SEC Proposes Rules to Implement the Private Fund Investment Advisers Registration Act

On November 19, 2010, the Securities and Exchange Commission ("SEC") proposed rules to implement certain provisions under the Private Fund Investment Advisers Registration Act of 2010 (the "Registration Act"), which was signed into law as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act"). If adopted as proposed, these new rules would effect significant changes to the existing registration and reporting regime applicable to both registered and unregistered advisers under the Investment Advisers Act of 1940 (the "Advisers Act"). Among other things, the rules would:

1. Clarify the scope of new exemptions from registration for certain advisers, including exemptions for advisers solely to venture capital funds, advisers solely to private funds managing less than $150 million in assets in the United States, and foreign private advisers;
2. Clarify eligibility requirements for registration as an investment adviser with the SEC for advisers with less than $100 million in assets under management (certain of these clarifications would also affect advisers with greater than $100 million in assets under management);
3. Set forth reporting requirements for certain advisers exempt from registering with the SEC;
4. Expand the information required to be provided by registered investment advisers under Form ADV, including by establishing substantial new reporting requirements with respect to each private fund advised by a registered adviser; and
5. Amend the political contribution rules adopted by the SEC earlier this year.

A summary of the SEC's proposed rules and other amendments implementing the Registration Act appears below. The SEC's proposed rules implementing the Registration Act may be found here and here. The SEC is accepting comments on the proposed rules until approximately January 4, 2011 (the exact date will be 45 days after publication of the proposed rules in the Federal Register).

1. Exemptions from the Advisers Act Registration Requirements

The Registration Act eliminated the so-called "private adviser exemption" under Section 203(b)(3) of the Advisers Act, which exempted any investment adviser from registration if the adviser did not hold itself out to the public as an investment adviser, had fewer than 15 clients (with each private fund counting as a single client for this purpose), and was not an adviser to a registered investment company. In lieu of the private adviser exemption, the Registration Act created three new exemptions from registration under the Advisers Act: (i) an exemption for advisers solely to venture capital funds (the "venture capital fund exemption"); (ii) an exemption for advisers solely to private funds with less than $150 million in assets under management in the United States, without regard to the number or type of private funds (the "private fund adviser exemption"); and (iii) an exemption for certain non-U.S. advisers with no place of business in the United States and minimal assets under management attributable to U.S. clients and investors (the "foreign private adviser exemption").

Exempt advisers relying on the venture capital fund exemption or the private fund adviser exemption are categorized by the SEC as "exempt reporting advisers." As further discussed below under "*Reporting Requirements for Exempt Reporting Advisers*," although exempt reporting advisers are not required to register as investment advisers with the SEC, they remain subject to certain reporting requirements and to examination by the SEC. The proposed rules released by the SEC implement each of the three exemptions, which are summarized below.

(a) Venture Capital Fund Exemption

Proposed Rule 203(l)-1 defines a venture capital fund as a private fund that: (i) invests solely in equity securities of "qualifying portfolio companies" and certain short-term debt obligations; (ii) directly (or through its adviser) offers or provides significant managerial assistance to (or controls) the qualifying portfolio company; (iii) is not leveraged; (iv) does not offer its investors redemption rights or other similar liquidity rights, except in extraordinary circumstances; (v) represents itself as a venture capital fund to investors; and (vi) is not registered under the Investment Company Act of 1940 (the "Investment Company Act"), and has not elected to be treated as a business development company. The SEC also proposed a grandfathering provision for certain existing funds that would not meet all of the conditions set forth above but have held themselves out historically as venture capital funds.

i. Qualifying Portfolio Company

Under the proposed rule, a venture capital fund must own solely equity securities of U.S. or non-U.S. qualifying portfolio companies, cash (or cash equivalents), and U.S. Treasuries with a remaining maturity of 60 days or less. A private fund will not fall within the definition of a venture capital fund if it invests in debt instruments of a portfolio company or otherwise loans money to a portfolio company (except for certain debt convertible into stock). At least 80 percent of a qualifying portfolio company's equity securities owned by a venture capital fund must be acquired directly from the qualifying portfolio company.

A qualifying portfolio company is a company that:

- *Is not publicly traded.* The SEC clarified that a venture capital fund may continue to hold securities of a portfolio company that becomes public, but it cannot make a new investment in a publicly traded company or an affiliate of a publicly traded company.
- *Does not borrow in connection with an investment by a fund.* Under the proposed rule, qualifying portfolio companies could borrow in the ordinary course of business; however, any loan or other debt financing provided in connection with an investment by a fund would disqualify a company.
- *Does not use capital provided by a fund for buying out security holders or distributing assets to security holders.* In effect, the capital is to be used for operating or business expansion purposes.
- *Is not a pooled investment vehicle.* In other words, the company must be an operating company. A fund-of-funds that invests in other private funds or investment companies could not qualify as a venture capital fund, even if the underlying portfolio funds were themselves venture capital funds.

ii. Managerial Assistance

To qualify as a venture capital fund under the proposed rule, the fund or its adviser must either (i) have an arrangement under which the fund or the adviser provides significant guidance and counsel regarding the management, operations, or business objectives and policies of the qualifying portfolio company, or (ii) control the qualifying portfolio company. The proposed rules do not specify that managerial assistance has a fixed character. Managerial assistance may be active involvement in the business, operations, or management of the portfolio company, or may be a less active form of control such as board representation or similar voting.

iii. Limitations on Leverage

For purposes of the exemption, a venture capital fund cannot 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. Any such borrowing, indebtedness, guarantee, or leverage must be for a non-renewable term of no longer than 120 calendar days.

iv. No Redemption or Similar Liquidity Rights

A venture capital fund cannot provide investors with redemption or withdrawal rights or the right to require the repurchase of securities, except in extraordinary circumstances.

v. Represents Itself as a Venture Capital Fund and is a Private Fund

The proposed rule further limits the definition of venture capital funds to funds that represent themselves to investors or potential investors as being venture capital funds. To satisfy this requirement, a fund could describe its investment strategy as venture capital investing or as a fund that is managed in compliance with the elements of the venture capital fund exemption rule. In addition, a venture capital fund must be a private fund (*i.e.*, a 3(c)(1) or 3(c)(7) fund) and not a registered investment company or a regulated business development company.

vi. Grandfathering Provision

Included in the definition of venture capital fund is any fund that: (i) represented to investors and potential investors that it was a venture capital fund at the time such fund offered its securities; (ii) has sold securities to one or more investors prior to December 31, 2010; and (iii) does not sell securities to, or accept additional capital commitments from, any person after July 21, 2011. The proposed grandfathering provision would include any fund that has accepted capital commitments by the specified dates even if none of the commitments have been called. Funds that meet these grandfathering conditions would not be required to satisfy the stricter definition of "venture capital fund" applicable to new funds.

(b) Private Fund Adviser Exemption

i. U.S. Advisers

Proposed Rule 203(m)-1 provides that a U.S. adviser (*i.e.*, an adviser with its principal office and place of business in the United States) solely to "private funds" is exempt from registration under the Advisers Act if the aggregate value of the adviser's assets under management in the United States is less than $150 million. A private fund for these purposes means any private fund (*i.e.*, a 3(c)(1) or 3(c)(7) fund) that is not registered under Section 8 of the Investment Company Act and has not elected to be treated as a business development company. Under the proposed rule, a U.S. adviser can advise an unlimited number of private funds, provided that the value of the adviser's aggregate private fund assets under management is less than $150 million. However, in order to rely on the private fund adviser exemption, a U.S. adviser must aggregate the value of all assets of private funds it manages, regardless of where the funds are organized, to determine whether the adviser remains below the $150 million limitation.

The proposed rules require an adviser to calculate its assets under management in accordance with the definition of "regulatory assets under management" set forth in amended Form ADV. See "*Eligibility for Registration with the SEC – Calculation of Assets Under Management*" below for more details on the calculation of assets under management for this purpose. Under the proposed rule, an adviser must calculate its assets under management on a quarterly basis.

ii. Transition Rule

Under the proposed rules, an adviser will have one calendar quarter after it exceeds $150 million in private fund assets (and therefore becomes ineligible to rely on the private fund adviser exemption) to register as an investment adviser with the SEC. However, this three month grace period is only available to advisers that have complied with all applicable SEC reporting requirements. (See "*Reporting Requirements for Exempt Reporting Advisers*" below for more information.)

iii. Non-U.S. Advisers

Under proposed Rule 203(m)-1, non-U.S. advisers (defined as those with their principal office and place of business outside of the United States) are exempt from registration if: (i) the adviser has no client that is a U.S. person, except for one or more private funds; and (ii) all assets managed by the adviser from a place of business in the United States are attributable solely to private fund assets, the total value of which is less than $150 million. The method for calculating assets under management, the definition of private fund, and the transition rule described above apply equally to non-U.S. advisers.

As a result of this implementation of the Registration Act, non-U.S. advisers with no U.S. operations would not need to register under the Advisers Act unless they have U.S. clients that are not private funds. It remains to be seen whether the SEC will further refine the concept of "managed by the adviser from a place of business in the United States" for non-U.S. advisers with a U.S. affiliate (*e.g.*, whether a private fund for which a U.S. affiliate is involved in the investment process, but does not make the final investment decision, would be included). As noted above, non-U.S. advisers exempt from registration pursuant to the private fund adviser exemption will still be subject to reporting requirements and examination. (See "*Reporting Requirements for Exempt Reporting Advisers*" below for more information).

(c) Foreign Private Adviser Exemption

The Registration Act provides for an exemption from registration for a "foreign private adviser," which is defined as an investment adviser that: (i) has no place of business in the United States; (ii) has fewer than 15 clients and investors in the United States in private funds advised by it; (iii) has less than $25 million in assets under management attributable to U.S. clients and investors in the United States in private funds advised by it; and (iv) neither holds itself out to U.S. investors as an investment adviser, nor acts as an investment adviser to any investment company registered under the Investment Company Act or any company that has elected to be a business development company.

Proposed Rule 202(a)(30)-1 defines certain terms for use by investment advisers seeking to avail themselves of the foreign private adviser exemption, highlights of which are discussed below:

- *Place of Business.* "Place of business" means any office where an 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 investment adviser conducts any such activities.
- *Clients.* A non-U.S. adviser is permitted to treat as a single client: (i) certain family members and related accounts; (ii) an entity to which the adviser provides investment advice based on the entity's investment objectives; and (iii) two or more entities that have identical shareholders, partners, limited partners, members, or beneficiaries. Further, any general partner, managing member, or other person acting as an investment adviser to a limited partnership or limited liability company must treat the limited partnership or the limited liability company as a client. If a client relationship involving multiple persons does not fall within this rule, the question of whether the relationship may appropriately be treated as a single client must be determined on the basis of the facts and circumstances involved. Finally, a non-U.S. adviser is not required to count a private fund as a client if the non-U.S. adviser is counting any investor (as discussed below) in that private fund as an investor in the United States in that private fund.
- *Investors.* An "investor" is 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, 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, except that certain adviser employees and their related persons and beneficial owners of short-term paper issued by the private fund will also be included in determining the number of beneficial owners of outstanding securities of a private fund. These tests under Section 3(c)(1) and Section 3(c)(7) require "looking through" an entity to its underlying investors under certain circumstances. A non-U.S. adviser may treat as a single investor any person that is an investor in two or more private funds advised by the non-U.S. adviser.
- *Assets Under Management.* Assets under management are determined in the same manner as described under "*Eligibility for Registration with the SEC – Calculation of Assets Under Management*" below.
- *In the United States.* "In the United States" is generally defined consistently with Regulation S under the Securities Act of 1933 (the "Securities Act") (which regulates non-U.S. offerings of securities).
- *Holding Out.* A non-U.S. adviser would not be deemed to be holding itself out to the public if it participates in a non-public offering in the United States of securities issued by a private fund.

Unlike a non-U.S. adviser relying on the private adviser exemption, non-U.S. advisers relying on the exemption for foreign private advisers (i) are not given any time in which to register with the SEC after becoming ineligible to rely on this exemption due to an increase in the value of private assets attributable to U.S. clients and investors in the United States, and (ii) do not need to comply with the reporting and examination requirements discussed in "*Reporting Requirements for Exempt Reporting Advisers*" below.

2. Eligibility for Registration with the SEC

In its current form, Section 203A of the Advisers Act (i) generally prohibits an adviser regulated by the state in which it maintains its principal office and place of business from registering with the SEC (unless the adviser has at least $25 million in assets under management) and (ii) preempts certain state laws that would otherwise regulate advisers registered with the SEC. Section 410 of the Dodd-Frank Act raises the threshold for SEC registration to $100 million by creating a new category of advisers called "mid-sized advisers" that have assets under management between $25 million and $100 million. The SEC has proposed amendments to several of its current rules and forms to implement the new registration rules applicable to mid-sized advisers. **Certain of the changes described below will affect all federally registered advisers, including those with assets under management of more than $100 million.**

(a) Determining Eligibility for Registration – Form ADV

Proposed Rule 203A-5 would require *each* adviser registered with the SEC as of July 21, 2011, including those with assets under management of more than $100 million, to file an amendment to its Form ADV no later than August 20, 2011. Each investment adviser must report (in that amendment and annually) whether it is eligible to remain registered. Proposed revisions to Item 2 of Form ADV would reflect the new $100 million statutory threshold for registration with the SEC and would require each adviser registered with the SEC (and each applicant for registration) to identify whether, under Section 203A of the Advisers Act, as amended, it is eligible to register with the SEC because it: (i) is a large adviser (having $100 million or more of regulatory assets under management); (ii) is a mid-sized adviser that does not meet the criteria for state registration and examination; (iii) has its principal office and place of business in Wyoming (which does not regulate advisers) or outside the United States; (iv) meets one or more of the exemptions from prohibition on registration set forth in the rules under Section 203A of the Advisers Act; (v) is an adviser (or subadviser) to a registered investment company; (vi) is an adviser to a business development company and has at least $25 million in assets under management; or (vii) has some other basis for registering with the SEC.

(b) Mid-Sized Advisers ($25 - 100 Million in Assets Under Management)

Section 203A(a)(2) of the Advisers Act will prohibit mid-sized advisers (*i.e.*, advisers with $25 million to $100 million in assets under management) from registering with the SEC if: (i) the adviser is required to be registered as an investment adviser with the securities commissioner (or any agency or office performing like functions) of the state in which it maintains its principal office and place of business; and (ii) if registered, the adviser would be subject to examination as an investment adviser by such commissioner, agency, or office. The SEC proposes to incorporate into Form ADV an explanation of how to determine whether a mid-sized adviser is "required to be registered" or is "subject to examination" by a particular state securities authority.

- *Required to be Registered*. Under Section 203A(a)(1) of the Advisers Act, a mid-sized adviser that is not regulated or required to be regulated as an investment adviser in the state in which it has its principal office and place of business must register with the SEC regardless of the amount of assets it has under management, unless an exemption from registration is otherwise available. The SEC has proposed changes to Form ADV to require a mid-sized adviser filing with the SEC to affirm, upon application and annually thereafter, that it is not required to be registered as an adviser with the state securities authority in the state where it maintains its principal office and place of business.

- *Subject to State Examination*. A mid-sized adviser must register with the SEC if the adviser is not subject to examination as an investment adviser by the state in which the adviser has its principal office and place of business. The SEC will correspond with each state securities commissioner (or official with similar authority) and request that each state securities commissioner (or official with similar authority) advise the SEC as to whether an investment adviser registered in the state would be subject to examination as an investment adviser by that state's securities commissioner.

(c) Calculation of Assets Under Management

In most cases, the amount of assets an adviser has under management will determine whether the adviser must be registered with the SEC or the states. Form ADV requires an adviser to report the market value of its assets under management, as determined within 30 days of the filing.

The SEC is proposing a uniform method of calculating assets under management for purposes of determining eligibility for SEC registration, reporting assets under management on Form ADV, and the new exemptions from registration under the Advisers Act. (See "*Exemptions from the Advisers Act Registration Requirements*" above for more information). Under the proposed rules, in calculating regulatory assets under management, an adviser would:

- include the value of any securities portfolios (i.e., at least 50% of the total value of the portfolio consists of securities) or any private fund for which it provides continuous and regular supervisory or management services, regardless of the nature of the assets held by the portfolio and/or the fund (e.g., proprietary assets, assets managed without receiving compensation, or assets of foreign clients);
- include the amount of any uncalled capital commitments made to a fund;
- not subtract any outstanding indebtedness and other accrued but unpaid liabilities that remain in a client's account and are managed by the adviser; and
- use fair value in determining assets under management.

Because advisers are required to assess their eligibility for registration on an annual basis, advisers will not need to switch frequently between state and SEC registration as a result of mid-year changes in the value of assets under management. As is the case under the current rules, if an adviser is no longer eligible for SEC registration at the end of its fiscal year, the rule provides a 180-day grace period from the adviser's fiscal year end to allow it to switch to state registration.

(d) Exemptions from the Prohibition on Registration with the SEC

Section 203A(c) of the Advisers Act provides the SEC with the authority to permit advisers to register with the SEC even though they would be prohibited from doing so otherwise. Under this authority, the SEC adopted six exemptions in Rule 203A-2 from the prohibition on registration. The SEC has proposed amendments to three of the exemptions to reflect developments since their adoption: (i) the exemption for nationally recognized statistical rating organizations would be eliminated; (ii) the exemption for pension consultants would be amended to increase the minimum value of plan assets from $50 million to $200 million; and (iii) the multistate exemption would be amended to permit SEC registration for an investment adviser required to register with 15 or more states.

3. Reporting Requirements for Exempt Reporting Advisers

As discussed above under "*Exemptions from the Advisers Act Registration Requirements*," certain advisers are exempt from registering with the SEC as investment advisers. Nevertheless, Section 203(l) and Section 203(m) under the Advisers Act permit the SEC to require exempt reporting advisers (*i.e.*, advisers relying on the venture capital fund exemption or the private fund adviser exemption) to maintain certain records and submit reports to the SEC.

Proposed Rule 204-4 requires exempt reporting advisers to file reports with the SEC on Form ADV through the Investment Adviser Registration Depository. However, exempt reporting advisers would only be required to complete certain items in Part 1A of Form ADV (as well as corresponding sections of the schedules to Part 1A), namely, basic identifying information and information regarding other business activities engaged in by the adviser, financial industry affiliations, private funds managed by the adviser (see "*Amendments to Form ADV*" below for more information), the adviser's control persons, and disciplinary history for the adviser and its employees. Exempt reporting advisers would not be required to prepare a client brochure (Form ADV Part 2) under the proposed rule; however, reports filed by exempt reporting advisers would be publicly available on the SEC's website. In addition, exempt reporting advisers would be required to update the information provided on Form ADV pursuant to the same timeframes applicable to registered investment advisers (*i.e.*, exempt reporting advisers will be required to update the information at least annually, and may be required to file interim updates in the event of certain changes to their businesses). In order to facilitate filings by exempt reporting advisers, the SEC proposed several corresponding amendments to Form ADV. Exempt reporting advisers are required to file an initial Form ADV with the SEC by no later than August 20, 2011. If the proposed rules are adopted without modification, exempt reporting advisers will need to solicit disciplinary history information from their personnel and controlled companies in advance of the August 20, 2011 filing deadline in order to be in a position to make a complete and accurate filing by such date.

In addition to the filing requirements for exempt reporting advisers set forth in the proposed rules, the SEC has explicitly noted in a release accompanying the proposed rules that exempt reporting advisers are subject to examination by the SEC. Because the venture capital fund exemption and the private fund adviser exemption are set forth in Section 203(l) and Section 203(m) of the Advisers Act, rather than Section 203(b) (as was the case with respect to the historic private adviser exemption), the SEC views exempt reporting advisers as subject to examination pursuant to Advisers Act Section 204(a). There is no indication in the proposed rules or rule releases what an examination of an exempt reporting adviser might entail; however, an exempt reporting adviser should, at a minimum, be prepared to demonstrate to the SEC the basis for its responses in Form ADV Part 1A.

4. Amendments to Form ADV

The proposed rules amend Form ADV to generally require advisers to provide the SEC with additional information about three specific areas of their operations. First, the proposed amendments expand the identifying information that an adviser is required to provide to the SEC with respect to each private fund it advises (the scope of the required information is described in further detail below). Second, the amendments expand and/or refine the information collected by the SEC with respect to an adviser's advisory business (including data about its clients, employees, and advisory activities), as well as business practices that may present significant conflicts of interest (including the use of affiliated brokers, soft dollar arrangements, and compensation for client referrals). Third, the proposed amendments require an adviser to provide additional information about its non-advisory activities and financial industry affiliations. The proposed amendments to Form ADV impact reporting for both registered investment advisers and exempt reporting advisers.

The proposed amendments to Form ADV would (i) significantly increase the scope of information required to be provided on Section 7.B of Schedule D to Part 1A concerning the private funds advised by an adviser, (ii) modify the scope of the current disclosure requirement by requiring completion of Section 7.B only for a private fund that the adviser (and not a related person) advises, and (iii) clarify the application of the disclosure requirements to master-feeder funds and non-U.S. funds. In particular, an adviser would be required to provide, with respect to each such private fund that it advises, information regarding:

- The name of the fund (although an adviser is permitted to use a code name, rather than the actual name);
- The organization of the fund (including the name of the general partner);
- The fund's regulatory status (i.e., exemptions from the Investment Company Act and Securities Act);
- Information about any other advisers or sub-advisers to the fund;
- Gross and net assets;
- Type of investment strategy employed (choosing from one of seven broad categories established by the SEC);
- A breakdown of assets and liabilities held by the fund by class and categorization in the fair value hierarchy established under GAAP;
- The number and types of investors, as well as minimum amounts required to be invested;
- Certain characteristics of the fund that may present the adviser with conflicts of interest; and
- Information concerning five types of service providers that the SEC has identified as providing important "gatekeeper" roles for private funds (*i.e.*, auditors, prime brokers, custodians, administrators, and marketers). Advisers would be required to name these service providers, and provide certain information concerning, among other things, the services they provide, whether they are affiliated with the adviser, and their regulatory status.

5. Amendments to Political Contribution Rules

On June 30, 2010, the SEC approved Rule 206(4)-5 under the Advisers Act, which addresses so-called "pay to play" practices in the selection of advisers to manage the assets of U.S. state and local government entities (*e.g.*, state pension funds, any state or local government controlled fund, or any investment program or plan sponsored or established by a state or local government, including participant directed plans such as 529 tuition plans and 403(b) and 457 retirement plans). The rule, which applies to both registered advisers and unregistered advisers, effectively prohibits investment advisers who advise or seek to advise government entities, as well as certain personnel of such advisers, from making, or causing to be made, greater than *de minimis* political contributions to government officials with authority or influence over the hiring of investment advisers. The rule also requires that any placement agent retained by an investment adviser to solicit a government entity be either a registered broker-dealer that is itself subject to "pay to play" regulations or a registered investment adviser. For more information about Rule 206(4)-5, please see *SEC Adopts Advisers Act Rule Addressing "Pay to Play" Practices*.

The SEC proposed three amendments to the political contribution rules:

- In order to avoid unintended narrowing of the application of the rule as a result of the recent amendments to the Advisers Act, the SEC proposes expanding the application of the rule to exempt reporting advisers and foreign private advisers.

- The SEC proposes the inclusion of "regulated municipal advisors" within the list of persons registered advisers will be permitted to pay to solicit government entities (previously, only registered investment advisers and registered broker-dealers could be retained for this purpose under the rule).
- The SEC proposes amending Rule 206(4)-5's definition of a "covered associate" of an investment adviser to clarify that a legal entity (not just a natural person) that is a general partner or managing member of an investment adviser would meet the definition.

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If you would like to learn more about the issues raised in this alert, please contact the lawyers listed below or your usual Ropes & Gray adviser.

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