

SEC's New Dodd-Frank Fund Oversight Rules

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SEC Releases

ÿ Three June 22, 2011 SEC releases adopting new rules under the Advisers Act to implement provisions of Dodd-Frank:

ÿ Release IA-3220: Family Offices

ÿ Release IA-3221: Rules Implementing Amendments to the Advisers Act

ÿ Release IA-3222: Exemptions for Certain Advisers

Implementing Release

The Implementing Release relates to:

- registration requirements for investment advisers; and
- reporting requirements for (1) registered investment advisers, and (2) exempt reporting advisers

Mid-sized Advisers

Y Advisers Act Section 203A generally prohibits an investment adviser regulated by the state in which it maintains its principal office and place of business from registering with the SEC unless it has at least \$25 million AUM

Y Dodd-Frank created a new category of covered mid-sized advisers:

- Y with \$25 million – \$100 million AUM, and

- Y subject to registration and examinations as investment advisers with the state of their principal office and place of business

 - Y Wyoming, New York and Minnesota are states that do not meet both requirements

Mid-sized Advisers

New Advisers Act Section 203A(a)(2) provides that no covered mid-sized adviser shall register with the SEC unless the adviser:

- advises a registered investment company;
- advises a “business development company”; or
- is required to register with 15 or more states

Mid-sized Advisers

- ÿ By raising the SEC registration threshold to \$100 million AUM, Dodd-Frank generally bars smaller and mid-sized investment advisers from choosing SEC registration over state registration
- ÿ According to the SEC, approximately 3,200 advisers will be required to withdraw their SEC registrations and register on a state level

Transition to State Registration

- Mid-sized advisers registered with the SEC as of July 21, 2011, must remain registered with the SEC until January 1, 2012, unless an exemption applies.
- Deadlines for mid-sized advisers no longer eligible to register with the SEC:
 - Those registered with the SEC on January 1, 2012, must file an amendment to Form ADV no later than March 30, 2012, to indicate that they are no longer eligible to remain registered with the SEC
 - Advisers required to withdraw must withdraw registration with the SEC by filing Form ADV-W no later than June 28, 2012

Assets Under Management

- ÿ The SEC revised the instructions to Form ADV Part 1A to create a uniform standard for advisers to calculate their AUM for determining eligibility for registration or exemptions, and other regulatory purposes
- ÿ Advisers Act Section 203A(A)(2) defines AUM as the “securities portfolios” with respect to which an adviser provides “continuous and regular supervisory or management services”
- ÿ New term, “regulatory assets under management” (RAUM), replaces “assets under management” in Form ADV Part 1

Assets Under Management

ÿ RAUM:

- ÿ to be calculated on a gross basis (without deduction of “any outstanding indebtedness or other accrued but unpaid liabilities”)
- ÿ to be valued at market value of private fund assets, or fair value if market value is unavailable
- ÿ must include:
 - ÿ the value of any securities portfolios for which the adviser provides continuous and regular supervisory or management services, regardless of the nature of the assets held by the private fund (e.g., proprietary assets, assets managed for which no compensation is received, and assets of foreign clients)
 - ÿ the amount of any uncalled capital commitments made to a private fund

Registration Prohibition Exemptions

- The SEC amended three exemptions from the prohibition on registration with the SEC:
 - Eliminated exemption in Rule 203A-2(a) from the prohibition on SEC registration for NRSROs
 - Amended the exemption available to pension consultants under Rule 203A-2(b) to increase the minimum value of plan assets required to rely on the exemption from \$50 million to \$200 million
 - Adopted amendments to the multi state adviser exemption under Rule 203A-2(d) so that all investment advisers who are required to register as an investment adviser with 15 or more states (versus 30 states currently) are permitted to register with the SEC

Exempt Reporting Advisers

- ÿ New Advisers Act Rule 204-4 requires advisers relying on the exemptions for
 1. advisers solely to venture capital funds and
 2. advisers solely to private funds with less than \$150 million AUM, to submit to the SEC, and periodically update, reports that consist of a limited subset of items on Form ADV

- ÿ Reports will be publicly available

Form ADV Amendments

Among other amendments to Form ADV, the SEC requires advisers to provide additional information about three areas of their operations:

- ÿ private funds advised
- ÿ advisory business, including data about:
 - ÿ types of clients, employees and advisory activities
 - ÿ business practices that may present significant conflicts of interest
 - ÿ e.g., use of affiliated brokers, soft dollar arrangements, and compensation for client referrals
- ÿ non-advisory activities and financial industry affiliations

Exemptions for Certain Advisers

- Prior to Dodd-Frank, IAA section 203(b)(3) exempted advisers with 14 or fewer clients during the preceding 12 months that
 - Did not hold themselves out as investment advisers
 - Did not advise registered investment companies or BDCs.
- Private funds generally counted as a single client for purposes of qualifying for this “private adviser” exemption
 - Left a big gap in SEC oversight
- Although it eliminated the private adviser exemption, Dodd-Frank created three new exemptions:
 - Advisers solely to **venture capital funds** (IAA Section 203(l))
 - Advisers solely to **private funds with less than \$150 million under management** (IAA Section 203(m))
 - Advisers that are **foreign private advisers** (IAA Section 203(b)(3))

Venture Capital Fund Exemption

- ÿ What is a venture capital fund? A private fund that
 - ÿ Generally holds equity securities of “qualifying portfolio companies” (excluding short-term holdings and non-qualifying investments)
 - ÿ Holds no more than 20 percent of the fund’s capital commitments in non-qualifying investments (other than short-term holdings)
 - ÿ Does not borrow or otherwise incur leverage, other than limited short-term borrowing
 - ÿ Excluding certain guarantees of qualifying portfolio company obligations by the fund
 - ÿ Does not offer investors redemption or other similar liquidity rights, except in extraordinary circumstances
 - ÿ Represents itself as pursuing a venture capital strategy to investors and potential investors
 - ÿ Is not registered under the ICA and has not elected to be treated as a BDC

Venture Capital Fund Exemption

Y What is a qualifying investment?

- Y Any equity security issued by a qualifying portfolio company (QPC) acquired directly by the fund (directly acquired equity)
- Y Any equity security issued by a QPC in exchange for directly acquired equity issued by the same QPC
- Y Any equity security issued by a company of which a QPC is a majority-owned subsidiary, or predecessor, and that is acquired by the fund in exchange for directly acquired equity

Y What is a qualifying portfolio company? Any company that

- Y Is not a reporting or foreign-traded company *and* does not have a control relationship with a reporting or foreign-traded company
- Y Does not incur leverage in connection with investments and distribute the proceeds of borrowings to the private fund in exchange for the private fund investment
- Y Is not itself a fund (i.e., is an operating company)

Venture Capital Fund Exemption

Y How does the 20% bucket work?

- Y Immediately after the acquisition of any asset (other than qualifying investments or short-term holdings) no more than 20% of the VCF's capital commitments can be in non-qualifying investments (other than short-term holdings)
- Y VCF calculates the 20% limit immediately after acquiring a non-qualifying investment (other than short-term holdings)
- Y VCF cannot purchase additional non-qualifying investments until the value of its then-existing non-qualifying investments falls below 20% of the fund's committed capital.
- Y Possible that a VCM invests all initial capital in non-qualifying assets as long as they do not exceed 20% of *bona fide* committed capital
 - Y If so, beware of anti-fraud violations!
- Y VCM may use either historical cost or fair value, if method is consistently applied

Venture Capital Fund Exemption

• What are short-term holdings?

• Includes:

- Cash and cash equivalents

- U.S. Treasuries with a remaining maturity of 60 days or less

- Shares of registered money market funds

- VCF does not count investments in short-term holdings when measuring compliance with 20 percent test

• Management involvement with QPCs

- SEC did not adopt managerial assistance requirement as proposed

Venture Capital Fund Exemption

• What are the limitations on leverage?

- VCF cannot 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
- Any such borrowing, indebtedness, guarantee, or leverage is limited to a non-renewable term of no more than 120 calendar days
 - A guarantee by the VCM of a qualifying portfolio company's obligations up to the value of the VCF's investment in the QPC is not subject to the 120-day limit

• No redemption rights

- Except in "extraordinary circumstances"
- Includes "foreseeable but unexpected circumstances" or due to regulatory or other legal requirements
- Quarterly or periodic withdrawals amount to redemption rights

Venture Capital Fund Exemption

• Application to non-U.S. advisers

• Non-U.S. advisers, as well as U.S. advisers, may rely on this exemption provided the adviser satisfies:

• All the elements of the rule, or

• The grandfathering provisions

• To rely on the exemption, all of the non-U.S. adviser's clients, whether U.S. or non-U.S., are VCFs

• That is, non-U.S. adviser cannot disregard its non-U.S. activities when evaluating whether it qualifies for VCF exemption

Venture Capital Fund Exemption

Y Grandfathering provisions

Y VCF includes a private fund that

Y Represented to investors and potential investors, at the time the fund offered its securities that it pursues a venture capital strategy

Y Has sold securities, to one or more investors prior to December 31, 2010, and

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

Y Includes any fund that has accepted all capital commitments by July 21, 2011 (capital commitment calls after July 21, 2011 would be consistent as long as investors became obligated by July 21, 2011 to make capital commitments)

Y Exempt Reporting Adviser

Y Advisers relying on the VCF adviser exemption are Exempt Reporting Advisers that are subject to

Y Reporting requirements

Y Supervisory requirements

Y Generally subject to anti-fraud provisions

Private Fund Adviser Exemption

- What is a private fund adviser? Must be an adviser:
 - Solely to private funds
 - With less than \$150 million AUM in the U.S.
- Advisers with any clients that are not private funds do not qualify
- Can a non-U.S. adviser rely on this exemption?
 - Yes, if *all* of the non-U.S. adviser's clients that are in the U.S. are qualifying private funds
 - Non-U.S. advisers may rely on this exemption without regard to the type or number of its non-U.S. clients or the amount of assets it manages outside of the U.S.
 - Reflects SEC's view that non-U.S. activities of non-U.S. advisers are less likely to implicate U.S. regulatory interests
 - Non-U.S. advisers that manage U.S. private funds from a location outside the U.S. may be required to register unless they qualify for another exemption
 - If a non-U.S. adviser has a place of business in the U.S., all clients managed at that place of business must be private funds in order to rely on this exemption

Private Fund Adviser Exemption

- ÿ Single-investor funds may qualify as private funds under certain circumstances
- ÿ Calculation of assets for determining eligibility for exemption
 - ÿ Adviser must aggregate all assets of private funds it manages
 - ÿ Form ADV provides uniform method of calculating RAUM, also used for determining eligibility for SEC registration and other regulatory purposes
 - ÿ Must include:
 - ÿ Proprietary assets
 - ÿ Assets managed without compensation
 - ÿ Uncalled capital commitments
 - ÿ Also, advisers must calculate:
 - ÿ Using market value (or fair value when market value is not available)
 - ÿ On gross basis (without deducting liabilities, accrued fees or expenses, or amounts of borrowing)

Private Fund Adviser Exemption

Y Frequency of calculation and transition period

- Y Advisers relying on private fund adviser exemption must annually calculate amount of private fund assets and report in annual amendments to Form ADV
- Y Changes in AUM between annual updating amendments will not affect ability of advisers to rely on private fund adviser exemption
- Y Advisers who no longer qualify for private fund adviser exemption may apply to register with SEC up to 90 days after filing annual update
 - Y May rely on private fund adviser exemption during that 90 day period

Y Assets managed in the U.S.

- Y All private fund assets of an adviser with *principal office and principal place of business in the U.S.* are “assets under management in the U.S.”
 - Y This is true even if the adviser has offices outside the U.S.
 - Y Non-U.S. advisers count only private fund assets managed at a place of business in the U.S. toward the \$150 million AUM limit

Private Fund Adviser Exemption

ÿ Who is a “United States person”?

ÿ U.S. person incorporates Regulation S definition

ÿ Regulation S generally looks to residence of an individual

ÿ Also addresses when a trust, partnership, or corporation is a United States person

ÿ A client will not be considered a United States person if the client was not one at the time of becoming a client of the adviser

ÿ A discretionary or other fiduciary account is a United States person if the account is held for the benefit of a United States person by a non-U.S. fiduciary who is a “related person” of the adviser

ÿ Exempt Reporting Adviser

ÿ Advisers relying on the private fund adviser exemption are Exempt Reporting Advisers that are subject to:

ÿ Reporting requirements

ÿ Supervisory requirements

ÿ Generally subject to anti-fraud provisions

Foreign Private Adviser Exemption

Y What is a foreign private adviser?

Y An adviser that

Y Has no place of business in the U.S.

Y Has, in total, fewer than 15 clients in the U.S and investors in the U.S. in private funds advised by the adviser

Y Has aggregate AUM 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

Y Does not hold itself out generally to the public in the U.S. as an investment adviser

Y Advisers to investment companies and BDCs may not rely on this exemption

Foreign Private Adviser Exemption

Y Who is a client?

Y An adviser may treat as a single client a natural person and:

Y The person's minor children (whether or not they live with the person)

Y Relatives, spouses, spousal equivalents, or their relatives with the same principal residence

Y All accounts of which the natural person or the person's minor child or enumerated relatives who have the same principal residence are the only primary beneficiaries

Y All trusts of which the natural person or the enumerated relatives who have the same principal residence are the only primary beneficiaries

Y An adviser may treat as a single client:

Y Corporations, general partnerships, LLCs, trusts, or other legal organizations to which the adviser provides investment advice based on client's objectives

Y Two or more entities that have identical shareholders, partners, limited partners, members, or beneficiaries

Foreign Private Adviser Exemption

Y Who is a client?

Y Double counting

- Y Don't count a private fund as a client if the adviser counts any investor in that fund as an investor for purposes of determining availability of the exemption
- Y Don't count a person as an investor if the adviser otherwise counts the person as a client of the adviser

Y Private fund investor

- Y Foreign private adviser cannot have more than 14 clients "or investors in the United States in private funds" advised by the adviser
- Y "Investor" defined as any person that would be included in determining the number of beneficial owners of 3(c)(1) or 3(c)(7) fund
 - Y Investor also includes owner of short-term paper issued by the private fund, even though investor is not counted for purposes of 3(c)(1) or 3(c)(7)
 - Y Adviser may count an investor in two or more funds managed by the adviser as a single investor

Foreign Private Adviser Exemption

ÿ Look-throughs

- ÿ May have to look through to ultimate beneficial owners
- ÿ Adviser to master fund must look through to investors of any feeder fund when counting the number of investors
- ÿ Adviser must count holder of a total return swap on the private fund
- ÿ Other situations depend on facts and circumstances
- ÿ Knowledgeable employees excluded from definition of “investor”

ÿ “In the United States”

- ÿ Foreign private adviser exemption uses this term in three contexts:
 - ÿ Limiting number of—and AUM attributable to—adviser’s clients “in the United States” and “investors in the United States in private funds advised by adviser”
 - ÿ Exempting only advisers without a place of business “in the United States”
 - ÿ Exempting advisers that do not hold themselves out as an an adviser “in the United States”

Foreign Private Adviser Exemption

Y Definition generally tracks Regulation S definition of “U.S. Person” and “United States,” but:

Y SEC treats as persons “in the United States” for purposes of the foreign private adviser exemption certain persons that would not be considered U.S. persons under Regulation S

Y For example, discretionary accounts owned by a U.S. person and managed by a non-U.S. affiliate of the adviser will be treated as a person “in the United States”

Y When is a person who is in the U.S. not in the U.S.?

Y A person who is “in the United States” may be treated as not being “in the United States” if the person was not “in the United States” at the time of becoming a client or, in the case of a private fund, *each time* the investor acquires securities issued by the fund

Foreign Private Adviser Exemption

ÿ Place of business

- ÿ Means any office where the 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 these activities
- ÿ Advisers must determine whether they have a place of business in the U.S. “in light of all the relevant facts and circumstances”
 - ÿ An office where the adviser regularly communicates with its clients (whether or not the clients are located in the U.S.) would be a place of business
 - ÿ An office where the adviser regularly conducts research would be a place of business
 - ÿ An office where the adviser solely performs administrative services or back-office activities would not be a place of business

Foreign Private Adviser Exemption

ÿ Subadvisory relationships with advisory affiliates

ÿ SEC reaffirmed its staff's position in the *Unibanco* no action letters and its progeny

ÿ The SEC staff took the position that it would not recommend enforcement action, subject to relatively heavy conditions, against non-U.S. unregistered advisers that are affiliated with SEC-registered advisers, despite sharing personnel and resources