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SEC proposes new rules to implement Dodd-Frank exemptions for certain categories of investment advisers

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In several recent releases, the US Securities and Exchange Commission (SEC) proposed a series of rules and rule amendments designed to clarify whether certain categories of investment advisers including "family offices"; advisers that advise only "venture capital funds"; advisers that advise only "private funds" and manage less than $150m in assets; certain "foreign private advisers"; and registered commodity trading advisers are eligible for exemption from the registration and other requirements of the Investment Advisers Act of 1940 (Advisers Act). The proposed rules are designed to implement the statutory exemptions created for these categories of investment advisers by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) that President Obama signed on July 21, 2010.

Historically, many family offices, as well as advisers to many private funds (such as hedge funds, private equity funds, and venture capital funds) relied on an exemption from Advisers Act registration found in section 203(b)(3) of the Advisers Act (Private Fund Adviser Exemption). *The Private Fund Adviser Exemption* exempted from registration an investment adviser that advised fewer than 15 clients (with each private fund being counted as a single client) in any rolling 12-month period, did not hold itself out generally to the public as an investment adviser, and did not advise registered investment companies. In addition, advisers exempt from registration under the Private Fund Adviser Exemption were not subject to reporting or record-keeping provisions of the Advisers Act and were not subject to periodic examination by the SEC.

The Dodd-Frank Act repealed the Private Fund Adviser Exemption in an attempt to obtain more transparency and regulatory oversight over such advisers, and replaced it with a series of more narrowly tailored exemptions for "family offices"; advisers that advise only "venture capital funds"; advisers that advise only "private funds" and manage less than $150m in assets; certain "foreign private advisers"; and registered commodity trading advisers.

The proposed rules, among other things, provide important definitions to terms, such as "family office" and "venture capital funds," that are critical to determining whether an investment adviser is eligible for an exemption. In addition, the proposed rules introduce new reporting obligations for certain categories of advisers, including advisers to venture capital funds and advisers to private funds with less than $150m in assets under management, even though such advisers would be exempt from Advisers Act registration. Such advisers could also become subject to the Advisers Act's recordkeeping requirements and periodic examination of their books and records by the SEC in the future.

This article, written by Arnold & Porter attorneys, provides a brief overview of each of the exemptions and the rules *proposed by the SEC relating to each exemption.*

Family offices

Generally, "family offices" are entities established by wealthy families to manage the family's wealth and to provide financial, tax, and estate planning advice and other services to the family members. Historically, family offices relied on the Private Fund Adviser Exemption or applied for an order from the SEC indicating that the requesting family office is not an "investment adviser" as defined in section 202(a)(11) of the Advisers Act. In light of the repeal of the Private Fund Adviser Exemption, Congress adopted section 202(a)(11)(G) of the Advisers Act which excludes a "family office" from the definition of an investment adviser. Qualifying family offices generally will not be subject to any provisions of the Advisers Act (including the registration, reporting, and recordkeeping provisions) and will not be subject to periodic examination by the SEC staff.

On October 12, 2010, the SEC issued a release (October release), in which it proposed rule 202(a)(11)(G)-1 under the Advisers Act, designed to define a "family office." Generally speaking, the proposed definition of a "family office" would be restricted to entities that (a) restrict investment advice about securities to certain "family clients," (b) are wholly owned by family members, and (c) do not hold themselves out to the public as investment advisers. The SEC reasoned that such entities are in a better position to protect their interests and are not as likely to be in a position to need the protection of the federal securities laws. In proposing the "family office" definition, the SEC seeks to exclude entities that provide investment advice to persons not affiliated with a family (other than certain family-office employees) as such arrangements would be more likely to resemble those of a typical commercial investment adviser. Therefore, entities that provide investment advice to multiple families would not fall within the definition of a "family office."

Entities that do not qualify under the "family office" definition may nonetheless apply for exemptive relief from the SEC as they have been permitted to do in the past.

Key definitions

As defined in the proposed rule, a "family client" would include any (a) family member; (b) key employee of the family office; (c) charitable foundation, charitable organization, or charitable trust, in each case established and funded exclusively by one or more family members or former family members; (d) trust or estate existing for the sole benefit of one or more family clients; (e) entity wholly owned and controlled exclusively by, and operated for the sole benefit of, one or more family clients; and (f) former family member or former key employee, provided that the family office can only advise such former family member or former key employee with respect to assets already invested (or committed to be invested) by the family office at the time such person becomes a former family member or former key employee and such former family member or former key employee is not permitted to make additional investments, other than those already contractually obligated to be made at the time such person becomes a former family member or former key employee.

The rule proposal would generally define a "family member" to include (a) the founders of the family office (including their spouses and spousal equivalents), their lineal descendants (including by adoption and stepchildren), and such lineal descendants' spouses or spousal equivalents; (b) the parents of the founders; and (c) the siblings of the founders and such siblings' spouses or spousal equivalents and their lineal descendants (including by adoption and stepchildren) and such lineal descendants' spouses or spousal equivalents. A "key employee" of the family office would include any natural person (including any person who holds a shared ownership interest with that person's spouse or spousal equivalent) who is an executive officer, director, trustee, general partner, or person serving in a similar capacity of the family office or any employee of the family office (other than an employee performing solely clerical, secretarial, or administrative functions with regard to the family office) who, in connection with his or her regular functions or duties, participates in the investment activities of the family office, provided that such employee has been performing such functions and duties for or on behalf of the family office, or substantially similar functions or duties for or on behalf of another company, for at least 12 months.

The SEC proposes to include key employees who are not family members as "family clients" to encourage highly skilled advisory employees to work for family offices. The SEC further proposes to allow family offices to advise former family members and former key employees with respect to assets already under management at the time such persons become former family members or former key employees to avoid triggering adverse investment or tax consequences for such former family members and former key employees.

Involuntary asset transfers

In the October Release, the SEC also addressed involuntary transfers of assets managed by a family office (such as transfers through bequests) noting that if such assets are transferred to a person that is not a "family client," the family office generally may not continue to render investment advice with respect to such assets without becoming an investment adviser subject to Adviser Act regulation. However, the family office can continue to render investment advice with respect to such assets for up to four months from the date of the involuntary transfer to permit the family office to transition the management of such assets to another adviser, seek exemptive relief or restructure its activities to comply with the family office exclusion.

Grandfathering provision

The SEC has also proposed a grandfathering provision for certain advisers that were not registered or required to be registered as of January 1, 2010, solely because they rendered investment advice to the following types of clients: (a) natural persons who, at the time of their applicable investment, are officers, directors, or employees of the family office who have invested with the family office before January 1, 2010, and are accredited investors, as defined in Regulation D under the Securities Act of 1933 (Securities Act); (b) any company owned exclusively and controlled by one or more family members; or (c) any investment adviser registered under the Advisers Act who provides investment advice and identifies investment opportunities to the family office, invests in such transactions on substantially the same terms as the family office invests, does not invest in other funds advised by the family office, and whose assets as to which the family office directly or indirectly provides investment advice represents, in the aggregate, not more than five percent of the value of the total assets as to which the family office provides investment advice. However, entities that qualify for the grandfathering provision would still be treated as investment advisers for purposes of (and therefore be subject to) certain anti-fraud provisions contained in the Advisers Act, including sections 206(1), (2), and (4).

Advisers to venture capital funds

Broadly speaking, venture capital funds are privately offered funds that make investments in private companies that are expanding, with the goal of either taking companies public or selling the companies in the future. As with family offices, advisers to venture capital funds have generally relied on the Private Fund Adviser Exemption. In light of its repeal, the Dodd-Frank Act enacted section 203(l) of the Advisers Act, which creates a new exemption from Advisers Act registration for advisers that advise only venture capital funds with the apparent goal of promoting capital-raising for early-stage companies. Although such advisers would be exempt from Advisers Act registration, they could nonetheless be subject to other requirements under the Advisers Act including reporting and recordkeeping obligations. In addition, such advisers could also become subject to periodic examination of their books and records by the SEC.

On November 19, 2010, the SEC issued a release (November release) in which it proposed rule 203(l)-1 under the Advisers Act, which is designed to define a venture capital fund and to define the parameters of the exemptive relief to be granted to advisers to such funds. Pursuant to proposed rule 203(l)-1, a venture capital fund would be defined as a private fund that (a) invests in equity securities of certain "qualifying portfolio companies" to provide operating and business expansion capital and acquires at least 80 percent of such equity securities directly from the qualifying portfolio company; (b) directly, or through its investment advisers, offers or provides significant managerial assistance to, or controls, the qualifying portfolio company; (c) does not borrow or otherwise incur leverage (other than limited short-term borrowing); (d) does not offer its investors redemption or other similar liquidity rights except in extraordinary circumstances; (e) represents itself as a venture capital fund to investors; and (f) is not registered under the Investment Company Act of 1940 (Company Act) and has not elected to be treated as a business development company.

Qualifying investments

To qualify as a venture capital fund, a fund generally would be permitted to invest only in the equity securities of qualifying portfolio companies (or hold cash, cash equivalents, and US Treasury securities with maturities of less than 60 days to fund anticipated investments and redemptions). A "qualifying portfolio company" would generally be defined as a company that (a) at the time of investment, is not publicly traded; (b) does not incur leverage in connection with the investment by the private fund; (c) uses the capital provided by the fund for operating or business-expansion purposes rather than to buy out other investors; and (d) is not itself a fund (i.e., is an operating company).

The SEC clarified that qualifying portfolio companies need not be US companies. In addition, the SEC clarified that if the securities of a qualifying portfolio company become publicly traded after the venture capital fund invests in the company, the venture capital fund may continue to hold the publicly offered securities or sell them on public markets (so as to permit the venture capital fund to exercise its business judgment with respect to the timing of investment dispositions). The SEC has also noted that it would consider a bridge financing in the form of debt convertible into the common or preferred securities of a qualifying portfolio company in a later round of investment to be an investment in the "equity securities" of the qualifying portfolio company.

In defining a venture capital fund, the SEC seeks to distinguish between traditional venture capital funds and buyout funds. Therefore, the definition of a venture capital fund requires that at least 80 percent of the qualifying portfolio company's securities acquired by the venture capital fund be acquired directly from the company itself (as opposed to the company's founders, angel investors, or other equity holders). Also, to qualify as a venture capital fund, a company in which the venture capital fund invests cannot obtain leverage in connection with the venture capital fund's investment, which many buyout funds arrange for in connection with an investment in a portfolio company.

Nonetheless, portfolio companies may use leverage in the ordinary course of business (for instance, to finance equipment, fund payroll, or otherwise manage cash flow) and still qualify as qualifying portfolio companies.

Managerial assistance

A qualifying venture capital fund must also either control the qualifying portfolio companies in which it invests or have an arrangement under which it offers to provide them significant guidance and counsel concerning the management, operations or business objectives and policies of the portfolio companies -- and actually provide such managerial assistance if the offer to provide such services is accepted by a qualifying portfolio company. The SEC noted that it believes that venture capital funds typically provide significant managerial expertise to their portfolio companies as both an integral component of their investments and also as a significant driver of value in such portfolio companies. The SEC noted that managerial assistance can take many forms, such as active involvement in the company's day-to-day affairs or less active involvement through board representation or the exercise of delineated voting rights. Nonetheless, the SEC declined to denote what specific activities would constitute significant managerial assistance pointing to the evolving needs of portfolio companies over time.

The SEC also addressed funds investing as a group noting that each fund in a group must offer (and if accepted, provide) managerial assistance to or exercise control over a qualifying portfolio company to be deemed a venture capital fund.

Leverage

To qualify as a venture capital fund, the fund would not be permitted to borrow money, 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 must be for a non-renewable term not to exceed 120 calendar days. The SEC notes that it has established this limit to address perceived concerns that the financial leverage used by venture capital funds could contribute to systemic risk.

No redemptions

To qualify as a venture capital fund, a fund would not be permitted to grant investors a redemption right except in extraordinary circumstances. However, the fund would be permitted to make pro rata distributions to investors as investments mature and are realized. While the November release did not designate what would constitute "extraordinary circumstances," it does point to several examples of "foreseeable but unexpected" circumstances where redemptions could be permitted, including changes in laws or regulations that impact an investor's investment in a fund.

Represents itself as a venture capital fund

The November release notes that a venture capital fund would include only those private funds that represent themselves as venture capital funds to investors and prospective investors. The SEC noted that a venture capital fund could represent itself as being a venture capital fund by describing its investment strategy as venture-capital-investing or describing itself as a fund that is managed in compliance with the elements of the proposed rule. The SEC proposes to include this requirement because other types of funds, including multi-strategy hedge funds, may be able to satisfy the other elements of the rule but may not otherwise be engaged in activities typical of most venture capital funds.

Private fund

The November release notes that only private funds (as defined in the Advisers Act by the Dodd-Frank Act) would qualify as venture capital funds. Section 202(a)(29) of the Advisers Act defines a private fund as an issuer that would be an investment company, as defined in section 3 of the Company Act but for sections 3(c)(1) or 3(c)(7) of the Company Act. This definition is designed to exclude registered investment companies, mutual funds, and companies electing to be treated as business development companies from being considered as private funds.

Grandfathering provision

In the November release, the SEC includes certain "grandfathered" funds as venture capital funds if such funds (a) represented themselves as venture capital funds to investors and potential investors at the time the fund offered its securities; (b) sold securities to one or more investors prior to December 31, 2010; and (c) does not sell any securities to, or accept any additional capital commitments from, any person after July 21, 2011. The SEC seemed to suggest in the text of the November release that a fund that has accepted capital commitments on or before the dates specified above would qualify as a venture capital fund even if the capital is called after the specified dates; however, this point is not clear from a reading of the text of the proposed rule. The SEC believes that most funds previously sold as venture capital funds would qualify as grandfathered funds.

Advisers to private funds

With the repeal of the Private Fund Adviser Exemption, an investment adviser would be subject to Advisers Act registration and regulation if it has at least $100m in assets under management. However, the Dodd-Frank Act created a new exemption from the Advisers Act registration (found in section 203(m) of the Advisers Act) for advisers that advise only private funds (as defined in Section 202(a)(29) of the Advisers Act), and have less than $150m in assets under management. Section 203(m) would not limit the number of private funds that could be managed by an adviser. Although such advisers would be exempt from Advisers Act registration, they could nonetheless be subject to other requirements under the Advisers Act including reporting and recordkeeping obligations. In addition, such advisers could also become subject to periodic examination of their books and records by the SEC.

Advisers solely to private funds

In the November release, the SEC affirmed that US advisers would not be eligible for the section 203(m) exemption if they manage assets of clients that are not private funds. However, foreign advisers that advise other non-private fund clients would still be eligible for the exemption as long as their clients that are United States persons are all qualifying private funds. For purposes of the exemption, the SEC proposes to use the definition of "United States person" found in Regulation S under the Securities Act (which generally uses the residence of an individual and the place of organization for entities) as the basis for determining whether a person or entity is a United States person. The SEC noted one exception from the definition of a United States person stating that discretionary accounts established offshore for the benefit of United States persons would be treated as United States persons.

Assets under management

As noted above, an adviser must aggregate its assets under management to determine whether it will qualify for the section 203(m) exemption. The SEC has proposed a new method for calculating assets under management which will be known as an adviser's "regulatory assets under management." The regulatory assets under management will likely be calculated differently from an adviser's actual assets under management. As proposed, an adviser would need to include as part of its regulatory assets under management proprietary assets, assets managed without compensation, and assets of foreign clients. In addition, the SEC has proposed new guidance for calculating the assets under management of private funds. Advisers would be required to count capital commitments made by investors even if such capital had not been called for contribution by the adviser. In addition, advisers would be required to value private-fund assets at fair value, as opposed to valuing such assets at cost. Sub-advisers to private funds would be required to report only those assets of private funds for which they provide sub-advisory services, as opposed to the total assets of the private fund.

An adviser with its principal office or place of business in the United States must count all of its assets under management towards the $150m threshold. Advisers that do not have a principal office or place of business in the United States need only count those assets managed from a place of business in the United States. For purposes of this exemption, the SEC considers an adviser's principal office and place of business as the location where the adviser controls, or has ultimate responsibility for, the management of private fund assets (i.e., the place where all the advisers' assets are managed, although day-to-day management of certain assets may also take place at another location).

Transition rule

The SEC noted that advisers could unexpectedly cross the $150m threshold in the course of day-to-day fluctuations in the value of their assets under management. As a result, the SEC has proposed giving an adviser three months from the date it crosses the $150m threshold to register with the SEC and to adopt compliance policies and procedures required by the Advisers Act. This transition period would only be available to advisers that are in compliance with all applicable SEC-reporting requirements.

Exempt reporting advisers

Although advisers that advise only venture capital funds and advisers that advise only private funds and have less than $150m in assets under management would be exempt from Advisers Act registration, the SEC has proposed that such advisers would nonetheless be subject to certain reporting requirements and be known as "exempt reporting advisers." In a companion release issued on November 19, 2010, the SEC proposed that exempt reporting advisers report a subset of the information required by Form ADV, relating to the investment advisory firm and its affiliates, their respective principals, advisory employees, potential conflicts of interest, and any disciplinary actions taken against the firm, its affiliates or its personnel. Forms ADV filed by an exempt reporting adviser would be filed with the SEC and available to the general public.

For a more in-depth discussion of the proposed reporting regime for exempt reporting advisers, please see SEC Proposes Rules to Redefine Registration and Reporting Obligations of Investment Advisers".

Sub-advisory relationships

The SEC recognized that some sub-advisers render services directly to primary advisers of venture capital funds and private funds as their clients, instead of having venture capital funds and private fund as direct clients. The SEC has noted that if the services rendered to primary advisors of venture capital funds and private funds by sub-advisors solely relate to venture capital funds or private funds, the sub-adviser would be permitted to rely on the exemptions provided in section 203(l) and section 203(m) of the Advisers Act respectively.

Foreign private advisers

The Dodd-Frank Act also created another exemption from Advisers Act registration for certain "foreign private advisers" that do not advise many US clients and investors or have many assets under management from US clients and investors. This exemption would be found in a new section 203(b)(3) of the Advisers Act which replaces the Private Fund Adviser Exemption. As a result, those advisers that qualify as "foreign private advisers" would be eligible for exemption not only from the Advisers Act's registration requirement, but also from its reporting and recordkeeping requirements. In addition, foreign private advisers would not be subject to the SEC's periodic examination of their books and records.

Pursuant to the Dodd-Frank Act, a "foreign private adviser" is defined in Section 202(a)(30) of the Advisers Act as an adviser that (a) has no place of business in the United States; (b) has, in total, fewer than 15 clients in the United States and investors in the United States in private funds advised by the investment adviser; (c) has aggregate assets under management attributable to clients in the United States and investors in the United States in private funds advised by the investment adviser of less than $25m; and (d) does not hold itself out generally to the public in the United States as an investment adviser. The SEC has proposed rule 202(a)(30)-1; it defines certain key terms designed to facilitate implementation of the foreign private adviser exemption.

Place of business in the United States

In determining whether a foreign adviser has a place of business in the United States, the SEC has proposed to define a "place of business" as 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. In addition, the SEC proposes to use the definition of "in the United States" based on the definition of "United States" provided in Regulation S under the Securities Act.

Counting US clients and investors in private funds

As noted above, to qualify for the foreign private adviser exemption, an adviser would not be permitted to have more than 15 clients in the United States and investors in the United States in private funds advised by the adviser. Proposed rule 202(a)(30)-1 under the Advisers Act would define a "client" to include (a) 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 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 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; (b) 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 (c) two or more legal organizations that have identical shareholders, partners, limited partners, members, or beneficiaries.

Advisers would need to count clients regardless of whether they receive compensation from such clients. Proposed rule 202(a)(30)-1 would define an "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 Company Act, or whether the outstanding securities of a private fund are owned exclusively by qualified purchasers under section 3 (c)(7) of the Company Act. The SEC proposed this "investor" definition to ensure that advisers would not structure nominee and similar relationships to circumvent the limitation on the number of investors in a private fund to do indirectly what it is not permitted to do directly.

The SEC's rule proposal would require an adviser to look through feeder funds in a master-feeder structure to count the holders of securities in the feeder fund as investors. In addition, where the risk of investing in a private fund is transferred from a record-owner to another person through an instrument such as a total return swap, the person that holds such an instrument would be considered the "investor" in the fund.

In addition, advisers would be required to count knowledgeable employees as "investors" even if they do not need to be counted as beneficial owners of a section 3(c)(1) fund or need to qualify as qualified purchasers in a section 3(c) (7) fund. Holders of the short-term paper issued by a private fund would also be counted as "investors" because the private fund's losses would impact such holders.

Nonetheless, to avoid double-counting, investors in the United States that invest in more than one fund need not be counted twice towards the total count. In addition, an adviser need not count a private fund as a client if that adviser has already counted any investor in that private fund as an investor.

In determining whether a "client" or "investor" in a private fund is "in the United States," the SEC proposes to make such a determination based on whether the client or investor is a "United States person" as defined in Regulation S under the Securities Act, except that (a) any discretionary account or similar account that is held on behalf of a person in the United States by a non-US dealer or other professional fiduciary is deemed "in the United States" if the dealer or professional fiduciary is a related person of the investment adviser relying on the exemption. In addition, as proposed, the determination as to whether a person would be deemed to be "in the United States" would only be required to be made at the time the person becomes a client or the person invests in the securities of the private fund. This would eliminate the need for advisers to continually monitor the whereabouts of their clients and investors.

Assets under management

For purposes of determining eligibility for the foreign private adviser exemption, an adviser would need to calculate its assets under management based on the SEC's proposed measure of "regulatory assets under management" described above.

Conclusion

With respect to the family office exemption, the SEC requested comments through November 18, 2010. With respect to the exemptions relating to advisers to venture capital funds, advisers to private funds with assets under management of less than $150m, and foreign private advisers, the SEC will accept comments on the rule proposals through January 24, 2011. Comments may be sent via the SEC's internet comment form, which can be found here, or by sending an email to rule-comments@sec.gov with a subject line of "File Number S7-37-10."

Note: If you have any questions about any of the topics discussed in this advisory, please contact the following Arnold & Porter attorneys: David F. Freeman, Jr., Richard P. Swanson, Richard Chen and John Stevens.

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