SEC Proposes New Rules for Investment Advisers to Private Funds

The Securities and Exchange Commission (the "SEC") recently proposed new rules that will significantly change the registration and reporting obligations of investment advisers to private investment funds.[1] The proposed rules would implement changes mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), that will generally become effective in July 2011.

Changes Required by the Dodd-Frank Act

The Dodd-Frank Act eliminated an exemption, previously relied on by many fund managers, permitting an investment adviser to be exempt from federal registration as an investment adviser if, among other things, the adviser had fewer than 15 clients, treating as a single client for these purposes a privately offered investment fund, such as a hedge fund, private equity fund or venture capital fund.

The Dodd-Frank Act directed the SEC to adopt regulations providing new exemptions for:

- Investment advisers providing investment advisory services only to venture capital funds;
- Investment advisers having less than $150 million in private fund assets under management and no clients other than private funds ("private fund advisers"); and
- Non-U.S. investment advisers ("foreign private advisers") that, among other things, have no U.S. place of business, have fewer than 15 clients in the United States and investors in the United States in private funds advised by the adviser, and have less than $25 million in assets under management from U.S. clients and investors.

Among the key items left to be determined by the SEC were: the definition of a "venture capital fund," the calculation of assets under management and some of the parameters of the private fund adviser and foreign private adviser exemptions. In addition, the SEC was given authority to impose additional reporting obligations on certain exempt advisers, and to collect new information from registered investment advisers.

The Dodd-Frank Act also effectively moved the dividing line between state and federal investment adviser registration of U.S-based investment advisers, by eliminating the federal preemption of state investment adviser regulation for most investment advisers having less than $100 million in assets under management. Under current law until these changes take effect, investment advisers having at least $30 million in assets under management are exempt from state regulation of investment advisers, and investment advisers with at least $25 million in assets under management may opt into federal rather than state regulation. After July 2011, investment advisers with between $25 million and $100 million in assets under management will generally be required to register (or find an exemption from registration) under applicable state investment adviser regulation. Those having at least $25 million in asset under management, that are not required to register as an investment adviser in the state in which they have their principal place of business, will continue to be required to register or find an exemption from registration under federal law.

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[1] The proposed rules are contained in SEC Release No. IA-3110, "*Rules Implementing Amendments to the Investment Advisers Act*," and SEC Release No. IA-3111, "*Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less Than $150 Million in Assets Under Management, and Foreign Private Advisers*," both issued on November 19, 2010.

Venture Capital Adviser Exemption

Under the proposed rules, a "venture capital fund" is a private fund that (in general terms):

- Holds itself out as a venture capital fund;
- Owns only cash, cash equivalents and equity securities of "qualifying portfolio companies;"
- Acquired at least 80% of the equity securities of each company in its portfolio directly from the issuer rather than other investors;
- Controls the portfolio company, or has an arrangement under which it offers to provide significant guidance to the portfolio company;
- Does not borrow or otherwise incur leverage except for certain short term borrowings in an amount no greater than 15% of the fund's aggregate capital contributions and uncalled capital commitments; and
- Does not issue securities that provide the holder with redemption rights or similar rights except in extraordinary circumstances.

In addition, there is a grandfather provision for funds that hold themselves out to be venture capital funds, if they have sold securities to third party investors prior to December 31, 2010, and do not make additional sales of securities (or accept additional capital commitments) after July 21, 2011.

For purposes of the exemption, a qualifying portfolio company is one that (i) is not publicly traded, or controlled by a publicly traded company, at the time of the initial investment, (ii) does not borrow, directly or indirectly, in connection with the fund's investment, (iii) does not redeem securities of other investors in connection with the fund's investment and (iv) is not itself an investment company, private fund or commodity pool. The equity securities acquired by the venture capital fund could include preferred stock or debt that was convertible into equity, but not the bridge loans that are sometimes made to emerging companies in anticipation of a round of equity financing.

The purpose of these requirements is, fundamentally, to distinguish venture capital funds from private equity funds and to limit the venture capital exemption to funds that do not engage in activities that could pose "systemic risk" to the overall economy. The structure of the exemption will force a specialization of both funds and advisers and influence the way that investments are made in portfolio companies.

Although venture capital advisers are exempt from federal registration of investment advisers, the proposed rules require venture capital advisers to file reports with the SEC using a modified version of Form ADV.

Private Fund Adviser Exemption

Under the proposed rules, a private fund adviser that has its principal place of business in the United States is exempt from federal registration as an investment adviser if it acts solely as an investment adviser to one or more private funds and has assets under management of less than $150 million. A private fund adviser that has its principal place of business outside the United States is exempt if its U.S. clients are limited to private funds, and the assets that it manages from any U.S. place of business have a value less than $150 million.

Assets under management, for purposes of the proposed rules, include both the value of the assets on the fund's balance sheet and any uncalled capital commitments. Each adviser will have to calculate value quarterly, on a fair value basis. Advisers will have one calendar quarter to register under the Investment Advisers Act of 1940, as amended, if the value of their assets increases above $150 million.

For advisers with offices in the United States and elsewhere, a key question will be where their principal office is located. If their principal office is in the United States, all of their assets will be counted. If this principal office is outside the United States, only assets managed from the U.S. office would count towards the $150 million limitation.

In order to rely on the private fund adviser exemption, a foreign adviser may not advise any client that is a U.S. person other than a private fund. The proposed rules rely on the definition of U.S. person that is contained in Regulation S under the Securities Act of 1933, as amended.

U.S. and foreign advisers using the private fund adviser exemption will be required to file reports with the SEC on the modified Form ADV.

Foreign Private Advisers

The foreign private adviser exemption is a more narrow exemption that applies only if the adviser has no place of business in the United States. Compliance with this exemption will be a complex task for many advisers, since it will require them to count both U.S. clients and U.S. investors in funds that they advise.

Complex look-through rules will apply, using generally the same principles for determining beneficial ownership as are used for compliance with the Section 3(c)(1) and 3(c)(7) exemptions from registration under the Investment Company Act of 1940, as amended. Holders of a fund's debt securities and certain derivative instruments will also be counted as investors.

Foreign private advisers will not be subject to the SEC reporting requirements applicable to venture capital advisers and private fund advisers.

broe@cohengresser.com

ph: 212 707 1331

fax: 212 975 4514

About the Author

Bonnie J. Roe is a partner in the Corporate Group of Cohen & Gresser LLP, where she represents publicly and privately held companies and investment funds.