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Securities and Exchange Commission finalizes registration exemptions for private fund advisers

By Craig F. Zappetti and Dawn Crowder

SUMMARY

The Commission recently passed final rules enacting exemptions from the registration requirements of the Investment Advisers Act for advisers to venture capital funds, advisers with less than $150 million in assets under management and certain foreign private advisers. These rules become effective on July 21, 2011.

On June 22, 2011, the Securities and Exchange Commission (the "Commission") adopted final rules under Sections 203(l) and 203(m) of the Investment Advisers Act of 1940, as amended (the "Advisers Act"), to implement three new exemptions from the registration requirements of the Advisers Act. The new rules exempt (i) advisers to venture capital funds, (ii) advisers with less than $150 million in assets under management and (iii) certain foreign private advisers from the registration requirements of the Advisers Act. Rule 203(l)-1 defines the term "venture capital fund" for purposes of the venture capital exemption. The final rule establishing these exemptions becomes effective on July 21, 2011. Advisers that satisfy any of these exemptions are "Exempt Reporting Advisers" and are required to submit annual information reports to the Commission beginning in the first quarter of 2012.

BACKGROUND

In the context of a venture capital fund, the entity or principals that manage the fund and make its portfolio company investment decisions could be deemed investment advisers to the fund under the Advisers Act. Accordingly, the general partner of most venture capital funds could be deemed an investment adviser.

On July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act was signed into law and section 203(b)(3) of the Advisers Act was repealed. Section 203(b)(3) of the Advisers Act had provided an exemption from registration to any investment adviser that: (1) had fewer than 15 clients in the preceding twelve months, (2) did not hold itself out to the public as

an investment adviser, and (3) did not act as an investment adviser to either a registered investment company or business development company. Under this old rule, each fund managed was considered a client. Accordingly, the old rule exempted most venture capital fund managers from the registration requirements of the Advisers Act and the requirements of all related rules.

In addition to eliminating the broad private adviser exemption in section 203(b), Congress amended the Advisers Act to create the following three new categories of private adviser exemptions.

- The Venture Capital Exemption: an investment adviser that solely advises venture capital funds is exempt from registration under the Advisers Act (Section 203(l) of the Advisers Act).
- Private Fund Adviser Exemption: an exemption provided to any investment adviser that solely advises private funds if the adviser has assets under management, in the United States, of less than $150 million. (Section 203(m) of the Advisers Act).
- Foreign Private Adviser Exemption: an investment adviser that has (i) no place of business in the United States, (ii) in total, fewer than 15 clients in the United States and investors in the United States in private funds advised by the adviser, (iii) less than $25 million in aggregate assets under management from such clients and investors and (iv) does not hold itself out generally to the public in the United States as an investment adviser. (Section 203(b)(3) provides the exemption; Section 202(a)(30) defines the term "foreign private adviser").

VENTURE CAPITAL FUND EXEMPTION

DEFINITION OF VENTURE CAPITAL FUND

An adviser is eligible to rely on the venture capital exemption if it solely advises private funds that meet all of the elements of the "venture capital fund" definition or if the adviser satisfies the criteria under the grandfathering provision in Rule 203(l)-1(b) promulgated under the Advisers Act. A private fund is an issuer that would be excluded from the definition of "investment company," set forth in Section 3 of the Investment Company Act of 1940, due to Section 3(c)(1) (exempts companies that have 100 or fewer beneficial owners) or 3(c)(7) (exempts companies that limit ownership to qualified purchasers) of that Act. Under the final rule, a private fund is a venture capital fund if it:

- holds no more than 20 percent of the fund's capital commitments in non-qualifying investments (other than short-term holdings)("qualifying investments" generally consist of equity securities of "qualifying portfolio companies" that are directly acquired by the fund);
- does not borrow or otherwise incur leverage, other than short-term borrowing (this excludes certain guarantees of qualifying portfolio company obligations by the fund);
- does not offer its investors redemption or other similar liquidity rights except in extraordinary circumstances;
- represents itself as pursuing a venture capital strategy to its investors and prospective investors; and
- is not registered under the Investment Company Act and has not elected to be treated as a business development company.

Alternatively, if a pre-existing fund does not meet the definition of a "venture capital fund" it may still qualify for this exemption if it meets the criteria of the grandfathering provision. Under the grandfathering provision, an existing private fund will be considered a "venture capital fund" if it is a fund that:

- represented to investors and potential investors at the time the fund offered its securities that it pursues a venture capital strategy;
- prior to December 31, 2010, has sold securities to one or more investors that are not related persons of any investment adviser of the venture capital fund; and
- does not sell any securities to, including accepting any additional capital commitments from, any person after July 21, 2011.

A grandfathered fund includes any fund that accepted all capital commitments by July 21, 2011 even if none of the capital commitments has been called by such date.

20 Percent Limit on Non-Qualifying Investments

Qualifying Investments

A venture capital fund is distinguished from hedge funds and private equity funds as a fund that invests capital directly in portfolio companies for the purpose of funding expansion and development rather than buying out existing security holders or trading in the secondary markets of target portfolio companies. To qualify as an exempt adviser, the funds advised by the adviser must generally hold equity securities of qualifying portfolio companies.

A qualifying investment generally consists of equity securities. The Commission has defined equity security, in accord with section 3(a)(11) of the Securities Exchange Act of 1934, as amended, as common stock or any similar security, preferred stock, warrants, and other securities convertible into common stock in addition to limited partnership interests. Under the rule, qualifying investments include:

- any equity security issued by a qualifying portfolio company that is directly acquired by the private fund from the company;
- any equity security issued by a qualifying portfolio company in exchange for directly acquired equity issued by the same qualifying portfolio company; and
- any equity security issued by a company of which a qualifying portfolio company is a majority-owned subsidiary, or a predecessor, and that is acquired by the fund in exchange for directly acquired equity.

The intention of this aspect of the rule is to limit the amount of secondary trading by these funds, while still allowing them to participate in mergers and reorganizations of portfolio companies and receive stock dividends of portfolio companies. This rule should not impact the use of "blocker entities" in investment transactions with portfolio companies.

A qualifying portfolio company is defined as any company that:

- is not a public reporting or foreign traded company and does not have a control relationship with a reporting or foreign traded company;
- does not incur leverage in connection with the investment by the private fund and distribute the proceeds of any such borrowing to the private fund in exchange for the private fund investment; and
- is not itself a fund but is an operating company.

The rule provides that equity securities of a previously qualified portfolio company that becomes a reporting company may continue to be treated as a qualifying portfolio company.

Non-Qualifying Investments

A qualifying venture capital fund may hold no more than 20 percent of its capital commitments in non-qualifying investments. This 20 percent limit is calculated each time the fund acquires a non-qualifying investment. The rules provide that the adviser does not need to dispose of a non-qualifying investment if there is an increase in the value of the non-qualifying investment subsequent to its acquisition by the fund that increases the fund's non-qualifying investments over the 20 percent limit. In that case, however, the fund cannot purchase additional non-qualifying assets until the value of its existing non-qualifying assets drops below the 20 percent threshold. Only bona fide capital commitments may be included in this calculation. For example, commitments made with an understanding that the commitment will not be called cannot be included. In performing this calculation, a fund may use either historical cost or fair value to value its investments in portfolio companies, as long as the same method is applied to all investments of a qualifying fund in a consistent manner during the life of the fund.

Investments in cash and short-term holdings are excluded as assets in determining whether a fund satisfies the 20 percent limit for non-qualifying investments. Accordingly, they are not included in the calculation described above. The Commission has limited the definition of short-term holdings to those investments generally used as cash management tools such as cash and cash equivalents, U.S. Treasuries with a remaining maturity of 60 days or less, and shares of registered money market funds. Investments in longer term debt are considered non-qualifying assets for purposes of the 20 percent calculation.

By allowing a venture capital fund to own some level of non-qualifying assets and to exclude short term holdings from the calculation, the Commission believes that it is providing advisers to venture capital funds with adequate flexibility to manage the fund and the fund's cash on hand to best meet the fund's objectives while still

requiring the adviser to maintain the characteristics of a venture capital fund.

Leverage Limitations

Under Rule 203(l)-1 promulgated under the Advisers Act, a venture capital fund cannot incur leverage in excess of 15 percent of the fund's capital contributions and uncalled committed capital, and any such borrowing must be for a non-renewable term of no longer than 120 calendar days. The 120 calendar day limit does not apply to guarantees by the private fund of a qualifying portfolio company's obligations up to the value of the private fund's investment in the qualifying company. The 15 percent threshold is calculated based on the venture capital fund's aggregate capital commitments.

No Redemption Rights

To qualify as a venture capital fund, a private fund may not provide redemption rights to investors except in extraordinary circumstances such as enactment of laws that may prohibit an investor's participation in the fund's investment in particular countries or industries. The trigger events for these rights are typically beyond the control of the adviser and the fund investor. This requirement does not prohibit return of capital and profits to investors through pro rata distributions.

Represents Itself as Pursuing a Venture Capital Strategy

The Commission believes that only funds that are offered to investors as funds that pursue a venture capital strategy should qualify for the venture capital fund exemption. It is not necessary for the fund to use the words "venture capital" in its name. Rather, the particular facts and circumstances of all statements and omissions made by a fund to its investors and prospective investors in light of the circumstances under which they were made will govern satisfaction of this criterion.

PRIVATE FUND ADVISER EXEMPTION

Under Rule 203(m)-1 promulgated under the Advisers Act, the Commission exempts from registration any investment adviser, solely to private funds, that has less than $150 million in assets under management in the United States. In order to qualify for this exemption, an adviser may advise an unlimited number of private funds so long as the aggregate value of the assets of the private funds is less than $150 million. An adviser that has one or more clients that are not private funds is not eligible for this exemption. In the case of an adviser with a principal office and a place of business outside of the United States, the exemption is available as long as all of the adviser's clients that are United States persons are qualifying private funds.

The Commission provides advisers with instructions, in Form ADV, that must be followed to determine whether the adviser's assets under management are below the $150 million threshold. Under the instructions in Form ADV, the adviser's calculations must include proprietary assets, assets managed without compensation, and uncalled capital commitments. The adviser's private fund assets must be determined based on the market value of the gross assets in the fund without deducting any of the fund's liabilities. If the market value is unavailable, then the adviser can use the fair value of the assets in its calculation.

An adviser relying on this exemption is required to file an annual updating amendment to its Form ADV within 90 days after the end of its fiscal year, and must calculate its private fund assets under management in the manner described in the instructions to Form ADV within 90 days prior to the date it makes the filing. The assets under management are required to be in the adviser's 2012 report to the Commission. If an adviser reports that its assets under management have increased to over $150 million from year to year then the adviser will no longer be eligible for the exemption. An adviser that has complied with all Commission reporting requirements for an exempt reporting adviser may delay its application for registration with the Commission for up to 90 days after filing the annual updating amendment and may continue to act as a private fund adviser during this transition period. This transition period is not available to advisers that have failed to comply with these reporting requirements or that have accepted a client that is not a private fund.

EXEMPT ADVISERS REPORTING REQUIREMENTS

Under sections 203(l) and 203(m) of the Advisers Act, exempt venture capital fund advisers and private fund advisers are required to submit reports to the Commission on Form ADV. After January 1, 2012, an exempt adviser must electronically submit its initial Form ADV within 60 days of relying on the exemption from registration under either section of the Advisers Act. The adviser must then

amend its reports on Form ADV at least annually within 90 days of the end of the adviser's fiscal year and more frequently if required.

Using Form ADV, exempt advisers will be required to disclose, among other things, the following information:

- name, address, form of organization;
- the other business activities in which the adviser and its affiliates are engaged;
- disciplinary history and a separate schedule containing details of each event;
- employees' disciplinary history and a separate schedule containing details of each event;
- information regarding each private fund under advisement; and
- the form and types of advisory services that it provides.

See Items 1, 2.C., 3, 6, 7, 10 and 11 of Part I as well as corresponding provisions of Schedules A, B, C and D of Form ADV.

The Commission has amended Form ADV to require advisers to complete a separate schedule for each private fund that it manages and to provide limited information regarding investors in the fund. Advisers now must determine whether they qualify for the new exemptions and should familiarize themselves with the new Form ADV so they can collect the data necessary to complete and file an initial report.

PRACTICAL IMPLICATIONS FOR PRIVATE FUND ADVISERS

Private fund advisers will need to review their present activities to ensure that they meet one of these new exemptions in order to avoid registration under the Advisers Act. In particular, private fund advisers should consider taking the following actions with each fund that it advises:

- Using current financial statements, categorize all assets as either short-term investments, qualifying investments or non-qualifying investments.
- Obtain the proper valuation for each portfolio company investment using either historical cost or fair market value.
- Perform the 20 percent calculation for non-qualifying investments.
- Implement a system that allows for regular, real-time updates to this calculation.
- Review cash management practices to ensure that all investments meet the short-term holdings definition.
- Review the rationale for debt investments in portfolio companies. Consider converting or calling existing debt investments in order to remove them from the non-qualifying investment category.
- Review bridge loans to portfolio companies and consider the necessity of either calling or refinancing these loans.
- Limit activities involving non-qualifying investments such as secondary purchases of portfolio company securities.
- Review all marketing materials and other statements to investors to clearly convey the fund's venture capital strategy.
- If relying on the Private Fund Investor Exemption, limit advisory activities to private funds and limit assets under management in all funds to $150 million.
- Ensure that redemption rights in all funds are limited to extraordinary circumstances.
- Set up an account with Investment Adviser Registration Depository ("IARD") by going to www.iard.com and familiarize yourself with the information required to complete Part I of Form ADV.

A complete copy of the new rules can be viewed at http://www.sec.gov/rules/final/2011/ia-3222.pdf.

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