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

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On June 22, 2011, to implement provisions of Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”) that apply to the creation of certain exemptions for advisers to venture capital funds, private fund advisers with less than $150 million in assets under management and foreign private advisers, the Securities and Exchange Commission (the “SEC” or the “Commission”) adopted final rules implementing new exemptions from the registration requirements of the Investment Advisers Act of 1940 (the “Advisers Act”).

The SEC created three new rules: (i) Rule 203(l) -1, which defines a “venture capital fund” for purposes of the exemption; (ii) Rule 203(m)-1, which provides an exemption from registration for advisers with less than $150 million in private fund assets under management in the United States; and (iii) Rule 202(a)(30)-1, which clarifies the meaning of certain terms included in a new exemption from registration for “foreign private advisers” that replaces existing Rule 203(b)(3). In addition, the SEC clarified rules relating to sub-advisory relationships and advisory affiliates.

Venture Capital Exemption

Rule 203(l)-1 exempts an adviser that solely advises venture capital funds from registration. The final rule defines a venture capital fund as a private fund that:

- Holds no more than 20 percent of the fund’s aggregate capital contributions and uncalled committed capital in non-qualifying investments (other than short-term holdings) valued at cost or fair value, consistently applied by the fund.

Qualifying Investments generally consist of equity securities (as that term is defined under the Securities Exchange Act of 1934, as amended) of qualifying portfolio companies that are directly acquired by the fund. Qualifying Portfolio Company is defined as a company:

- That is not a reporting or foreign traded company, which is determined at the time of investment by the venture capital fund.
- That does not borrow or issue debt in connection with a venture capital fund investment and distribute to the venture capital fund the proceeds of such borrowing or the issuance in exchange for the fund's investment.
- That is not itself a fund.

- Does not borrow, issue debt obligations, provide guarantees or otherwise incur leverage, in excess of 15 percent of the fund's capital contributions and uncalled committed capital, and any such borrowing, indebtedness, guarantee or leverage is for a non-renewable term of no longer than 120 calendar days (except that certain guarantees of qualifying portfolio company obligations by the fund are not subject to the 120 calendar days limit);
- 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 Business Development Fund.

In addition, Rule 203(l)-2 grandfathers existing venture capital funds that meet the following criteria:

- Represents to investors and potential investors at the time the fund offered its securities that it pursues a venture capital fund strategy;
- Has sold securities to one or more investors prior to December 31, 2010;

- Does not sell any securities to, including accepting any additional capital commitments from, any person after July 21, 2011.

Application to Non-U.S. Advisers – The final rule permits a non-U.S. adviser to rely on the venture capital exemption if all of its clients, whether U.S. or non-U.S., are venture capital funds.

Exemption For Private Fund Advisers With Less Than $150 Million in Assets Under Management in the U.S.

Rule 203(m)-1 exempts an adviser that solely advises private funds that has aggregate assets under management in the U.S. of less than $150 million.

Under this new rule the Commission addressed the following interpretive questions:

Advises Solely Private Funds:

- To qualify for this exemption the private fund adviser must have no client that is a U.S. person other than qualifying private funds, which are defined as funds that are not registered under the Investment Company Act (i.e., a 3(c)(1) or 3(c)(7) fund). In a note, the Commission explained that even if a fund qualifies under another exemption from Section 3 of the Investment Company Act, such as certain real estate funds excluded under Section 3(c)(5)(C), it will be deemed a qualifying private fund as long as the fund is treated as a private fund under the Advisers Act for all purposes.
- Non-U.S. advisers, which are advisers with principal office and place of business outside the U.S., will qualify for the exemption so long as all of the clients that are U.S. persons are qualifying private funds.

Method of Calculating Assets Under Management

- All assets for which the adviser provides continuous and regular supervisory or management services in the U.S. (“Regulatory Assets Under Management”); including any proprietary assets, assets managed without receiving compensation and assets of non-U.S. clients, uncalled capital commitments;
- The calculation must be made on a gross basis, without deducting liabilities;
- The calculation must be made on a market value basis, or fair value basis where market value is unavailable.
- A sub-adviser must only count that portion of the assets for which it has supervision.

Frequency of Calculation and Transition Period

- Must annually calculate the amount of private assets under management and report it in annual updating amendment to Form ADV.
- For an adviser that loses this private fund exemption under Rule 203(m)-1 by increasing its assets under management over $150 million, it will have 90 days after filing the annual updating amendment to register as an investment adviser with the SEC.
- This grace period is only available if the adviser complied with all reporting requirements for SEC-exempt advisers.

Assets Managed in the United States

- Any adviser with its principal office and place of business in the U.S. must count all private fund assets, including those from offshore funds, as assets under management.
- A “principal office and place of business” would be the location where the advisers controls, or has ultimate responsibility for, management of private fund

assets, even if day-to-day management of certain assets takes place at another location.

- A Non-U.S. Adviser, which is an adviser with a principal place of business outside the U.S., **need only count** the private fund assets it manages at a place of business in the U.S.; all other assets managed outside the U.S. do not need to be counted. However, if the Non-U.S. Adviser has any client in the U.S. that was not a private fund at the time it became a client, then the exemption is unavailable.
- Note: This differs from the foreign private adviser exemption discussed below, which requires a Non-U.S. Adviser to have no place of business in the U.S. as a condition for qualifying under the exemption.
- A "place of business" is defined as an office where the adviser regularly provides advisory services, solicits, meets with, or otherwise communicates with clients.

Foreign Private Adviser Exemption

Section 202(a)(30) exempts a foreign private adviser from registration that:

- Has no place of business in the U.S.;
- Has fewer than 15 clients and/or investors in the U.S. in private funds;
- Has aggregate assets under management attributable to clients in the U.S. and investors in the U.S. in private funds advised by the adviser of less than $25 million; and
- Does not hold itself out generally to the public in the U.S. as an adviser.

Rule 202(a)(30)-1 defines the following terms from Section 202(a)(30):

- Client
- Investor
- In the United States

- Place of Business
- Assets under Management

The Counting of Clients and Investors:

- The final rule 202(a)(30)-1 includes a safe harbor for advisers to count clients for purposes of the definition of “foreign private adviser” that is similar to the safe harbor included in former rule 203(b)(3)-1.
- An adviser may treat as a single client a natural person and: (i) that person’s minor children (whether or not they share the natural person’s principal residence); (ii) any relative, spouse, or relative of the spouse of the natural person who has the same principal residence; (iii) all accounts of which the natural person and/or the person’s minor child or relative, spouse, or relative of the spouse who has the same principal residence are the only primary beneficiaries; and (iv) all trusts of which the natural person and/or the person’s minor child or relative, spouse, or relative of the spouse who has the same principal residence are the only primary beneficiaries.
- An adviser may also treat as a single “client”: (i) 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 (ii) two or more legal organizations that have identical shareholders, partners, limited partners, members, or beneficiaries.
- The former safe harbor rule permitting an adviser not to count as a client any person for whom the adviser provides investment advisory services without compensation has been eliminated. Therefore, Foreign Advisers must count U.S. persons to whom they provide investment advisory services for no compensations as clients for the purposes of determining the availability of the exemption.

- The term “investor” in a private fund is defined 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 Investment Company Act, or whether the outstanding securities of a private fund are owned exclusively by qualified purchasers under section 3(c)(7) of that Act.
- In addition, holders of equity or debt securities, including short term paper issued by the fund, as well as a total return swap on the private fund, would be deemed an investor.
- An adviser to a master fund in a master-feeder arrangement would have to treat as investors the holders of securities of any feeder fund formed or operated for the purpose of investing in the master fund rather than the feeder funds, which act as conduits.
- 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 investment adviser.
- The new rule also includes two provisions that clarify that advisers need not double count private funds and their investors as clients and investors for purposes of determining the availability of the exemption when (1) an adviser counted an investor in a private fund as an investor, then the private fund itself need not be counted as a client and (2) where the adviser counts a person as a client and that person is also an investor it need not count that person also as an investor.
- The new rule does not treat as investors beneficial owners who are “knowledgeable employees”.

In the U.S.

- The new rule defines “in the U.S.” generally by incorporating the definition of a “U.S. person” and “United States” under Regulation S, except that any discretionary account or similar account that is held for the benefit of a person in the United States by a non-U.S. dealer or other professional fiduciary is deemed "in the United States" if the dealer or professional is a related person of the investment adviser.

- A person that is "in the United States" may be treated as not being "in the United States" if such person was not "in the United States" at the time of becoming a client or, in the case of an investor in a private fund, at the time the investor acquires the securities issued by the fund.

Place of Business

- The new rule defines "place of business" to mean 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.
- The determination is fact and circumstance specific. For example a place of business would not include an office where an adviser solely performs administrative services and back office services if they are not activities intrinsic to providing investment advisory services and do not involve communicating with clients.
- Note: There is no presumption that a non-U.S. adviser has a place of business in the United States solely because it is affiliated with a U.S. adviser.

Assets Under Management

The final rule defines "assets under management" by reference to the calculation of "regulatory assets under management" for Item 5 of Form ADV. See "**Method of Calculating Assets Under Management**" above.

Advisers Relying on the Foreign Private Adviser Exemption as Compared to Foreign Advisers Relying on Venture Capital Fund Exemption or Private Funds with Less than $150 million in Assets Under Management in the U.S. Exemption

- Do not need to comply with the reporting and examination requirements for exempt reporting advisers (See Implementation Release)
- Do not have a transition period within which to register after becoming ineligible to rely on this exemption due to an increase in the value of private assets attributable to U.S. clients and investors in the U.S.

Sub-advisory Relationships and Advisory Affiliates

- Sub-advisers would be permitted to rely on each of the new exemptions, provided that sub-advisers satisfy all terms and conditions of the applicable exemption.
- Two or more affiliated advisers that are separately organized but operationally integrated would be treated as a single adviser for purposes of determining eligibility for an exemption from registration.
- However, in the case of a non-U.S. advisory affiliate, the Commission affirmed its position developed in the *Unibanco* line of no-action letters that it would continue to not recommend enforcement action if a non-U.S. advisory affiliate of a registered adviser shares personnel with, and provides certain services through, the registered adviser affiliate, without the non-U.S. advisory affiliate registering under the Advisers Act and where such non-U.S. advisory affiliate provides advisory service to its non-U.S. clients.

The final rules go into effect on July 21, 201,1 but advisers will not need to apply for their exemption (which is done by filing Form ADV) until March 30, 2012.

For those wishing to see a side-by-side comparison of the final rules vs. the proposed rules, we have prepared the attached chart, which sets forth each proposed rule alongside the final rule, and highlights and discusses in the final rule the differences between the proposed rule and final rule.

If you have any questions or wish to discuss the new rules, please contact Stephen Cohen at scohen@loeb.com or Erika Clampitt at eclampitt@loeb.com.

Loeb & Loeb's Financial Reform Task Force monitors key issues surrounding approval of the Dodd-Frank Wall Street Reform and Consumer Protection Act that are relevant to a broad spectrum of firm clients in the financial services industry. The multidisciplinary Task Force is comprised of attorneys across core practice areas - including general corporate, private equity, securities, mergers and acquisitions, consumer protection and banking and finance - who are focused on analyzing the historic legislation and interpreting the significant business implications for financial institutions and commercial companies nationwide.

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