AKIN GUMP
STRAUSS HAUER & FELD LLP

Investment Funds Alert

SEC Adopts Exemptions for Advisers to Certain Private Funds and Venture Capital Funds and Delays Registration

July 11, 2011

On June 22, 2011, the Securities and Exchange Commission (SEC) adopted rules to clarify the new exemptions from registration in the Investment Advisers Act of 1940 (the "Advisers Act") that were added by the Dodd-Frank Wall Street Reform Protection Act (the "Dodd-Frank Act"). The rules further define the new exemptions and exclusions in the Advisers Act for investment advisers that (i) advise only private funds and have less than $150 million in assets under management (AUM) in the United States and (ii) advise only venture capital funds. The rules also specify the filings that the above exempt investment advisers must make with the SEC. In addition, the SEC adopted amendments to Form ADV that will change the methodology of computing AUM.

The SEC also delayed until March 30, 2012, the date that investment advisers currently relying on the "fewer than 15 clients" exemption in Section 203(b)(3) of the Advisers Act will be required to register so long as they continue to satisfy the previous requirements of Section 203(b)(3). It should be noted, however, that some states that incorporate the "fewer than 15 clients" exemption in Section 203(b)(3) of the Advisers Act in their state securities statutes or regulations have not adopted a similar transition period for their statutes or regulations and may, therefore, require registration with the state by July 21, 2011, if the adviser is not SEC-registered.[1]

The rules providing for the exemptions and exclusions will be effective on July 21, 2011, with a delayed compliance date until March 30, 2012.

Exemption for Advisers Only to Private Funds with Less Than $150 Million in AUM

The Dodd-Frank Act added new Section 203(m) to the Advisers Act, which requires the SEC to adopt a rule exempting from registration an investment adviser that only advises private funds or issuers that qualify for another exclusion from the definition of an investment company (each such issuer or private fund a "Qualifying Private Fund") if such adviser has less than $150 million in AUM in the United States (the "Private Fund Adviser Exemption"). Section 203(m) also requires investment advisers exempted by the Private Fund Adviser Exemption to maintain records[2] and make annual or other reports as the SEC determines is necessary or appropriate for the public interest or for the protection of investors. The new rules answer several questions relating to the exemption, including the impact of non-United States activities, the method of calculating AUM and the reporting that is required.

Is an investment adviser that has a managed account that is located outside of the United States prohibited from using the Private Fund Adviser Exemption?

[1] The Commonwealth of Virginia is an example of a state that has not adopted a similar transition rule.
[2] A record keeping rule has yet to be adopted or proposed.

The answer depends on the adviser's principal office and place of business. An investment adviser with a principal office and place of business located in the United States is prohibited from relying on the Private Fund Adviser Exemption if it has any clients that are not Qualifying Private Funds irrespective of whether the client is a United States person defined generally as a "U.S. person" pursuant to Regulation S under the Securities Act of 1933 (the "Securities Act"). An investment adviser with a principal office and place of business outside of the United States will be prohibited from using the Private Fund Adviser Exemption due to having a client that is not a Qualifying Private Fund only if that client is a United States person.[3]

Will an investment adviser that advises an entity with only one investor that meets the technical criteria of a "Qualifying Private Fund" be able to rely on the Private Fund Adviser Exemption?

If an investment adviser advises a single-investor fund that is a private fund, the private fund would likely not be viewed as a Qualifying Private Fund, and the Private Fund Adviser Exemption would be unavailable. If, however, the client entity only has one investor because of other investors' redemptions or because the investor is a seed investor, the client entity would likely be deemed a Qualifying Private Fund, and the investment adviser would be able to use the Private Fund Adviser Exemption.

What will AUM in the United States include?

The rule computes AUM in the United States differently for advisers with a principal office and place of business in the United States than for those with a principal office and place of business outside the United States. An investment adviser with a principal place of business in the United States will be required to include the "regulatory" AUM (as defined below) of all of its Qualifying Private Funds even if some of the AUM is managed from a non-U.S. branch office. An adviser with a principal office and place of business outside of the United States that has a place of business in the United States will only be required to include assets managed from a place of business in the United States. Investment advisers that have no place of business in the United States will be able to use the Private Fund Adviser Exemption regardless of the number of United States investors in any Qualifying Private Fund that they manage or advise or the assets attributable to those investors.

Will research or due diligence functions from a U.S. office be considered managing assets from a place of business in the United States?

If a person outside of the United States makes independent investment decisions on behalf of the investment adviser and implements those decisions, the research or due diligence activities will not be considered to be managing assets. The SEC looks to the standard in the AUM test, i.e., whether such services are continuous and regular management services, in determining if an adviser is managing assets in the United States.

Which reports will an adviser relying on the Private Fund Adviser Exemption be required to file with the SEC?

An adviser relying on the Private Fund Adviser Exemption will be required to file a partial Form ADV Part 1A as set forth below under "Required Filings for Exempt Reporting Advisers." No other reports are contemplated by the new rules.

When will an investment adviser that exceeds $150 million in regulatory AUM be required to register with the SEC?

An investment adviser using the Private Fund Adviser Exemption will be required to measure its regulatory AUM as of the end of the calendar year. If the adviser's regulatory AUM as of the end of any calendar year were to equal or exceed $150 million, it would be required to register with the SEC. If the formerly exempt investment adviser had filed all reports that it was required to file on Form ADV, it would have 90 days after crossing the threshold to register with the SEC. The investment adviser would then file its exit report as an exempt reporting adviser and its registration

[3] Several places in the rules incorporate the definition of "U.S. Person" under Regulation S under the Securities Act. The new rules, however, vary from the Regulation S definition in certain respects.

application through the same filing. The transitioning investment adviser could continue operating during the pendency of its application, but until it is registered could not accept clients that are not Qualifying Private Funds.

Will an investment adviser that combines its assets with an affiliated investment and ends up with regulatory AUM in excess of $150 million be able to rely on the Private Fund Adviser Exemption?

The SEC stated that it will continue to apply its integration analysis under the previous "fewer than 15 clients" exemption; the answer will depend on whether the advisers are separately organized and managed.

Will an investment adviser be subject to examination by the SEC if it is using the Private Fund Adviser Exemption?

The SEC has the authority to examine any investment adviser (regardless of its registered status) other than investment advisers that are exempt from registration under 203(b) of the Advisers Act, e.g., "foreign private advisers" or registered commodity trading advisors that do not predominantly provide advice as to securities. As the Private Fund Adviser Exemption is located in Section 203(m) of the Advisers Act, the SEC will have examination authority over investment advisers exempt under the Private Fund Adviser Exemption. Chairman Schapiro's statements in the open meeting adopting the rules, however, clarify that the SEC does not currently intend to conduct routine examinations of investment advisers that are not registered.

Advisers to Venture Capital Funds

The Dodd-Frank Act added new Section 203(l) to the Advisers Act, which will exempt investment advisers that only advise "venture capital funds" (as defined by the SEC) from the registration requirements of the Advisers Act (the "Venture Capital Exemption"). Section 203(l) will require investment advisers exempted by the Venture Capital Exemption to maintain the records and make annual or other reports as the SEC will determine is necessary or appropriate for the public interest or for the protection of investors.

How will the rules define a "venture capital fund"?

"Venture capital funds" will be defined as any private fund[4] that—

- immediately after the acquisition of any asset,[5] holds no more than 20 percent of its capital commitments in assets other than—
  - equity securities of a qualifying portfolio company directly acquired from the qualifying portfolio company
  - certain equity securities received in exchange for those securities
  - cash
  - cash equivalents
  - treasury securities with no more than 60 days maturity or
  - securities of registered open-end investment companies regulated as money market funds

[4] Investment advisers may treat funds organized outside of the United States as private funds even if they do not use U.S. means of interstate commerce.
[5] The above requirements will be tested after each acquisition of an asset, and the value for assets may be cost or fair value as long as the test is applied consistently.

- does not borrow, provide guarantees or issue debt obligations or otherwise incur leverage in excess of 15 percent of the private fund's aggregate capital contributions and uncalled committed capital
- limits any such borrowing, indebtedness or guarantees (other than through guarantees of a qualifying company's obligations up to the amount of the private fund's investment) to a term of 120 days on a nonrenewable basis
- does not permit its investors to redeem or withdraw except in extraordinary circumstances[6]
- represents itself as pursuing a venture capital strategy to investors[7]
- neither registered as a investment company nor has it elected to be treated as a business development company.

The final rule omits or alters several of the requirements that were originally proposed. A private fund will not be required to have management rights or offer management counsel to an issuer in order to be a venture capital fund. Also, a potential venture capital fund will not be required to represent itself as a venture capital fund, but need only describe a venture capital strategy. Finally, the basket for securities acquired in the secondary market was broadened into a general 20 percent basket.

What is a qualifying portfolio company?

A "qualifying portfolio company" is defined as a company that does **not** (i) file reports with the SEC under the Securities Exchange Act of 1934, (ii) have its securities listed or traded on a foreign exchange, (iii) borrow or issue debt obligations in connection with the venture capital fund's investment and distribute the proceeds thereof to the private fund in exchange for the fund's investment and (iv) act as an investment company, a private fund, a commodity pool or an issuer of asset-backed securities that would be an investment company were it not for Rule 3a-7 under the Investment Company Act of 1940.

In what circumstances can an investor redeem its investment?

A venture capital fund will be allowed to permit an investor to withdraw from the fund for foreseeable but unexpected circumstances, such as changes in the law or corporate events such as mergers. The venture capital fund will also be permitted to exclude investors from participation in some funds' investments, for reasons including a change in tax laws or other regulatory changes, without requiring registration. Venture capital funds are also permitted to conduct pro rata distributions to all holders.

If a private fund prohibits redemptions, but permits frequent transfers of interests, could it satisfy the Venture Capital Exemption?

An investment adviser relying on the Venture Capital Exemption could neither regularly identify potential investors on behalf of investors seeking to exit the relevant fund nor regularly waive its prohibition against redemption.

If a venture capital fund has held itself out as a venture capital fund, but would not satisfy the above definitional requirements, would its related investment adviser be able to use the Venture Capital Exemption?

The new rule will grandfather certain investment funds that do not satisfy all of the requirements of the "venture capital fund" definition. The grandfathered funds will include any private fund that has represented to investors and potential investors at the time of the offering that it pursues a venture capital strategy, commenced its offering to unaffiliated investors prior to December 31, 2010, and does not sell any securities to, or accept any additional committed capital from, any person after July 21, 2011.

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[6] A private fund with a lengthy lock-up will not satisfy the requirement to prohibit redemptions.
[7] Note that merely including a venture capital strategy within a multi-strategy fund does not satisfy this requirement.

Changes to AUM Calculation

The rules discussed above require determinations of an investment adviser's "regulatory AUM." Regulatory AUM is a new term used to indicate the AUM of an investment adviser as determined in accordance with specified instructions to Part 1A of Form ADV (rather than for purposes of Part 2A of Form ADV). The calculation of regulatory AUM in the instructions to Part 1A of Form ADV is similar to that in previous versions, with a few changes for private funds and discretionary assets. Under both the current and the revised AUM definition, "AUM" is defined as the value of securities portfolios with respect to which the investment adviser provides continuous and regular supervisory or management services. The new regulatory AUM definition changes the accounts to be counted as "securities portfolios" and the value of those securities portfolios. To review the definition of regulatory AUM, see instruction 5.F. available **here**.

How will the changes to Form ADV affect the accounts that are determined to be "securities portfolios"?

The current definition of AUM allows, but does not require, investment advisers to include securities portfolios that are (i) proprietary and family assets, (ii) assets managed without compensation and (iii) assets of clients that are not United States persons.[8] The amended Form ADV will require investment advisers to include those securities portfolios in regulatory AUM. The amended Form ADV will also require investment advisers to include all of the assets of private funds as a securities portfolio regardless of the nature of those assets and include any uncalled capital commitments in that securities portfolio.

How will the amendments to Form ADV change the calculation of the value of the regulatory AUM?

As with the previous AUM calculation, an adviser will be required to calculate the AUM based on the current market value of the assets determined within 90 days of the filing of the relevant Form ADV. The revised Form ADV will define a private fund's AUM to be the current market value or, in the event that market quotations are unavailable, fair value of the private fund's assets. Any fair valuing will be in accordance with generally accepted accounting standards or another international accounting standard.

How will a sub-adviser's regulatory AUM be calculated?

A sub-adviser's regulatory AUM will only include that portion of the portfolio for which the sub-adviser provides continuous and regular supervisory or management services.

Will the assets be reduced for liabilities or debt?

No, the previous AUM calculation stated that securities purchased on margin should not be deducted. The new Form ADV will expand the exclusion to prohibit an adviser from subtracting any outstanding indebtedness and other accrued but unpaid liabilities that remain in a client's account and are managed by the adviser. Investment advisers could use the total value of assets in a double-entry balance sheet.

[8] Although a person is not an investment adviser for purposes of the Advisers Act unless it receives compensation for providing advice to others, once it meets that definition, the Advisers Act applies to the relationship between the adviser and any of its clients.

Required Filings for Exempt Reporting Advisers

Investment advisers taking advantage of the Private Fund Adviser Exemption or the Venture Capital Exemption (together "Exempt Reporting Advisers") will be required to file a limited Form ADV Part 1A.

What information will be required to be included in Exempt Reporting Advisers' reports on Form ADV?

An Exempt Reporting Adviser will be required to complete the following sections of Part 1A of Form ADV—

- identifying information (Item 1)
- a new section relating to Exempt Reporting Advisers containing a checkbox identifying whether the relevant Exempt Reporting Adviser is relying on the Private Fund Adviser Exemption or the Venture Capital Exemption and, if the former, the amount of private fund assets the investment adviser manages (Item 2.C)
- information regarding the investment adviser's form of organization (Item 3)
- other business activities of the investment adviser (Item 6)
- the reporting of information relating to private funds set forth below and affiliations with other entities in the financial industry (Item 7)
- information regarding control persons (Item 10)
- disclosure information regarding disciplinary and other events (Item 11)
- schedules A, B, C or D of Part 1A.

Exempt Reporting Advisers will not be required to complete the remainder of the form or a brochure under Part 2A of Form ADV.

Will the information in a report filed by an Exempt Reporting Adviser be publicly available?

Yes, information in a report filed by an Exempt Reporting Adviser will be publicly available just as other Form ADVs are.

When will Exempt Reporting Advisers be required to file their limited reports on Form ADV?

Exempt Reporting Advisers will be required to file their initial reports within 60 days of initially relying on the exemptions, i.e. March 30, 2012. After their initial filing, Exempt Reporting Advisers will report on an annual basis. An Exempt Reporting Adviser will also be required to update its Form ADVs if there is any change to the identification information, form of organization or disciplinary history or if there is a material change to its control persons disclosure.

Conclusion

The SEC clarified the exemptions for Exempt Reporting Advisers and delayed the registration deadline for investment advisers currently relying on the "fewer than 15 clients" exemption so that they have time to prepare their compliance processes and procedures.

Non-United States investment advisers will be subject to a more expansive interpretation of SEC jurisdiction, but they will also be most able to use the new investment adviser exemptions and other changes. The SEC stated multiple times in the adopting releases that any investment adviser that uses the United States instrumentalities of interstate commerce are subject to its jurisdiction. However, investment advisers with a principal office and place of business outside of the United States will frequently be able to use the Private Fund Adviser Exemption. The SEC also reaffirmed that it will continue its previous "Unibanco" line of no-action letters, which permit investment advisers outside of the United States to "ring fence" their activities so that SEC registration results in the application of the substantive requirements of the Advisers Act only to clients that are United States persons.

We advise our investment adviser clients, especially those that will not be Exempt Reporting Advisers, to use the extra time that the SEC provided wisely to prepare themselves for the requirements of registration.

CONTACT INFORMATION

If you have any questions concerning this alert, please contact—

Mark H. Barth
mbarth@akingump.com
212.872.1065
New York

Jason M. Daniel
jdaniel@akingump.com
214.969.4209
Dallas

Prakash H. Mehta
pmehta@akingump.com
212.872.7430
New York

Fadi G. Samman
fsamman@akingump.com
202.887.4317
Washington, D.C.

Stephen M. Vine
svine@akingump.com
212.872.1030
New York

David M. Billings
dbillings@akingump.com
44.20.7012.9620
London

Robert M. Griffin
bgriffin@akingump.com
971.2.406.8534
Abu Dhabi

Eliot D. Raffkind
eraffkind@akingump.com
214.969.4667
Dallas

Simon Thomas
swthomas@akingump.com
44.20.7012.9627
London

Ying Z. White
ywhite@akingump.com
86.10.8567.2212
Beijing