ALERTS AND UPDATES

Dodd-Frank Act Update: SEC Proposes Rules Applicable to Investment Advisers

December 6, 2010

On November 19, 2010, the U.S. Securities and Exchange Commission (the "SEC") issued proposed rules, pursuant to title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). 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 in the United States and certain foreign private advisers. These new limited exemptions would replace portions of the former statutory exemption for limited advisors—those with fewer than 15 clients—which were removed by the Dodd-Frank Act.
The proposed rules would also implement expanded disclosure and registration requirements set forth in the Dodd-Frank Act for advisers to hedge funds and other private funds. This *Alert* provides a brief summary of the proposed rules. For a more detailed explanation of the new registration requirements enacted under the Dodd-Frank Act, please see our earlier *Alert*, "Registration of Advisors to Private Investment Funds and Pools, and of Small Advisory Firms."

Exemption for Advisers to Venture Capital Funds

The Dodd-Frank Act amended the Investment Advisers Act of 1940 (the "Advisers Act") to exempt advisers that manage only venture capital funds from registration under the Advisers Act. The Dodd-Frank Act directed the SEC to define the term "venture capital fund" for purposes of this new exemption. Proposed Rule 203(l)-1(a) defines a "venture capital fund" as any private fund that meets all of the following criteria:

- The fund represents itself as a venture capital fund to investors.
- The fund owns solely equity securities of private companies and cash, cash equivalents and certain U.S. treasuries.
- At least 80 percent of the equity securities of each portfolio company of the fund were acquired by the fund directly from the portfolio company.
- The fund and/or its managers: (i) offer to provide significant guidance regarding the management, operations or business objectives and policies of each portfolio company (and, if accepted, actually provides such guidance) or (ii) control each portfolio company.
- The fund does not borrow, issue debt obligations, provide guarantees or otherwise incur leverage in excess of 15 percent of the fund's committed capital, and any such borrowing, indebtedness, guarantee or leverage is for a nonrenewable term of no longer than 120 calendar days.
- None of the portfolio companies of the fund: (i) issue debt obligations (directly or indirectly) in connection with the fund's investment in such company; (ii) redeem, exchange or repurchase any securities of the company or distribute to existing security holders cash or other company assets in connection with the fund's investment in such company or (iii) are themselves a private fund or other pooled investment vehicle.
- The fund only issues securities whose terms do not provide a holder with any right, except in extraordinary circumstances, to withdraw, redeem or require the repurchase of such securities.
- The fund is not registered under Section 8 of the Investment Company Act of 1940 and has not elected to be treated as a business development company pursuant to Section 54 of the Investment Company Act.

The above definition appears to exclude funds whose portfolio companies "go public," unless the fund sells (or otherwise disposes of) those securities. This may not be an issue if the fund's interest in the portfolio company is registered for sale as part of the Securities Act registration, and the fund's shares are sold as part of the offering. In addition, the proposed definition also appears to exclude funds whose interest in a portfolio company can be converted into debt. It is possible that these issues will be considered and discussed by the SEC as part of the comment and adoption process.

Under a proposed grandfathering provision, existing funds that make venture capital investments would generally be deemed to meet the proposed definition, thereby exempting them from registration, as long as they have represented themselves as venture capital funds to their investors, sold securities to one or more third-party investors prior to December 31, 2010, and hold their final closing on or before July 21, 2011.

Exemption for Private Fund Advisers with Less Than $150 Million in Assets

The Dodd-Frank Act also directs the SEC to issue a rule exempting from Advisers Act registration an adviser that acts solely as an investment adviser to one or more qualifying private funds and manages private fund assets of less than $150 million in the United States. The proposed rules clarify which private fund assets an adviser must count toward the $150 million limit.

Advisers with a principal office and place of business in the United States would count all of their private fund assets toward the limit, even if day-to-day management of certain assets may take place outside of the United States. Advisers with a principal office and place of business outside of the United States would count toward the limit only private fund assets managed from a place of business in the United States. To that end, the proposed rules clarify that only the "securities portfolios" for which the non-U.S. adviser provides "continuous and regular supervisory or management services" from a U.S. place of business are counted toward the limit.

Exemption for Foreign Private Advisers

The Dodd-Frank Act established a new exemption from Advisers Act registration for "foreign private advisers." A "foreign private adviser" is defined as any investment adviser that (i) has fewer than 15 U.S. clients and private fund investors,(ii) has less than $25 million in aggregate assets under management from U.S. clients and private fund investors, (iii) does not have a place of business in the United States and (iv) does not hold itself out generally to the public in the United States as an investment adviser.

The SEC proposes to define certain terms in order to clarify the application of the foreign private adviser exemption. Specifically, the proposed rules define the phrase "in the United States" by incorporating the definition of a "U.S. person" and "United States" used in Regulation S under the Securities Act of 1933. The proposed rule clarifies that if a client or investor was not "in the United States" at the time of becoming a client or at the time the investor acquired the securities, the person may be treated as not being "in the United States" for purposes of this exemption. The proposed rules also define "place of business" as any office where the adviser regularly provides advisory services, meets with or communicates with clients; and any location held out to the public as a place where the adviser conducts such activities.
The SEC has also specified the calculation of "assets under management" for purposes of the "foreign private adviser" exemption. The proposed rules require that assets under management for purposes of the $25 million threshold be calculated in accordance with the rules and guidance on determining "regulatory assets under management." Finally, the proposed rules provide guidance on counting clients and private fund investors.

Regulatory Assets Under Management

In order to determine whether an adviser qualifies for an exemption from registration, its "regulatory assets under management" would be required to be calculated according to the proposed rules. Advisers would be required to include in their "regulatory assets under management": (i) proprietary assets, (ii) assets managed without receiving compensation and (iii) assets of foreign clients. 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.

Additional SEC Reporting Requirements for Investment Advisers

Under the proposed rules, advisers to private funds would be required to provide additional information about the funds they manage, including basic organizational and operational information related to the amount of assets held by the fund; the types of investors in the fund and the adviser's services to the fund. The SEC is also proposing other amendments to the adviser registration form that would require registered advisers to provide more information about the types of clients they advise, their employees and their advisory activities.

In addition, exempt advisers would be required to provide basic identifying information about their owners and affiliates, about the private funds the advisers manage, any business activities that may present conflicts of interest and the disciplinary history of the adviser and its employees.

State Registration Requirements

The Dodd-Frank Act raises the threshold for SEC investment adviser registration to $100 million by creating a new category of advisers called "mid-sized advisers." A mid-sized adviser, which generally may not register with the SEC and will be subject to state registration, is defined as an adviser that (i) manages between $25 million and $100 million for its clients; (ii) is required to be registered in the state where it maintains its principal office and place of business and (iii) would be subject to examination by that state, if required to register.

As a result of this amendment to the Advisers Act, the SEC states that more than 4,000 of the current 11,850 registered advisers will switch from registration with the SEC to registration with one or more states. The proposed rules would allow the SEC to rely on representations by state securities commissioners on whether a mid-sized adviser registered with that state would be subject to examination by the state securities commissioner or similar agency.

Pay-to-Play Rule

The SEC also proposed to amend the investment adviser "pay-to-play" rule in response to changes made by the Dodd-Frank Act. The "pay-to-play rule" (*i.e.*, Investment Adviser Rule 206(4)-5)) prohibits advisers from engaging in pay-to-play practices. Under the proposed amendment, an adviser would be permitted to pay a registered municipal advisor, instead of a "regulated person," to solicit government entities on its behalf if the municipal advisor is subject to the Municipal Securities Rulemaking Board's (the "MSRB") pay-to-play rules. The MSRB received new authority over municipal advisors under the Dodd-Frank Act.

The SEC is seeking public comment on the proposed rules for a period of 45 days following their publication in the *Federal Register*.

About Duane Morris

Duane Morris has an online **Financial Services Reform Center**—www.duanemorris.com/FinancialReform—which includes videos and the firm's comprehensive series of *Alerts* analyzing the provisions of the Dodd-Frank Act and emerging policies, as well as links to relevant government websites. Duane Morris' attorneys are monitoring the rules and regulations released under the Dodd-Frank Act, as well as the regulatory agencies' interpretive guidance, and continuously update the Financial Services Reform Center.

For Further Information

If you have any questions about the proposed SEC rules, please contact Robert P. Bramnik, Loren Schechter, Jennifer Briggs Fisher, any member of the Broker-Dealer & Securities Regulation Practice Group, any member of the Corporate Practice Group or the attorney in the firm with whom you are most regularly in contact.