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SEC Proposes Exemptions for Advisers to Venture Capital Funds, Foreign Private Advisers, and Private Fund Advisers with Less than US$150 Million in Assets Under Management

November 22, 2010

On November 19, 2010, the US Securities and Exchange Commission ("**SEC**") proposed rules (the "**Release**")[1] interpreting certain exemptions from the registration requirements of the Investment Advisers Act of 1940, as amended (the "**Advisers Act**") for advisers to privately offered investment funds. The registration exemptions - covering venture capital funds, advisers to private funds with a limited amount of assets under management in the US, and certain foreign advisers - were originally signed into law by President Obama on July 21, 2010 as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "**Dodd-Frank Act**").[2]

The Release provides much awaited interpretive guidance to US and non-US investment advisers seeking to rely on the following exemptions:

- **Venture Capital Exemption**: The Dodd-Frank Act provides that an investment adviser that solely advises venture capital funds is exempt from registration under the Advisers Act and directs the SEC to define the term venture capital fund (the "**Venture Capital Exemption**"). The Release proposes a new rule providing a definition of the term "venture capital fund" and seeks commentary on how the Venture Capital Exemption will apply to non-US investment advisers. An O'Melveny & Myers Client Alert addressing the Venture Capital Exemption will be forthcoming this week.

- **US$150 Million Assets under Management Exemption**: The Dodd-Frank Act provides an exemption from registration to any investment adviser that solely advises private funds[3] if the adviser had assets under management in the US of less than US$150 million (the "**De Minimis Exemption**"). The Release proposes a new rule which includes provisions for determining the amount of an adviser's private fund assets for purposes of the De Minimis Exemption and when those assets are deemed managed in the US for both US and non-US advisers.
- **Foreign Private Adviser Exemption**: The Dodd-Frank Act provides an exemption from registration for "foreign private advisers" that (i) have no place of business in the US, (ii) do not generally hold themselves out to the public in the US, (iii) have fewer than 15 clients and investors in the US, and (iv) have less than US$25 million of aggregate assets under management attributable to clients and investors in the US in private funds (the "**Foreign Private Adviser Exemption**"). The Release proposes a new rule clarifying the application of the Foreign Private Adviser Exemption and defining a number of key terms.

The SEC also proposed rules, that among other things, increase the statutory threshold for registration by investment advisers with the SEC, introduce reporting requirements for certain investment advisers that are exempt from registration, and amend Form ADV, the investment advisers registration statement under the Advisers Act.[4] The proposed rules will be the subject of a forthcoming O'Melveny & Myers LLP client alert.

The SEC has requested comments on the Release on or before 45 days after the publication of the Release in the Federal Register, which we expect will occur during the week of November 22, 2010. During its open meeting to propose the Release, the SEC encouraged all affected US and non-US advisers to participate in the comment process. A summary of the De Minimis Exemption and Foreign Private Adviser Exemption is included below. Investment advisers that are not able to satisfy a registration exemption will be required to register with the SEC under the Advisers Act by the expiration of the statutory transition period on July 21, 2011.

<u>Elimination of the Private Adviser Exemption</u>

The Dodd-Frank Act eliminates the so-called "private adviser exemption" effective July 21, 2011, and in its place, provides several limited registration exemptions.[5] Many US and non-US investment advisers to privately offered investment funds (including hedge funds, private equity funds, and most securitization vehicles) currently rely upon the "private adviser exemption," pursuant to which advisers who (i) have fewer than 15 <u>clients</u> during the preceding 12 months, (ii) do not hold themselves out to the public as investment advisers, and (iii) do not act as investment advisers to a registered investment company or business development company are exempt from the registration requirement under the Advisers Act. Because the term "clients" currently includes only a privately offered investment fund and not the investors in the fund, an investment adviser could rely on the private adviser exemption and sponsor up to 14 privately offered investment funds without limitation on the number of investors in the funds or the assets under management. This note focuses on two such exemptions – the De Minimis Exemption and Foreign Private Adviser Exemption. Taken together, these two exemptions would effectively create three categories of exemptions from Advisers Act registration:

- US advisers who have to count all assets under management towards the US$150 million threshold;
- Pure non-US advisers with no presence in the US but with assets under management attributable to US clients and investors of less than US$25 million and fewer than 15 US clients and investors; and
- Non-US advisers with a place of business in the US but who manage assets less than US$150 million from this US location.

De Minimis Exemption for Advisers to Private Funds with Less than US$150 Million Assets Under Management

As discussed above, the SEC proposed the De Minimis Exception under the Dodd-Frank Act to exempt from registration any investment adviser that solely advises private funds if the adviser had assets under management in the US of less than US$150 million. The Release proposes a new rule which includes provisions for:

- Calculating an investment adviser's aggregate private fund assets under management; and
- Determining whether an investment adviser's private fund assets under management are deemed managed in the US.

"Solely" Advises Private Funds – US Advisers

A US investment adviser may only rely on the De Minimis Exemption if it serves as an adviser solely to private funds. Such an exemption will not be available if a US adviser provides advisory services to a client other than to a private fund (*e.g.*, a single investor managed account, a business development company, or a registered investment company). However, a US investment adviser is permitted to advise an unlimited number of private funds as long as the aggregate value of the adviser's private fund assets is less than US$150 million.

The Release provides that all private fund assets of an adviser with a principal office and place of business in the US would be counted as assets under management in the US, even if the adviser has offices outside of the US. A principal office and place of business would be deemed to be in the US if a US office is the location where the adviser controls, or has ultimate responsibility for, the management of private fund assets, and therefore, is the place where all of the adviser's assets are managed, although day-to-day management of certain assets may also take place at another location.

Application to Non-US Advisers

The SEC has proposed to extend the De Minimis Exemption to advisers with a principal office and place of business outside of the US so long as all of the adviser's clients that are US Persons[6] are qualifying private funds. Like US advisers, a non-US adviser may not have any clients that are US Persons other than private funds (*e.g.*, registered investment companies or single investor managed accounts), however a non-US adviser could have such other advisory relationships with non-US clients. As a result, a non-US adviser could avail itself of the De Minimis Exemption without regard to the type or number of its non-US Person clients or any of its business activities outside of the US. Unlike US advisers, a non-US adviser is only required to count private fund assets that it manages from a place of business in the US toward the US$150 million limit.

Calculating Assets under Management

The Release provides that an adviser must aggregate the value of all assets of private funds it manages in the US to determine if the adviser remains below the US$150 million threshold. Advisers would be required to calculate the value of private fund assets by reference to Form ADV, the investment advisers' registration statement under the Advisers Act. In the case of a sub-adviser, the sub-adviser would only be required to count the portion of the private fund assets for which it has responsibility.

In addition to assets appearing on a fund's balance sheet, investment advisers would be required to include any uncalled capital commitments and securities purchased using margin in their aggregate assets under management. Further, advisers would have to determine the value of assets under management quarterly, based on the fair value of the assets at the end of the quarter.

Transition Rule

The SEC has proposed a transition period which provides an adviser with one calendar quarter to register with the SEC after becoming ineligible to rely on the De Minimis Exemption due to an increase in the value of its private fund assets. This transition period is designed to allow the adviser sufficient time to register with the SEC and develop supervisory procedures after determining that its assets under management have reached US$150 million at the end of a quarterly period.

The transition period would not be available for an investment adviser who is ineligible to rely on the De Minimis Exemption for a reason other than reaching the US$150 million assets under management threshold (*e.g.*, because the adviser manages a client that is not a private fund, such as a single investor managed account or an investment company).

Foreign Private Adviser Exemption

The Dodd-Frank Act also provides an exemption from the Advisers Act registration for "foreign private advisers." The Dodd-Frank Act defines a foreign private adviser as any investment adviser that:

- has no place of business in the US;

- has, in total, fewer than 15 clients in the US and investors in the US in private funds advised by the investment adviser;
- has aggregate assets under management attributable to clients in the US and investors in the US in private funds advised by the investment adviser of less than US$25 million; and
- does not hold itself out generally to the public in the US as an investment adviser.

In order to provide advisers with interpretive guidance regarding the Foreign Private Adviser Exemption, the SEC has included in the Release proposed definitions of "client," "investor," "in the United States," "place of business," and "assets under management."

Clients

The SEC has included in the Release the safe harbor for counting clients currently provided in Rule 203(b)(3)-1 of the Advisers Act (which provides a safe harbor for determining who may be deemed a single client for purposes of the private adviser exemption), but excludes the exception provided therein allowing advisers not to count clients from which they receive no compensation. The Release would, among other things, allow an adviser to treat as a single client (i) a natural person and such person's minor children, any relative, spouse, or relative of the spouse of the natural person who has the same principal residence (together with such natural person, "Related Parties"), all accounts and trusts of which such Related Parties are the only primary beneficiaries, (ii) 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 (iii) two or more entities that have identical owners. Further, to avoid double counting, the SEC has included a provision stating that advisers are not required to count a private fund as a client if the adviser counts any investor in that private fund as an investor in the United States in that private fund.

Investors

The SEC has proposed to define the term "investor" in a private fund as any person who 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 1940 Act or whether the outstanding securities of a private fund are owned exclusively by qualified purchasers under Section 3(c)(7) of the 1940 Act.[7] In order to avoid double counting, an adviser would be able to treat as a single investor any person who is an investor in two or more private funds advised by the adviser. In the case an "investor" was a vehicle formed-for-the-purpose of investing in the adviser's private fund (*e.g.*, a feeder fund or a special purpose investment vehicle), the adviser would be required to "look-through" the investor and count the underlying beneficial owners of the investor for purposes of counting the number of investors in the private fund and determining whether the adviser had less than 15 clients or investors in the US.

Further, under the proposed rule, an adviser would have to avoid structuring arrangements that may have the effect of circumventing the registration requirements of the Advisers Act. For example, the adviser to a master fund in a master-feeder arrangement would have to treat as investors the holders of the securities of any feeder fund formed or operated for the purpose of investing in the master fund. Also, an adviser would have to count as an investor any holder of an instrument, such as a total return swap, that effectively transfers the risk of investing in the private fund from the record owner of the private fund's securities.

The Release also proposes to count as investors beneficial owners (i) who are "knowledgeable employees"[8] with respect to the private fund and certain other persons related to such employees and (ii) of short term paper issued by the private fund, even though these persons are not counted as beneficial owners for purposes of the exemptions provided by Section 3(c)(1) or Section 3(c)(7) of the 1940 Act.

In the United States

In determining the meaning of the term "in the United States" for purposes of determining (i) the number of an adviser's clients and investors, (ii) the adviser's place of business, and (iii) whether the adviser holds itself out to the public in the United States, the SEC has proposed to adopt the definition of "US Person" and "United States"[9] promulgated under Regulation S of the Securities Act.[10] In addition, the SEC has proposed that a person that is "in the United States" may be treated as not being "in