SEC PROPOSES RULES TO IMPLEMENT THE DODD-FRANK ACT'S ADVISERS ACT PROVISIONS

December 22, 2010

To Our Clients and Friends:

The Securities and Exchange Commission (the "SEC") has proposed new rules under the Investment Advisers Act of 1940 (the "Advisers Act")[1] to implement provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") relating to certain new exemptions from registration under the Advisers Act.[2]

Under the Dodd-Frank Act, many private fund sponsors and other financial institutions (including certain non-U.S. advisers and financial institutions) that relied on the "fewer than 15 clients" exemption under the Advisers Act will be required to register with the SEC by July 21, 2011 unless a new exemption is available to them. The proposed rules would implement three new exemptions from registration contained in the Dodd-Frank Act:

- an exemption for advisers solely to venture capital funds (the "VC Adviser Exemption");
- an exemption for advisers solely to private funds with less than $150 million in assets under management in the United States (the "Limited PF Exemption"); and
- an exemption for non-U.S. advisers with less than $25 million in aggregate assets under management attributable to, in total, fewer than 15 clients in the United States and U.S. investors in private funds managed by the adviser (the "Foreign Private Adviser Exemption").

The Limited PF Exemption may be of particular interest to a private fund sponsor whose principal office and place of business is outside of the United States (a "Non-U.S. Adviser"). (Under the proposed rules, an adviser's principal office and place of business is the executive

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1 *References to the Advisers Act hereinafter refer to the Advisers Act, as amended by the Dodd-Frank Act. The provisions discussed in this memorandum become effective July 21, 2011.*

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, SEC Rel. No. IA-3111 (Nov. 19, 2010) and Rules Implementing Amendments to the Investment Advisers Act of 1940, SEC Rel. No. IA-3110 (Nov. 19, 2010) (both available at http://sec.gov/rules/proposed.shtml).*

office of the investment adviser from which the officers, partners or managers of the investment adviser direct, control and coordinate the activities of the investment adviser.)

In fact, the Limited PF Exemption, if adopted as proposed, will undoubtedly be of greater utility to Non-U.S. Advisers than the Foreign Private Adviser Exemption. The Limited PF Exemption, as well as the VC Adviser Exemption, does come with some regulatory baggage, however. As discussed below, an adviser that avails itself of either of these two exemptions will be subject to reporting requirements and SEC examinations.

The SEC has requested that comments on the proposals be submitted by January 24, 2011.

FOREIGN PRIVATE ADVISERS

The Dodd-Frank Act will replace the current private adviser exemption in Section 203(b)(3) with the Foreign Private Adviser Exemption. This exemption will be available to a Non-U.S. Adviser that:

- has no place of business in the United States;
- has, in total, fewer than 15 clients in the United States and U.S. investors in private funds advised by the investment adviser;
- has aggregate assets under management attributable to such clients and investors in the United States of less than $25 million; and
- neither holds itself out to the U.S. public as an investment adviser nor acts as an investment adviser to an investment company registered under the Investment Company Act of 1940 (the "Investment Company Act"), or a company that has elected to be a business development company under the Investment Company Act.

The SEC interprets a person "in the United States" to mean a person who is a "U.S. person" under Regulation S under the Securities Act of 1933 (the "Securities Act"). For example, a natural person would be considered a U.S. person (and therefore, "in the United States") if that person is a resident of the United States. Similarly, a partnership or corporation would be a U.S. person if it is either (*i*) organized or incorporated under the laws of the United States or (*ii*) organized or incorporated under the laws of any foreign jurisdiction and formed by a U.S. person principally for the purpose of investing in securities not registered under

the Securities Act (*e.g.*, interests in a private fund), unless it is organized or incorporated, and owned, by accredited investors that are not natural persons, estates or trusts.[3]

Proposed Rule 202(a)(3)-1 defines certain other terms and sets forth rules with respect to client counting that are similar in many respects to current Rule 203(b)(3)-2. For example, a natural person, certain family members of such person and all accounts or trusts of which such natural person and family members are the beneficiaries may be counted as a single client. Unlike the existing rule, clients who do not pay fees must be counted.

In order to rely on the Foreign Private Adviser Exemption, the adviser must also determine the number of U.S. persons who are investors in private funds managed by the investment adviser. Generally, the SEC proposes to define an "investor" as any person that 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 (a privately offered fund with fewer than 100 investors) or whether the outstanding securities of a private fund are owned exclusively by qualified purchasers under Section 3(c)(7) of the Investment Company Act (a privately-offered fund with only qualified purchasers as investors). The effect of proposed Rule 202(a)(3)-1 is that the foreign private adviser will have to "look through" certain private fund investors organized as pooled investment vehicles to determine the number of investors in the United States. The Rule also specifies that investors that are knowledgeable employees, as well as the holders of short-term paper issued by a 3(c)(1) fund, must be counted as investors for purposes of determining whether the adviser may rely on the exemption.

These look-through provisions, coupled with the $25 million cap on assets under management attributable to U.S. persons, suggest that this exemption will be of very limited utility to a Non-U.S. Adviser, particularly one that manages a fund that has raised capital from U.S. persons.

VENTURE CAPITAL FUND ADVISERS

Section 203(l) of the Advisers Act provides an exemption from registration for advisers who provide advice solely to venture capital funds. Proposed Rule 203(l)-1 sets out several criteria for the definition of "venture capital fund":

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3 *There is one exception to this approach: any discretionary account or similar account that is held for the benefit of a U.S. person by a non-U.S. dealer or other professional fiduciary would be deemed to be "in the United States" if the dealer or professional fiduciary is a related person of the investment adviser relying on the exemption.*

- *Private Fund.* The fund must not be registered under the Investment Company Act or have elected to be regulated as a business development company under that Act.
- *Public Representations.* The fund must represent to investors that it is a "venture capital fund."
- *Permissible Investments.* Other than cash and short-term U.S. treasuries, the fund must hold only equity securities issued by "qualifying portfolio companies," at least 80 percent of which were acquired directly from the portfolio company. A "qualifying portfolio company" is generally a private company that is not an investment company, private fund or commodity pool and that has not borrowed or engaged in a share repurchase, distribution or similar transaction in connection with the fund's investment.
- *Control or Managerial Assistance.* The fund must either control each portfolio company or, either directly or through the fund's investment adviser, offer to provide (and provide, if accepted) significant guidance and counsel concerning the management, operations or business objectives and policies of the portfolio company.
- *Debt Limitations.* The fund's borrowing must be (*i*) limited to 15 percent of the fund's aggregate capital contributions and uncalled committed capital and (*ii*) for a non-renewable term of no longer than 120 calendar days.
- *Limitation on Investor Withdrawal.* The ability of investors in the fund to withdraw or redeem their interests in the fund is limited to extraordinary circumstances.

The proposed Rule provides for limited grandfathering for private funds that have represented themselves as "venture capital funds" to investors.

Finally, in an approach that is inconsistent with Rule 203(m)-1 (discussed below), the SEC has proposed that Section 203(l) only be available to a Non-U.S. Adviser where all of its clients, whether U.S. or non-U.S., are venture capital funds. The SEC has requested comment on this approach.

PRIVATE FUND ADVISERS

Proposed Rule 203(m)-1 would implement the Limited PF Exemption. The ability of an adviser to rely on the exemption would depend upon whether it is a U.S. adviser or Non-U.S. Adviser:

- *Assets Under Management Determination.* A Non-U.S. Adviser need only include the assets that it manages from any offices it has inside the United States in determining whether it

has less than $150 million under management. Assets managed from a place of business outside the United States would not count toward the $150 million. A place of business would be defined as (*i*) an office at which the investment adviser regularly provides investment advisory services to, solicits, meets with, or otherwise communicates with clients; and (*ii*) any other location that is held out to the general public as a location at which the investment adviser provides investment advisory services to, solicits, meets with or otherwise communicates with, clients. In contrast, a U.S. adviser must include its total assets under management, regardless of the location of the office from which those assets are managed.

- *Nature of Clients*. In determining whether it has clients that are not private funds, a Non-U.S. Adviser need only focus on its clients that are U.S. persons. In other words, the Non-U.S. Adviser may have clients that are not private funds if those clients are not U.S. persons. A U.S. adviser must consider all of its clients in making this determination.

Proposed Rule 203(m)-1 would require advisers with a U.S. place of business to calculate the value of private fund assets using the following framework:

- An adviser would have to determine the amount of its private fund assets quarterly, based on the fair value of the assets at the end of the quarter.
- A subadviser seeking to rely on the exemption would have to count only that portion of the private fund's assets for which it has responsibility.
- The adviser would also have to include any uncalled capital commitments in determining the private fund's assets.
- Assets in funds for which the adviser receives no compensation must be included in the calculation.

As currently proposed, this exemption would allow many Non-U.S. Advisers to be exempt from registration under the Advisers Act. In particular, a Non-U.S. Adviser with no place of business in the United States that does not provide investment advice with regard to any U.S. person that is not a private fund, would be exempt from registration under this provision, regardless of the amount of money it sources from U.S. investors in private funds.

SUBADVISERS, AFFILIATES AND UNANSWERED QUESTIONS

The proposed rules reflect the SEC's determination that it would be appropriate to permit a subadviser to rely on the new exemptions if the subadviser satisfies the terms and conditions of the applicable exemption. For example, if the subadviser has contractual privity with a

private or venture fund's primary adviser rather than the fund itself, the fund would be viewed as the client and, assuming the subadviser does not have non-fund clients, it could rely on the applicable exemption.

The SEC anticipates that an adviser with advisory affiliates will encounter interpretative issues as to whether it may rely on any of the exemptions without taking into account the activities of its affiliates. The examples that the SEC provides are an adviser that has an advisory affiliate that is a registered investment adviser, and an affiliate that provides advisory services that are inconsistent with the exemption on which the adviser may seek to rely. The SEC requested comment on these issues, and the SEC's further assessment of these issues could have a significant impact on the availability of the exemptions.

DISCLOSURE REQUIREMENTS FOR EXEMPT AND REGISTERED ADVISERS

Advisers relying on the VC Adviser Exemption and Limited PF Exemption ("Exempt Advisers") will not be entirely free of SEC oversight. An Exempt Adviser may be subjected to recordkeeping and reporting requirements and SEC examinations.

In addition, an Exempt Adviser would be required to file reports with the SEC electronically on Part 1A of Form ADV. An Exempt Adviser would not be required to provide all of the information required by Part 1A; rather, it would only be required to provide certain identifying information concerning the Exempt Adviser and the private funds that it manages, including the Exempt Adviser's:

- name, contact information and principal office and place of business;
- form of organization;
- business activities, and the activities of its affiliates;
- disciplinary history (including that of its employees);
- financial industry affiliations; and
- control persons.

Exempt Advisers would not be required to file Part 2A of Form ADV, which provides more extensive information concerning an adviser's business, its advisory personnel and the conflicts of interest that the adviser may face.

Both Exempt Advisers and registered investment advisers would be required to provide information concerning the private funds that they manage. This information would include the following:

- basic identifying information of the fund (which could be provided on an anonymous, code-based basis);
- the fund's structure (master-feeder, fund of funds, etc.);
- the type of the fund (hedge, private equity, real estate, etc.);
- the value of the fund's assets;
- information concerning the number and types of investors in the fund; and
- information concerning the fund's service providers (*i.e.*, its auditors, prime brokers, custodians, administrators and marketers).

The SEC expects to propose additional reporting requirements that will be applicable to Exempt Advisers in 2011.

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Please feel free to contact us with any questions.

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