Hunton & Williams
Private Investment Fund Update

December 2010 SEC Implementation of the Dodd-Frank Wall Street Reform Act

SEC Proposes Rules Relating to Investment Adviser Registration Exemptions and Reporting Requirements

On November 19, 2010, the Securities and Exchange Commission ("SEC") proposed new rules under the Investment Advisers Act of 1940, as amended (the "Advisers Act"), as required by Sections 403, 407, 408 and 410 of the "Dodd-Frank Wall Street Reform and Consumer Protection Act" ("Dodd-Frank"). If adopted as proposed, the "Exemptive Release" would define the scope of the registration exemptions available to advisers to venture capital funds, advisers to private funds with less than $150 million in assets under management in the United States, and foreign private advisers. The "Implementation Release" would require reporting by certain "exempt reporting advisers" (including advisers to venture capital funds and private funds with less than $150 million in assets under management in the United States). Further, the Implementation Release would expand the reporting requirements for registered investment advisers on Form ADV. A copy of the SEC's Exemptive Release is available here and a copy of the SEC's Implementation Release is available here.

Background

Sections 403, 407 and 408 of Dodd-Frank eliminated the private adviser exemption from investment adviser registration and added new exemptions for foreign private advisers, advisers to venture capital funds and advisers to private funds with less than $150 million in assets under management in the United States, but left to the SEC responsibility to define the exemptions. The SEC also was directed by Sections 407 and 408 to impose recordkeeping and reporting requirements on advisers to venture capital funds and advisers to private funds with less than $150 million in assets under management in the United States. Section 410 of Dodd-Frank created a new category of "mid-sized" advisers with between $25 million and $100 million in assets under management and shifted primary responsibility for those advisers from the SEC to the states. The proposals would delineate the scope of these exemptions, expand Form ADV reporting requirements and provide rules for the transition from federal to state regulatory authority.

The proposed rules are the first step in the process for implementing the related Dodd-Frank requirements and, following a comment period, the SEC will adopt final rules, which may differ from the proposed rules in significant respects. For additional information on the impact of Dodd-Frank on investment advisers, please see our memorandum Dodd-Frank Act Impacts Private Fund Advisers.

The SEC is expected to propose additional rules in the future regarding recordkeeping requirements required by Dodd-Frank.

Exemption for Advisers to Venture Capital Funds

Under Section 203(l) of the Advisers Act, which was added by Dodd-Frank, an adviser may qualify for the venture capital fund adviser exemption if it advises solely "venture capital funds" — without regard to the number or size of such funds. Advisers that qualify for this exemption would be considered "exempt reporting advisers" and will be required to file reports with the SEC as described in more detail below.

To be considered a "venture capital fund," a fund must satisfy all of the following key elements:

1. ***Representation as a Venture Capital Fund***: The fund must hold itself out to investors and potential

investors as a venture capital fund.

2. ***Limitation on Fund Investments***: The fund may own only:

- equity securities issued by one or more "qualifying portfolio companies," and at least 80 percent of the equity securities of each qualifying portfolio company owned by the fund must have been acquired directly from the qualifying portfolio company; and
- cash and cash equivalents and U.S. Treasuries with a remaining maturity of 60 days or less.

A "qualifying portfolio company" is any company that:

- is not publicly traded (but this condition would not prevent a venture capital fund from continuing to hold its stake in a portfolio company that goes public after the venture capital fund makes its investment);
- does not borrow or issue debt obligations in connection with the private fund's investment;
- does not redeem, exchange or repurchase any of its securities, or distribute to preexisting security holders cash or other assets, directly or indirectly, in connection with the private fund's investment; and
- is not an investment company, a private fund or an issuer that would be an investment company but for the exemption in Rule 3a-7 of the Investment Company Act of 1940 ("Investment Company Act"), or a commodity pool.

A qualifying portfolio company need not be in the United States. The proposal prohibits venture capital funds from investing in other private funds or pooled investment vehicles (such as a venture capital fund of funds).

The restriction on redemptions and repurchases from existing shareholders reflects the SEC's view that venture capital funds provide growth capital used to operate and grow a business, rather than to buy out existing shareholders as with many private equity or buyout funds. While the 80 percent limitation permits the fund to acquire up to 20 percent of the qualifying portfolio company's securities directly from existing investors, the proposals appear to prohibit an indirect takeout through an investment in the company and redemption of the company's securities.

3. ***Management Involvement***: The fund or the adviser either must offer to provide significant managerial assistance to, or must control, the portfolio company. Managerial assistance would require active involvement in the business, operations or management of the portfolio company or less active forms of control such as through board representation or voting rights. The proposal does not require the managerial assistance to have a fixed character. The proposal does not specify what constitutes "control" but the SEC notes in the proposing release that Form ADV's instructions include a presumption of control if a person has the power to vote 25 percent or more of the voting securities or a person acts as a manager of a limited liability company.

4. ***Limitation on Leverage***: Both the fund and the portfolio companies must satisfy separate leverage limitations. First, venture capital funds may not incur leverage in excess of 15 percent of the private fund's aggregate capital contributions and uncalled committed capital, and any such leverage must be for a non-renewable term of no longer than 120 calendar days. Second, as described above, qualifying portfolio companies may not borrow in connection with the private fund's investment.

The fund borrowing restrictions are intended to provide some flexibility for short-term borrowing and, because the restrictions are determined on an aggregated committed capital basis, would permit short-term financing of 100 percent of a particular transaction or capital call as long as it was less than 15 percent of the fund's committed capital and was outstanding for less than 120 days. The portfolio company borrowing restrictions are intended to prevent any financing or loan to a portfolio company that was provided by, or was a condition of the contractual obligation with, the fund or its adviser as part of the fund's investment, but are not intended to prevent portfolio companies from borrowing in the ordinary course of their business.

5. ***No Redemption Rights***: The private fund may only issue securities that do not provide a holder with any right, except in "extraordinary" circumstances, to withdraw, redeem or require the repurchase of such securities. The restriction on redemption rights is intended to distinguish venture capital funds from hedge funds. The SEC recognized that many fund partnership agreements provide for withdrawal or exclusion rights for certain investors (such as ERISA or governmental plan investors) based on tax or regulatory developments or changes in certain laws, but stopped short of stating that such rights would satisfy the "extraordinary" requirements.

6. ***Private Fund Requirement***: Venture capital funds must qualify as "private funds" as defined in new Section 202(a)(29) under the Advisers Act. A private fund is any fund excluded from the Investment Company Act under Section 3(c)(1) or Section 3(c)(7). As a result, registered investment companies and entities relying on other exclusions from investment company status do not qualify for the exemption. Further, it should be noted that a non-U.S. fund that does not make an offering in the U.S. under Section 3(c)(1) or 3(c)(7) would not qualify for the venture capital exemption, even if it otherwise met the venture capital exemption criteria.

Grandfathering Provision: The SEC also proposed a grandfathering provision that includes in the venture capital fund exemption any "private fund" that (1) held itself out to investors and potential investors as a venture capital fund, (2) held a closing with third-party investors prior to December 31, 2010 and (3) does not sell any securities after July 21, 2011, regardless of whether such fund meets the other venture capital fund exemption conditions.

The SEC indicated that it crafted a relatively broad grandfathering provision so as to avoid any unintended consequences that may result from existing venture capital funds modifying their investment conditions or liquidating portfolio company holdings to qualify for the exemption. Funds identifying themselves as private equity or hedge funds would not be able to rely on the grandfather provision.

Exemption for Advisers to Private Funds with Less than $150 Million in AUM in the United States

Under Section 203(m) of the Advisers Act, which was added by Dodd-Frank, an adviser could qualify for an exemption from the Advisers Act registration requirements if it advises only private funds and has assets under management in the United States of less than $150 million. The SEC proposes to apply different standards for this private fund adviser exemption for U.S. advisers and non-U.S. advisers. The narrow scope of the foreign private adviser exemption discussed below may be somewhat mitigated by the more flexible approach provided to non-U.S. advisers in the private fund adviser exemption. As with venture capital fund advisers, these private fund advisers will be "exempt reporting advisers" and will be required to file reports with the SEC as described in more detail below.

U.S. Advisers: An adviser with its "principal office and place of business" in the U.S. would qualify for the private fund adviser exemption if it:

- acts solely as an adviser to one or more "qualifying private funds"; and
- manages "private fund assets" of less than $150 million.

For a U.S. adviser, in order to qualify for the private fund adviser exemption, all of the adviser's clients must be private funds. In addition, all of a U.S. adviser's assets under management will be counted, even if managed by an office outside of the U.S.

Non-U.S. Advisers: An adviser with its "principal office and place of business" outside the U.S. would qualify for the private fund adviser exemption if it:

- has no client that is a "United States person" except for one or more "qualifying private funds"; and
- all assets managed by the adviser from a "place of business" in the U.S. are solely attributable to "private fund assets," the total value of which is less than $150 million.

For a non-U.S. adviser, only the U.S. clients must be qualifying private funds. The exemption does not take into account the business activities outside the U.S. and thus the type and number of its non-U.S. clients are not relevant for purposes of the exemption. In addition, for non-U.S. advisers, only the private fund assets managed from a place of business in the U.S. are counted toward the $150 million limit. Thus, the key determination for non-U.S. advisers in applying the private fund adviser exemption will be

to confirm they do not have a "principal office and place of business" in the U.S.

For purposes of this exemption, the SEC has proposed a number of new definitions.

- "***Assets under management***" (discussed in more detail below) means the "regulatory assets under management" and would include assets appearing on the private fund's balance sheet (based on fair value) as well as uncalled capital commitments and would not deduct liabilities such as accrued fees and expenses and the amount of any borrowing. As a result, significant appreciation in an investment held by a fund could take that fund's adviser outside the scope of this exemption, requiring registration.
- "***Principal office and place of business***" means the executive office of the adviser from which the officers, partners or managers of the adviser direct, control and coordinate the activities of the adviser.
- "***Private fund assets***" means the adviser's assets under management attributable to a qualifying private fund. The proposals further require that calculations of the amount of private fund assets be made as of the end of each calendar quarter. Since many private fund partnership agreements specify the timing and methodology for particular calculations for purposes of management fees or otherwise, this may require an additional set of calculations to be made.
- "***Qualifying private fund***" means any private fund that is not registered under the Investment Company Act and has not elected to be treated as a business development company. In contrast to the venture capital fund exemption, a qualifying private fund is not limited to investing in operating companies and may include a fund of funds.
- "***United States person***" means any "U.S. person" as defined in Rule 902(k) of Regulation S, except that any discretionary account or similar account that is held for the benefit of a United States person by a dealer or other professional fiduciary is a United States person if the dealer or professional fiduciary is a related person of the adviser relying on this section and is not organized, incorporated, or if an individual resident in the United States. Regulation S generally looks to the residence of an individual, the jurisdiction of incorporation for partnerships and corporations and the residence of the trustee for trusts. The proposed rule contains this special rule for discretionary accounts out of concern that non-U.S. discretionary accounts maintained by an offshore affiliate of an adviser could disguise what otherwise would be a U.S. client or investor.

Transition Rule: The SEC proposes to afford an adviser one calendar quarter to register with the SEC after becoming ineligible to qualify for the exemption as of a particular quarter end. The transition period would be available only to an adviser that has complied with the applicable proposed exempt adviser reporting requirements described below.

Exemption for Foreign Private Advisers

Section 403 of Dodd-Frank eliminated the private adviser exemption for advisers with fewer than 15 clients and added a new "foreign private adviser" exemption for any foreign private adviser that:

- has no place of business in the United States;
- has in total fewer than 15 clients and investors in the U.S. in private funds advised by the adviser;
- 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 (or such higher amount as the SEC may prescribe); and
- does not hold itself out generally to the public in the U.S. as an investment adviser or act as an adviser to a registered investment company.

Although there was some hope that the $25 million limitation would be increased, the SEC did not alter this limitation in their proposals. Instead, the SEC proposals made clear that non-U.S. advisers that do not meet the $25 million limitation but have less than $150 million in assets under management could look to the private fund adviser exemption described above. However, private fund advisers (but not foreign private advisers) will be exempt reporting advisers subject to Advisers Act recordkeeping and SEC examination, in addition to the reporting described below.

The SEC proposes to include many of the existing safe harbor and client counting rules currently applied in the context of the private adviser exemption (eliminated by Dodd-Frank) in the context of counting clients for purposes of the foreign private adviser exemption, with a notable difference. The foreign private adviser exemption will require the counting of clients for which no compensation is received.

As required by Dodd-Frank, the foreign private adviser exemption requires the counting of "investors" in a private fund. The SEC proposes to count investors in a fund in the same manner it counts beneficial owners of outstanding securities of a Section 3(c)(1) fund, or determines whether the outstanding securities of a private fund are owned exclusively by "qualified purchasers" of a Section 3(c)(7) fund. However, unlike the existing beneficial ownership rules, the foreign private adviser exemption count includes both "knowledgeable employees" and holders of short-term paper issued by the private fund.

The adviser does not need to double-count both the fund (as a client) and the investors in the fund. The adviser in a master feeder arrangement must look through the feeder fund and treat as investors the holders of securities in any feeder fund formed or operated for the purpose of investing in the master. Any investor that is an investor in two or more funds may be counted only once. In addition, a fund must count as investors any holder of instruments (such as total return swaps) that transfer the risk of ownership.

For purposes of the exemption, private funds will not need to continually monitor the location of their clients. Instead, the proposals provide that a person will be determined to be "in the United States" at the time of becoming a client or at the time the investor acquires securities issued by the fund.

In addition, an adviser will have a "place of business" in the U.S. if it has an 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 any such activities.

Calculation of AUM

The SEC is proposing to amend the instructions to Form ADV to provide a uniform method for calculating "assets under management" for purposes of determining eligibility for SEC registration and determining the availability of the private fund adviser and foreign private adviser exemptions. This calculation methodology uses a new definition for "regulatory assets under management" in the Form ADV instructions and will require the following:

- Advisers must include securities portfolios for which they provide continuous and regular supervisory or management services, regardless of whether these assets are proprietary assets, assets managed without receiving compensation or assets of foreign clients (all of which may be excluded under the current calculation instructions).
- Advisers may not subtract accrued fees, expenses or the amount of borrowing.
- Advisers must include the value of any private fund over which it exercises continuous and regular supervisory or management services, regardless of the nature of the assets held by the fund. This valuation must include the amount of any uncalled capital commitments to the fund and will require advisers to use the fair value (rather than the cost basis) of the fund's assets. The SEC is not requiring a specific fair value methodology under U.S. GAAP or international accounting standards and advisers may use a specific process for calculating fair value required by the fund's governing documents.

Reporting Requirements For Exempt Reporting Advisers

The SEC refers to venture capital fund advisers and private fund advisers as "exempt reporting advisers." Dodd-Frank codified the new exemptions for the exempt reporting advisers in Sections 203(l) and 203(m) of the Advisers Act — rather than in Section 203(b) where the private adviser exemption had been located and the new foreign private adviser exemption is now located. This technicality is significant — it means that exempt reporting advisers will be subject to the SEC's examination authority under Section 204(a) of the Advisers Act, while foreign private advisers will not. These exempt reporting advisers will be using the same reporting form as registered investment advisers (Form ADV — although they will be required to complete only a subset of its required items), will be required to submit much of the same information, will be subject to (as yet undetermined) recordkeeping requirements and most importantly will be subject to the SEC's exam authority. The SEC proposals for exempt reporting advisers impose a significant regulatory burden on these advisers that some may argue

is nearly indistinguishable from the burden imposed on registered investment advisers.

The key elements of the reporting requirements for exempt reporting advisers that are similar to those for registered investment advisers include:

- Form ADV will be considered filed upon acceptance by the IARD system.
- FINRA, which operates the IARD system, will charge a filing fee, likely based on assets under management.
- Form ADVs for exempt reporting advisers will be publicly available.
- Form ADV will permit exempt reporting advisers to satisfy both state and SEC filing requirements with a single filing.
- An exempt reporting adviser can transition to a registered investment adviser by filing an amendment to Form ADV.
- Form ADV will require each exempt reporting adviser to specify which exemption it is relying on to report, rather than register.
- Exempt reporting advisers will be required to complete a number of Form ADV items, such as name, address, contact information, form of organization and ownership of the adviser, conflicts, disciplinary history of the adviser and its employees, and new proposals for "census" type information regarding private funds they manage.
- Exempt reporting advisers will be required to update and amend their Form ADVs on the same timetable as registered investment advisers (at least annually, within 90 days of the fiscal year-end or more frequently as required by the Form ADV instructions).

Unlike registered investment advisers, exempt reporting advisers will not be required to complete Part 2 — the client brochure — and certain other portions of Part 1 of Form ADV.

Timing: The SEC proposes that exempt reporting advisers file their first Form ADV no later than August 20, 2011 (30 days after the July 21, 2011 effective date of Dodd-Frank), but this deadline may be extended if the new programming for the IARD system to accept the revised form is not ready.

Additional Form ADV Amendments

The SEC is proposing additional amendments to Part 1 of Form ADV to apply to registered investment advisers (and for certain items to apply to exempt reporting advisers) to provide it with additional information regarding investment adviser operations. This information, together with the additional information required as a result of the SEC's recent amendments to Part 2 of Form ADV, will result in the disclosure of significantly more information. The proposed disclosure includes:

- ***Private Fund Reporting***: Advisers (and exempt reporting advisers) will be required to provide information for any "private fund" that the adviser (and not a related person) advises. Affiliates will be expected to separately report information regarding their private funds. An adviser with a principal office and place of business outside the United States could omit any private fund that is not organized in the United States and that is not offered to or owned by United States persons. Expanded information would be required, including basic organizational, operational and investment characteristics of the fund, the amount of assets held by the fund and the nature of the investors in the fund. In addition, information regarding five types of service providers that the SEC regards as "gatekeepers" (auditors, prime brokers, custodians, administrators and marketers) will be required, including their name, location, whether they are related persons and their registration status.
- ***Advisory Business Information***: Each registered investment adviser (but not exempt reporting advisers) will be required to provide refined or clarifying information about its business, including the number of employees, the number of employees that are registered representatives, the amount of assets it manages, the number and types of clients, the percentage of clients that are not U.S. persons, and the types of advisory services.
- ***Financial Industry Affiliations***: Advisers (and exempt reporting advisers) will be required to provide additional and more detailed information regarding those financial services provided by the adviser as well as its related persons.
- ***Participation in Client Transactions***: Advisers (but not exempt reporting advisers) will need to provide information relating to whether the adviser or a related person engages in

transactions with clients as a principal, sells securities to clients or has discretionary authority over client assets.

- ***Reporting $1 Billion in Assets***: Because Section 956 of Dodd-Frank requires the SEC, with certain other federal regulators, to adopt rules addressing incentive-based compensation arrangements for advisers with $1 billion or more in assets, the SEC will require advisers (and exempt reporting advisers) to indicate whether they meet the $1 billion threshold based on the adviser's balance sheet for the most recent year-end. For purposes of this item, the SEC interprets the Dodd-Frank provision to mean the total assets of the advisory firm rather than the total "assets under management."

State/Federal Registration For "Mid-Sized" Advisers With Between $25 Million and $100 Million in AUM

Section 410 of Dodd-Frank amended Section 203A of the Advisers Act and created a new category of "mid-sized" advisers with between $25 million and $100 million in assets under management. Section 203A generally prohibits an adviser from registering with the SEC unless the adviser has at least $25 million in assets under management. Dodd-Frank shifted primary responsibility for the new category of "mid-sized" advisers from the SEC to the states. However, under Dodd-Frank, these mid-sized advisers may still register with the SEC under certain circumstances. In addition, in order to facilitate the transition from federal to state registration, the SEC is proposing a two-step process: The first step will require *all* investment advisers registered as of July 21, 2011 to file an amendment to Form ADV no later than August 20, 2011 (30 days after effectiveness of Dodd-Frank) to report the market value of their "assets under management." The second step will require only those investment advisers that no longer qualify for federal registration to withdraw their federal registration by filing Form ADV-W no later than October 19, 2011 (60 days after effectiveness of Dodd-Frank).

Pay to Play Rule Amendments

The SEC proposes to extend Rule 206(4)-5, the "pay to play" rule adopted in July 2010, to apply to exempt reporting advisers and foreign private advisers. Additional proposed amendments include: (1) permitting an adviser to pay a "regulated municipal advisor" (which is a new category of regulated person created by Dodd-Frank) to solicit government entities on its behalf (rather than a registered broker-dealer subject to FINRA rules) and (2) clarifying that "covered associates" of an investment adviser include entities as well as natural persons.

Timetable

The SEC currently plans to finalize and adopt final rules in the second quarter of 2011. The SEC's deadline for submitting comments on the proposals is January 24, 2011.

The SEC requested comments on a number of aspects of the proposals and it is possible that the final rules may differ in material respects from the proposals.

Additional Information

The Hunton & Williams Private Investment Fund practice group regularly represents funds, sponsors and a variety of investors in all types of private investment fund matters, including structuring, formation, offerings and compliance. We will continue to monitor the progress of the SEC's rulemaking to implement Dodd-Frank's requirements relating to investment advisers as well as relevant trends in private investment fund regulation. We are available to assist in evaluating these issues, preparing to address the new rules and drafting proposed comments to the SEC regarding the proposals.

For additional information on financial industry recovery proposals, see our related memoranda, available on www.huntonfinancialindustryrecovery.com. For additional information on recent legislation and regulations relating to regulation of private investment funds and their advisers, see our prior memoranda available on our website at www.hunton.com.

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