Legal Risk Management Tip
December 2010

THE SEC PROPOSES NEW EXEMPTIONS FOR ADVISERS TO VENTURE CAPITAL FUNDS, US PRIVATE FUND ADVISERS WITH LESS THAN $150 MILLION IN ASSETS UNDER MANAGEMENT AND FOREIGN PRIVATE ADVISERS

On November 19, 2010, the U.S. Securities and Exchange Commission (the "SEC") issued proposed rules[1] pursuant to Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[2] The proposed rules would clarify and implement three new exemptions created under the Dodd-Frank Act for advisers to venture capital funds, private fund advisers with less than $150 million in assets under management ("AUM") in the United States and certain foreign private advisers. Collectively, these three new types of exempt advisers are known as "exempt reporting advisers" and, as the name implies, will be subject to certain, limited reporting obligations. Furthermore, the new exemptions are aimed at replacing the former statutory exemption known as the private advisor exemption — previously available to advisors with fewer than 15 clients — which was removed by the Dodd-Frank Act.

The Proposed Exemptions

1. New Definition of Venture Capital Fund

The Dodd-Frank Act amended the Investment Advisers Act of 1940 (the "Advisers Act") to exempt advisers that only manage venture capital funds from registration,[3] and directed the SEC to define the term "venture capital fund." Under this directive, the SEC has proposed to define a "venture capital fund" as a private fund[4] that:

- Represents itself to investors as being a venture capital fund;
- Only invests in equity securities of private operating companies to provide primarily operating or business expansion capital (not to buy out other investors), U.S. Treasury securities with a remaining maturity of 60 days or less, or cash;
- Does not borrow or otherwise incur leverage (other than limited short-term borrowing) and its portfolio companies do not incur leverage in connection with the investment by the private fund;
- Offers to provide a significant degree of managerial assistance, or controls its portfolio companies; and

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[1] Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less Than $150 Million in Assets Under Management, and Foreign Private Advisers, Investment Advisers Act Release No. 3111 (Nov. 19 2010), *available at* http://sec.gov/rules/proposed/2010/ia-3111.pdf, [hereinafter *the Proposed Rules*].
[2] Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111th Cong. [hereinafter *the Dodd-Frank Act*].
[3] 15 U.S.C. § 80b-1[hereinafter *the Advisers Act*].
[4] "Private Fund" is defined in the the Dodd-Frank Act as an issuer that would be an investment company, but for either Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act of 1940. *The Dodd-Frank Act*, *supra note 2*, § 402.

- Does not offer redemption rights to its investors.[5]

Under a proposed grandfathering provision, existing funds that make venture capital investments would generally be deemed to meet the proposed definition, as long as they have represented themselves as venture capital funds.[6] It is thought that the SEC is proposing this approach because it could be difficult or impossible for advisers to conform existing funds, which generally have terms in excess of 10 years, to the new definition.[7]

2. <u>Proposed Exemption for US Private Fund Advisers with Less than $150 Million AUM</u>

The SEC also is proposing to implement a new statutory exemption for US-based private fund advisers with less than $150 million in "regulatory assets under management."[8] Under the same approach the SEC has taken in the past in applying the Advisers Act to foreign advisers, the availability of the exemption would vary depending on whether an adviser is a U.S.-based adviser or a foreign adviser.

In order to rely on the exemption, a U.S.-based adviser would have to meet the conditions of the exemption with respect to all of its private fund assets under management. A foreign adviser would have to meet the conditions with respect to its AUM in the United States, but generally not with respect to its assets managed from abroad.

In order to determine whether an adviser qualifies for the exemption from registration, the calculation of its "regulatory assets under management" would be required to include: (i) proprietary assets, (ii) assets managed without receiving compensation and (iii) assets of foreign clients.[9] Advisers may not subtract outstanding indebtedness and other accrued liabilities in the calculation of "regulatory assets under management" and must include any uncalled capital commitments. In addition, all private fund assets must be valued at fair value, rather than at cost.[10]

3. <u>Amended Exemptions for Foreign Private Advisers</u>

The Dodd-Frank Act also amended the Advisers Act to provide for an exemption from registration for foreign advisers that have:

- No “place of business” in the United States;
- Fewer than 15 clients in the United States;
- Aggregate AUM attributable to US advisory clients and US private fund investors (advised by the investment adviser) of less than $25 million; and
- Not held itself out generally to the public in the US as an investment adviser.[11]

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[5] *See Proposed Rules*, *supra* note 1, at 11-16.
[6] *Id.* at 11.
[7] *Id.,* at 13.
[8] *Id.* at 58.
[9] *Id.* at 60-63.
[10] *Id.*
[11] *Id*. at 72-75.

As it applies to foreign advisers, the proposed rule defines "place of business" as an 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. Furthermore, advisers would be required to use the "regulatory assets under management" calculation, described above, for determining whether they exceed the $25 million threshold under this exemption.

Reporting Requirements for Venture Capital Funds, US Private Fund Advisers with Less than $150 Million in Assets Under Management and Foreign Private Advisers (hereinafter "Exempted Advisers")

Despite the proposed exemptions described above, the SEC proposes to retain its authority to require that such Exempted Advisers file reports with the SEC as it deems necessary and appropriate. In a separate but related rule release,[12] the SEC proposed to require "exempt reporting advisers" to complete some, but not all, of the questions in Part 1A of Form ADV including:

- Basic identifying information about the adviser and its owners/affiliates (Item 1);
- The basis for its exemption from SEC registration (Item 2.C);
- Its form of organization (Item 3);
- Its other business activities (Item 6);
- Its financial industry affiliations and private funds it manages (Item 7);
- Its control persons (Item 10); and
- Disciplinary history (Item 11).[13]

This reporting would occur by filing Form ADV through the IARD system, which would be made available to the public.[14]

To comment on these proposed rules, send an e-mail to rule-comments@sec.gov and include File Number S7-37-10 in the subject line. For any questions regarding the proposed rule, please contact us. To you and yours, a very Happy Holiday season!

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This article is for information purposes and does not contain or convey legal advice. The information herein should not be relied upon in regard to any particular facts or circumstances without first consulting with a lawyer.

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[12] Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Act Release No. 3110 (Nov. 19, 2010), *available at* http://sec.gov/rules/proposed/2010/ia-3110.pdf.
[13] *Id.* at 35-48.
[14] *Id.*