*, they are operating companies).[8]

1. *Private Companies*

A qualifying portfolio company is one that is not publicly traded and does not control, is not controlled by, and is not under common control with, a publicly traded company at the time of each investment by the venture capital fund. An adviser could, therefore, continue to rely on the exemption after a qualifying portfolio company is taken public, and could continue to do so even once the venture capital fund's portfolio consists entirely of publicly traded securities. The SEC believes this approach would provide advisers to venture capital funds "sufficient flexibility to exercise their business judgment on the appropriate time to dispose of portfolio company investments - which may occur at a time when the company is privately held or publicly held."[9] The SEC does not propose to define "venture capital fund" as a fund that invests only in U.S. companies.

2. *Equity Securities, Cash and Cash Equivalents and Short-Term U.S. Treasuries*

A venture capital fund must limit its investments to equity securities of qualifying portfolio companies, cash and cash equivalents and U.S. Treasuries with a remaining maturity of 60 days or less. A fund would not be considered a venture capital fund "if it invested in debt instruments (unless they met the definition of 'equity security') of a portfolio company or otherwise lent money to a portfolio company, strategies that are not the typical form of venture capital investing."[10] With regard to debt instruments or loans, the SEC proposes to adopt the definition of "equity security" in Section 3(a)(11) of the Securities Exchange Act of 1934 and rule 3a11-1 thereunder, which is relatively broad and includes common and preferred stock, warrants and other securities convertible into common stock, and limited partnership interests.

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[8] *Id*. at 13-14.

[9] *Id*. at 21.

[10] *Id*. at 22.

3. *Portfolio Company Leverage*

As defined by the SEC, a "qualifying portfolio company" is "one that does not borrow, issue debt obligations or otherwise incur leverage in connection with the venture capital fund's investments."[11] The SEC views "any financing or loan (unless it met the definition of equity security) to a portfolio company that was provided by, or was a condition of a contractual obligation with, a fund or its adviser as part of the fund's investments as being a type of financing that is 'in connection with' the fund's investment."[12] The SEC's proposed definition of "qualifying portfolio company" does not exclude companies that borrow in the ordinary course of their business.

4. *Capital Used for Operating and Business Purposes*

In its attempt to differentiate between venture capital funds, which "provide capital to portfolio companies for operating and business purposes (in exchange for an equity investment) and leveraged buyout funds, which acquire controlling equity interests in operating companies through the 'buy out' of existing security holders," the SEC proposes to include in its definition of "venture capital fund" that "at least 80 percent of each company's equity securities owned by the venture capital fund were acquired directly from each such qualifying portfolio company."[13] Thus, an adviser that advises private equity funds that acquire the majority of the portfolio companies' equity securities directly from other security holders are not eligible for the exemption. While a venture capital fund would still be able to rely on the exemption if it purchased the remaining 20 percent of each portfolio company's equity securities directly from existing shareholders, "a company that achieves an indirect buyout of its security holders, such as through the complete recapitalization or restructuring of the portfolio company capital structure would not be a qualifying portfolio company."[14] Conversely, the SEC suggests that it would not consider as a breach of the "80 percent requirement" a capital reorganization aimed merely at simplifying a qualifying portfolio company's capital structure and outstanding securities without altering the existing beneficial owners' rights, priority, or economic terms.

Because venture capital funds have the distinguishing characteristic of investing directly in portfolio companies "for the purpose of funding the expansion and development of the company's business rather than buying out existing security holders, otherwise purchasing securities from other shareholders, or leveraging the capital investment with debt financing," the SEC also proposes to include, as an element of its definition of "qualifying portfolio company," that the company "does not distribute company assets to other security holders in connection with the venture capital fund's investment in the company (which could be an indirect buyout)."[15] Furthermore, the SEC proposes to define a "qualifying portfolio company" as one that neither redeems not repurchases outstanding securities in connection with a venture capital fund's investment.

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[11] *Id*. at 27.

[12] *Id*. at 28.

[13] *Id*. at 29.

[14] *Id*. at 32.

[15] *Id*. at 29-30.

5. *Funds of funds excluded*

The SEC's proposed rule would define "qualifying portfolio company" as excluding any private fund or other pooled investment vehicle. "Without this definition, a venture capital fund could circumvent the intended scope of the exemption by investing in other pooled investment vehicles that are not themselves subject to the definitional criteria" under the SEC's proposed rule.[16]

B. Managerial Assistance

Because one of the distinctive features of venture capital investing is assistance to the fund's qualifying portfolio companies beyond simply the provision of capital, the SEC proposes that in order to be considered a venture capital fund, the fund or its investment adviser must either control the portfolio company or offer "to provide significant guidance and counsel concerning the management, operations or business objectives and policies of the portfolio company (and, if accepted, actually provides the guidance and counsel)."[17] The SEC recognizes that the nature of this managerial assistance may evolve with the needs of the qualifying portfolio companies and thus does not specify the character of the managerial assistance.

C. Limitation on Leverage

A venture capital fund, under the SEC's proposed definition, is "a private fund that does not borrow, issue debt obligations, provide guarantees or otherwise incur leverage, in excess of 15 percent of the fund's [aggregate] 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."[18] The requirement that the loans be non-renewable prevents short-term debt from being converted into long-term debt without full repayment to the lender.

These leverage criteria are in addition to the restrictions on a qualifying portfolio company's ability to issue debt in connection with the venture capital fund's investment.

D. No Redemption Rights

Another element of the proposed definition of a venture capital fund is that such a fund "issues securities that do not provide investors redemption rights except in 'extraordinary circumstances' but that do entitle investors generally to receive *pro rata* distributions."[19] Although venture capital funds do not generally allow investors to redeem their interests during the life of the fund, they may provide extraordinary rights for an investor to withdraw from the fund under circumstances that are foreseeable (*i.e.*, known to occur, such as changes in law) but are unexpected (in their timing or scope), or "rights to be excluded from particular investments due to regulatory or other legal requirements."[20] Thus, such withdrawal or exclusion rights are usually triggered by

[16] *Id*. at 35.

[17] *Id*. at 36.

[18] *Id*. at 41.

[19] *Id*. at 47.

[20] *Id*. at 47-48.

events beyond the control of the adviser and fund investor. Funds that permit withdrawals at certain periodic intervals would be considered to have granted investors redemption rights in the ordinary course and would thus not be eligible for the venture capital fund exemption.

E. Representation as a Venture Capital Fund

The SEC proposes to limit the definition of venture capital fund to "a private fund that represents itself as being a venture capital fund to its investors and potential investors."[21] This element can be satisfied if, for instance, a private fund describes itself as being managed in compliance with the elements of the SEC's proposed rule or if it portrays its investment strategy as venture capital investing.

F. Private Fund Requirement

The SEC's definition of the venture capital fund definition encompasses only "private funds" as defined in the Advisers Act. As such, it excludes registered investment companies (such as mutual funds) and BDC's regulated under the Investment Company Act.

G. Application to Non-U.S. Advisers

Congress gave no indication of whether it intended the exemption for advisers to venture capital funds to be available to advisers operating primarily outside the U.S. but that invest in U.S. companies or solicit U.S. investors. Therefore, the SEC is seeking comment on whether the proposed rule should allow an adviser with its principal office and place of business outside the U.S. (a "non-U.S. adviser") to rely on the exemption even if it advises funds that do not meet the SEC's proposed definition of "venture capital fund," provided that these funds are non-U.S. persons.

H. Grandfathering Provision

The SEC proposes to grandfather an existing private fund as a venture capital fund if it "(i) represented to investors and potential investors at the time the fund offered its securities that it is a venture capital fund; (ii) has sold securities to one or more investors prior to December 31, 2010; and (iii) does not sell any securities to, including accepting any additional capital commitments from, any person after July 21, 2011."[22] Thus, this grandfathering provision would include any fund that has accepted capital commitments by the specified dates even if the commitments have not been called. The SEC presumes that a fund meeting these criteria is unlikely to have been structured to evade the requirements of the exemption.

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[21] *Id*. at 50.

[22] *Id*. at 56.

II. Exemption for Investment Advisers Solely to Private Funds With Less Than $150 Million in Assets Under Management

The SEC's proposed rules also implement the new statutory exemption from registration for "any investment adviser solely to private funds that has less than $150 million in assets under management in the United States" (the "private fund adviser exemption").[23]

A. Advisers Solely to Private Funds

Like the venture capital fund advisers' exception, the private fund adviser exemption is available only to those advising "private funds" as the term is defined in the Advisers Act. The private fund adviser exemption does not place a limit on the number of private funds the adviser advises, but the aggregate value of the adviser's private fund assets must be less than $150 million.

With regard to non-U.S. advisers, the SEC proposes to provide the exemption if all of the adviser's clients that are U.S. persons are qualifying private funds, regardless of the type or amount of its non-U.S. clients.

B. Private Fund Assets

In order to determine whether an adviser is below the $150 million threshold, the SEC proposes to require advisers to calculate the value of all assets of private funds it manages in the U.S. by reference to Form ADV, which would provide a uniform method of calculating assets under management for purposes of the Advisers Act. The SEC proposes to require advisers to include not only the assets on a private fund's balance sheet but also uncalled capital commitments, "which are contractual obligations of an investor to acquire an interest in, or provide the total commitment amount over time to, a private fund, when called by the fund."[24]

The proposed rule would require advisers "to determine the amount of its private fund assets quarterly, based on the fair value of the assets at the end of the quarter."[25] Although the SEC proposes quarterly valuation of assets, it proposes that for purposes of reporting on Form ADV advisers report their regulatory assets under management annually.

C. Assets Managed in the United States

Under the SEC's proposed rule, all private fund assets of an adviser with a principal office and place of business in the U.S. would be deemed "assets under management in the United States," regardless of whether the adviser maintains offices abroad. 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, and therefore

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[23] *Id*. at 58.

[24] *Id*. at 61.

[25] *Id*.

. . . *the* place where all the advisers' assets are managed, although day-to-day management of certain assets may also take place at another location."[26]

A non-U.S. adviser, however, would only be obligated to include private fund assets it manages from a place of business in the U.S. in calculating assets toward the exemption's $150 million limit. The SEC has designed this approach to "encourage the participation of non-U.S. advisers in the U.S. market by applying the U.S. securities laws in a manner that does not impose U.S. regulatory and operational requirements on an adviser's non-U.S. advisory business."[27]

D. United States Person

The SEC proposes that the private fund adviser exemption would not be available to non-U.S. advisers that advise any "United States person" other than a private fund. The SEC proposes to adopt generally the definition of "United States person" in Regulation S.[28] The proposed definition, however, would contain "a special rule for discretionary accounts maintained outside of the United States for the benefit of United States persons. Under the proposed rule, an adviser must treat a discretionary or other fiduciary account as a United States person if the account is held for the benefit of a United States person by a non-U.S. fiduciary who is a related person of the adviser."[29] This special rule would prevent advisers from relying on the exemption if they have "established discretionary accounts for the benefit of U.S. clients with an offshore affiliate that would then delegate the actual management of the account back to the adviser."[30]

E. Transition Rule

The SEC proposes to give an adviser one calendar quarter (three months) to register with the SEC once the value of its private fund assets exceed the $150 million threshold, rendering the adviser ineligible under the private fund adviser exemption. This grace period would only be available to those advisers who have complied with all applicable SEC reporting requirements.

III. Foreign Private Adviser Exemption

In addition to the venture capital fund adviser exemption and the private fund adviser exemption, Congress authorized an exemption from registration under the Advisers Act for foreign private advisers. A foreign private adviser is defined in the newly revised Advisers Act as any investment adviser that:

- has no place of business in the United States;

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26 *Id*. at 65.

27 *Id*. at 67.

28 *See* Regulation S Rule 902(k).

29 *Id*. at 70.

30 *Id*.

- has, in total, fewer than 15 clients in the United States and investors in the United States in private funds advised by the investment 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; and
- does not hold itself out generally to the public in the United States as an investment adviser.[31]

The SEC proposes a new rule that would adopt the safe harbor rules and many of the client counting rules currently in effect under the private adviser exemption and would define several key terms used in the definition of "foreign private adviser."

A. Clients

The SEC's proposed rule would retain the criteria for allowing natural persons or legal organizations to be treated as a single client for purposes of the private adviser exemption. The propose rule, however, would be modified to eliminate the provision permitting advisers not to count clients from which they do not receive compensation. The SEC also proposes to add a provision, aimed at avoiding the double-counting of private funds and their investors, that "would specify that an adviser need not count a private fund as a client if the adviser counted any investor, as defined in the rule, in that private fund as an investor in that private fund for purposes of determining the availability of the exemption."[32]

B. Private Fund Investors

The foreign private adviser exemption applies only where an adviser does not advise more than 14 clients or investors in the United States in private funds. The SEC proposes to define "investor" in a private fund as "any person who would be included in determining the number of beneficial owners of the outstanding securities of a private fund under section 3(c)(1) of the Investment Company Act, or whether the outstanding securities of a private fund are owned exclusively by qualified purchasers under section 3(c)(7) of that Act."[33] An adviser would be permitted to treat as a single investor any person who is an investor in more than one private fund advised by the adviser.

The SEC is further proposing "to treat as investors beneficial owners (i) who are 'knowledgeable employees' with respect to the private fund, and certain other persons related to such employees" (collectively, "knowledgeable employees") and "(ii) of 'short-term paper' issued by the private fund, even though these persons

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[31] *Id*. at 72.

[32] *Id*. at 75.

[33] *Id*. at 77. Section 3(c)(1) exempts from registration funds having not more than 100 security holders and Section 3(c)(7) exempts from registration funds having only "qualified purchasers" as security holders and in each case, such funds must not make or propose to make a public offering of their securities.

are not counted as beneficial owners for purposes of section 3(c)(1), and knowledgeable employees are not required to be qualified purchasers under section 3(c)(7)."[34]

Although the SEC's proposal allows consolidation of clients under certain circumstances, it does not allow consolidation of investors for counting purposes.

C. In the United States

The new statutory definition of "foreign private adviser" uses the term "in the United States" in several contexts (*e.g.*, exempting only advisers without a place of business "in the United States," limiting the number of and assets attributable to the advisers' clients "in the United States" and investors "in the United States" in private funds advised by the adviser, exempting only advisers that do not hold themselves out to the public "in the United States" as investment advisers). With respect to a place of business "in the United States" or the public "in the United States," the SEC proposes to incorporate the definition of "United States" in Regulation S.[35] References to clients or private fund investors "in the United States" are proposed to mean anyone that is a "U.S. person" as defined in Regulation S, "except that any discretionary account or similar account that is held for the benefit of a person 'in the United States' by a non-U.S. dealer or other professional fiduciary is deemed in the Untied States if the dealer or professional fiduciary is a related person of the investment adviser relying on the exemption."[36] The SEC is proposing to add, for purposes of this definition, that "a person that is 'in the United States' may be treated as not being 'in the United States' if such person was not 'in the United States' at the time of becoming a client or, in the case of an investor in a private fund, at the time the investor acquires the securities issued by the fund."[37]

D. Place of Business

The SEC's proposed rule defines "place of business" as "any office where the investment adviser regularly provides advisory services, solicits, meets with, or otherwise communicates with clients, and any location held out to the public as a place where the adviser conducts any such activities."[38]

E. Assets Under Management

The SEC proposes to define "assets under management" by reference to Form ADV's calculation of "regulatory assets under management." The SEC believes that all advisers should employ the same method for calculating assets under management in order to achieve a higher level of consistency in asset calculations and reporting across the industry, and thus a more coherent application of the Advisers Act's requirements.

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[34] *Id*. at 80.

[35] *See* Regulation S Rule 902(l).

[36] *Id*. at 82.

[37] *Id*.

[38] *Id*. at 85.

IV. Conclusion

By repealing the current private adviser exemption, Congress indicated that advisers to private funds must generally register under the Advisers Act. While Congress created three new exemptions to take the place of the private adviser exemption, these exemptions are narrow in scope and if adopted as proposed, are not likely to provide an exemption from registration for many advisers not presently required to register.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com; or Yafit Cohn at 212.701.3089 or ycohn@cahill.com.

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