Client Advisory

Katten
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Comments Due January 24 on SEC's Proposed Exemptions from Investment Adviser Registration Mandated by Dodd-Frank

The Securities and Exchange Commission has proposed rules defining three new exemptions from investment adviser registration (the Proposed Exemptive Rules) mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), which made significant changes to the Investment Advisers Act of 1940, as amended (the Advisers Act). Comments are due January 24 on the exemptions, which would be available to:

- advisers solely to "private funds" that have less than $150 million of assets under management (AUM) in the United States (the Private Fund Adviser Exemption);
- non-U.S. advisers that have less than $25 million in AUM from U.S. clients and U.S. private fund investors and fewer than 15 such clients and investors (the Foreign Private Adviser Exemption); and
- advisers solely to "venture capital funds" (the VC Adviser Exemption) (collectively, the Proposed Exemptive Rules).

In addition, the SEC has proposed a number of rules and amendments (the Proposed Implementing Rules) to implement provisions of Dodd-Frank, including amendments to Form ADV. The Proposed Implementing Rules are the subject of a separate Katten advisory.[1]

Title IV, the Private Fund Investment Advisers Registration Act, was intended to require many managers of hedge funds and private equity funds to register with the SEC. Effective July 21, 2011, Dodd-Frank repeals the private adviser exemption from registration under Section 203(b)(3) of the Advisers Act (the PAE) for investment advisers who (i) have had fewer than 15 clients in the preceding 12 months; (ii) do not generally hold themselves out to the public as investment advisers; and (iii) do not act as advisers to registered investment companies or business development companies. Because a pooled investment vehicle was generally counted as a single "client" for purposes of the PAE, many advisers to hedge funds, venture capital funds and other private investment vehicles have been able to rely upon this exemption.

If you would like assistance in commenting on the Proposed Exemptive Rules or more information about the matters discussed in this Client Advisory, please contact your Katten Muchin Rosenman LLP attorney or any of the following members of Katten's **Financial Services Practice**.

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[1] The Proposed Exemptive Rules were published in Release No. IA-3111 (Nov. 19, 2010). On the same day, the SEC also issued the Proposed Implementing Rules in Release No. IA-3110.

Private Fund Adviser Exemption

Proposed Rule 203(m)-1 under the Advisers Act defines the new Private Fund Adviser Exemption. Under Dodd-Frank, a "private fund" is defined as an issuer that would be an "investment company" within the meaning of the Investment Company Act of 1940, as amended (the Company Act), but for Section 3(c)(1) or 3(c)(7) thereof. The availability of the Private Fund Adviser Exemption depends on whether an adviser has its principal office and place of business in the United States (U.S. Advisers) or outside the United States (non-U.S. Advisers).

U.S. Advisers. The Private Fund Adviser Exemption is available to a U.S. Adviser that:

- acts solely as an adviser to one or more private funds; and
- has private fund AUM of less than $150 million.

For purposes of determining the $150 million AUM limitation, Rule 203(m)-1 would deem all of the assets managed by an adviser to be managed "in the United States" if the adviser's "principal office and place of business" is in the United States. The SEC states that it would consider the adviser's principal office and place of business as the location where the adviser controls, or has ultimate responsibility for, the management of private fund assets, and therefore as the place where all the advisers' assets are managed, although day-to-day management of certain assets may also take place at another location.

Thus, a U.S. Adviser with a principal place of business in the United States would have to count all assets of the private funds it manages as assets under management "in the U.S." even if it has offices outside the United States from which certain assets are managed. Moreover, a U.S. Adviser would have to count all of the assets (even the assets of non-U.S. person investors) of any offshore fund it manages that has any U.S. persons as investors and therefore relies on Section 3(c)(1) or 3(c)(7) for exclusion from the Company Act. In order to rely on the exemption, a U.S. Adviser could not have any clients that are not private funds, whether in the United States or elsewhere.

Non-U.S. Advisers. For a non-U.S. Adviser, the location of the principal office and place of business is not determinative. Instead, for such an adviser the SEC will look to the investment management activities that are conducted in the United States, even if the principal office and place of business are elsewhere. The Private Fund Adviser Exemption for a non-U.S. Adviser with its principal office and place of business outside the United States would be available if:

- all of the adviser's clients that are "U.S. persons" (as defined in Regulation S under the Securities Act of 1933, as amended) are private funds, without regard to the type or number of its non-U.S. clients; and
- all of the assets it manages from a place of business in the United States are solely attributable to private funds with total AUM of less than $150 million.

The SEC explained in the Proposed Exemptive Rules release that it intended its proposal to take a "territorial approach" that focuses on the location from which the assets are managed and is designed to encourage participation of non-U.S. advisers in the U.S. market by applying the laws in a manner that does not impose U.S. regulatory requirements on the non-U.S. adviser's non-U.S. advisory business. The SEC indicated that it believes this approach is similar to the "jurisdictional approach" to regulation supported by the G20 Working Group that would focus on the location where the primary business is conducted. While the SEC's proposed rules with respect to U.S.-based advisers would seem to follow the "territorial approach," the proposal with respect to non-U.S. Advisers does not, as it focuses for U.S. regulatory purposes on the location of the investors rather than that of the adviser.

The AUM of private funds would be calculated quarterly in accordance with the instructions to the Form ADV on calculation of "regulatory assets under management" (RAUM), a concept addressed in the Proposed Implementing Rules, which were released in conjunction with the Proposed Exemptive Rules and which are the subject of a separate Katten advisory. Under the proposed definition of RAUM, foreign assets of an adviser must be included, and it is not clear how this concept will work for purposes of determining the $150 million asset limitation for non-U.S. Advisers seeking to qualify for the Private Fund Adviser Exemption. Nor do the Proposed Exemptive Rules provide a specific methodology for counting assets advised by teams or affiliates located in multiple jurisdictions within and outside the United States. The SEC has requested comment on this and other issues related to the asset calculation for non-U.S. Advisers, including whether the application of the asset test should be based upon the source of the assets (i.e., whether the assets were invested by U.S. investors) rather than the location from which they are managed.

A non-U.S. Adviser would be disqualified from claiming this exemption if it manages any assets from a place of business in the United States for clients other than private funds. Thus, it appears that a non-U.S. Adviser relying upon this exemption could not manage assets for non-U.S. clients (other than private funds) from a place of business in the United States. Conversely, it appears that a non-U.S. Adviser could advise a managed account for a non-U.S. person from a place of business outside the United States and would be able to rely on this exemption.

Exempt Reporting Advisers. As is discussed more fully below, advisers relying on the Private Fund Adviser Exemption, as well as the VC Adviser Exemption, would be categorized as "exempt reporting advisers" and would be subject to various SEC reporting and recordkeeping requirements, notwithstanding their exemption from registration. These requirements are discussed more fully in a separate Katten advisory.

Transition Period. Under the Proposed Exemptive Rules, an adviser that becomes ineligible for the Private Fund Adviser Exemption because the value of its private fund AUM equals or exceeds $150 million would have one calendar quarter after becoming ineligible to file for registration with the SEC, as long as it had previously complied with all applicable reporting requirements.

Foreign Private Adviser Exemption

Proposed Rule 202(a)(30)-1 under the Advisers Act would define the Foreign Private Adviser Exemption. This exemption would be available to advisers that:

- have no place of business in the United States;
- have fewer than 15 clients and private fund investors in the United States;
- have less than $25 million of aggregate "regulatory assets under management," as determined in accordance with the proposed instructions to Form ADV, attributable to such U.S. clients and investors; and
- do not hold themselves out generally to the U.S. public as investment advisers.

Client and Investor Counting Rules. Section 202(a)(30) of the Advisers Act provides that to be eligible for the exemption, a foreign private adviser cannot have more than 14 clients or "investors in the U.S. in private funds advised by the adviser." For purposes of counting the number of U.S. clients advised by a foreign private adviser, advisers would apply counting rules substantially similar to those currently contained in the "safe harbor" counting provisions under Advisers Act Rule 203(b)(3)-1, with slight modifications. Thus, the proposed rule would permit advisers to count as a single client:

- a natural person and various family members and related accounts or trusts of which they 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 ownership.

However, unlike the current safe harbor, advisers must also count as clients persons to whom the adviser provides advisory services without compensation (such as knowledgeable employees).

To avoid "double-counting," the SEC proposal would allow an adviser to omit counting a private fund as a separate client if the adviser has already counted any investor in that private fund for purposes of determining its eligibility for the Foreign Private Adviser Exemption.

Investors in the United States. The Foreign Private Adviser Exemption also requires that the adviser count "investors in the U.S." in private funds advised by the adviser for purposes of determining the adviser's eligibility for the exemption. The SEC proposal would define "investor" to include any person that would be included in determining the number of beneficial owners of a Section 3(c)(1) fund, or required to meet the definition of a "qualified purchaser" in a Section 3(c)(7) fund. In addition, the SEC's proposed definition would also require the adviser to count:

- "knowledgeable employees" (and their related persons); and
- beneficial owners of debt securities (including "short-term paper") issued by the private fund, as well as "voting securities," as under current law.

Advisers would also have to count underlying owners of fund securities, including:

- beneficial owners in nominee or similar arrangements;
- holders of instruments (such as total return swaps) that effectively transfer the risk of investing in the private fund to such holder; and
- in the case of master-feeder structures, the holders of the securities of feeder funds formed or operated for the purpose of investing in the master fund. (To avoid double-counting, the adviser would be able to count a person who has invested in two or more private funds advised by the adviser as a single investor.)

The Foreign Private Exemption uses the term "in the United States" in a number of contexts. The SEC has proposed to define that term in accordance with the definition of "U.S. Person" and "United States" under Regulation S. However, under the proposed rule, a person that would be deemed "in the United States" at the time of any calculation of assets or investors may be excluded if such person was not "in the United States" at the time of becoming a client or investing in the private fund.

Place of Business. An adviser with a "place of business" in the United States may not rely on the Foreign Private Adviser Exemption. The Proposed Exemptive Rules would define "place of business" consistent with current definitions used by the SEC and state authorities to determine regulatory jurisdiction, 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."

Venture Capital Adviser Exemption

An adviser that solely advises venture capital funds is exempt from registration under the Advisers Act. Proposed Rule 203(l)-1 generally defines a venture capital fund as a private fund that:

- invests in equity securities of "qualifying portfolio companies" in order to provide them with operating and business expansion capital, and acquires at least 80% of each qualifying portfolio company's securities held by such venture capital fund directly from such qualifying portfolio company;
- directly, or through its investment advisers, offers or provides significant managerial assistance to, or controls, the qualifying portfolio companies in which it invests;
- 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 Company Act and has not elected to be treated as a business development company.

Investment in Qualifying Portfolio Companies. Venture capital funds would be permitted to hold only cash and cash equivalents, U.S. Treasury securities with a remaining maturity of 60 days or less, and equity securities of "qualifying portfolio companies." Proposed Rule 203(l)-1(c)(4) defines a "qualifying portfolio company" as any company that:

- is not publicly traded on a U.S. or non-U.S. exchange, or affiliated with a publicly traded company;
- does not incur leverage in connection with the investment by the venture capital fund;

- uses the capital provided by the venture capital fund for operating or business expansion purposes rather than to buy out other investors; and
- is not itself a private fund or other pooled investment company (i.e., is an operating company).

The definition would exclude portfolio companies that borrow, issue debt obligations or otherwise incur leverage in connection with a private investment fund's investment (but would not exclude companies that borrow in the ordinary course of their business). This requirement is intended to indirectly exclude from the "venture capital fund" definition certain categories of funds (such as hedge funds and leveraged buyout funds) that use leverage or finance their investments in portfolio companies or the buyout of existing investors with debt incurred by the portfolio company. As a further means of distinguishing venture capital funds from buyout funds, qualifying portfolio companies would be limited to companies that do not redeem or repurchase outstanding securities of, or distribute cash or other company assets to, other security holders in connection with the private investment fund's investment. A company will not cease to be a qualified portfolio company because it is "taken public" after the investment is made by the venture capital company.

Management Involvement. Under the SEC's proposed definition, a venture capital fund or its adviser must either (i) have an arrangement pursuant to which it offers to provide (and, if accepted, does provide) significant guidance concerning the management, operations or business objectives and policies of the portfolio company, or (ii) control the portfolio company. Managerial assistance generally takes the form of active involvement in the operations of the portfolio company or may consist of less active forms of control, such as board representation, and may evolve in nature over the life of the venture capital fund's investment.

Leverage Limitation. The SEC's proposed definition also restricts the ability of a venture capital fund to borrow, issue debt obligations, provide guarantees or otherwise incur leverage. This requirement is a corollary to the leverage limitation described above for qualifying portfolio companies and is intended to distinguish venture capital funds from other types of funds that utilize substantial leverage in their trading and investment activities. Under the proposed definition, a venture capital fund would not be permitted to incur leverage in excess of 15% of such fund's aggregate capital contributions and uncalled capital commitments, and any such permitted leverage could only be for a non-renewable term not to exceed 120 days (to prevent short-term debt from being turned into long-term debt).

Redemption Restrictions. Venture capital funds cannot provide investors with redemption rights except under extraordinary circumstances, although they would be permitted to make periodic pro rata distributions to their investors.

The SEC does not expressly define what constitutes "extraordinary circumstances," but notes that such circumstances would likely include events that are beyond the control of the adviser and the investor, such as corporate events and tax and regulatory changes. The Proposed Exemptive Rules provide that a fund that provides for periodic withdrawals would be deemed to have granted redemption rights to investors, even if such withdrawals are subject to an initial lock-up or suspension.

Representation as a Venture Capital Fund. An eligible venture capital fund also must represent itself as a venture capital fund to its investors and potential investors. The SEC states that an adviser relying upon the VC Adviser Exemption could not identify a fund advised by such adviser as a "hedge fund" or "multi-strategy fund," or include the fund in a hedge fund database or hedge fund index.

Application to Non-U.S. Advisers. A non-U.S. Adviser may rely upon the VC Adviser Exemption if all of its U.S. and non-U.S. clients are venture capital funds, as defined.

Grandfathering Provision. The SEC's proposed definition includes a grandfathering provision that would include within the definition of "venture capital fund" any private fund that: (i) represented itself as a venture capital fund to investors and potential investors at the time the fund offered its securities; (ii) has sold securities (including through the acceptance of capital commitments) to one or more investors prior to December 31, 2010; and (iii) does not sell any securities to, or accept any additional capital commitments from, any person after July 21, 2011.