Private Equity Advisory

From the Buchanan Ingersoll & Rooney Private Equity Group

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July 2011

SEC Adopts Dodd-Frank Act Investment Adviser Rules

On June 22, 2011, the Securities and Exchange Commission (the "SEC") adopted new rules which require managers of hedge and private equity funds with $150 million or more in assets under management to register with the SEC by March 30, 2012, impose reporting obligations on certain private fund advisers that are exempt from SEC registration and require most investment advisers with less than $90 million in assets under management currently registered with the SEC to switch to state registration by June 28, 2012.

The new rules implement the investment adviser registration, exemption from registration and reporting provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").

Advisers to hedge funds, private equity funds, venture capital funds and other private investment funds need to be aware of these new rules to determine how the new registration and reporting requirements apply to them.

New Private Fund Adviser Registration Requirements

Many advisers to hedge funds, private equity funds and venture capital funds now rely upon the "private adviser exemption" in Section 203(b)(3) of the Investment Advisers Act of 1940 (the "Advisers Act") to avoid registration under the Advisers Act. Title IV of the Dodd-Frank Act repealed this exemption and created three new exemptions for (1) advisers solely to venture funds, (2) advisers solely to private funds with less than $150 million in assets under management in the United States and (3) certain foreign advisers without a place of business in the United States. These provisions of the Dodd-Frank Act will become effective on July 21, 2011.

Private fund advisers that will now be required to register with the SEC under the Advisers Act may delay registering with the SEC until March 30, 2012. Because of the time required to approve a registration application, the SEC's adopting release recommends filing a completed application on Form ADV by no later than February 14, 2012.

New Exemptions from Registration

Venture Capital Fund Advisers

Section 203(l) of the Advisers Act provides a registration exemption for advisers solely to one or more venture capital funds. New Rule 203(l)-1 provides a definition of "venture capital fund" to give effect to this exemption.

Existing venture capital funds may qualify for the exemption based upon a "grandfathering" provision contained in new Rule 203(l)-1(b). To qualify for this exemption, an existing fund must:

- Have sold securities prior to December 31, 2010 to investors who are not related persons.
- Have represented that it pursues a venture capital strategy at the time it offered its securities.

- Not sell securities to any person after July 21, 2011. While new capital commitments may not be accepted after that date, capital may be called after July 21, 2011 on commitments made before that date.

A venture capital fund not qualifying for this "grandfathering" provision will need to satisfy the definition of venture capital fund in new Rule 203(l)-1(a). Under this definition, a venture capital fund is a private fund that:

- Represents to investors and potential investors that it pursues a venture capital strategy.
- Immediately after the acquisition of an asset, other than qualifying investments (defined below), holds no more than 20% of the fund's aggregate capital commitments in assets that are not qualifying investments. Investments in cash, cash equivalents, U.S. Treasuries with a remaining maturity of 60 days or less and shares of registered money market funds are not taken into consideration for this purpose.
- Doesn't borrow, issue debt obligations, provide guarantees or otherwise incur leverage in excess of 15% of the fund's aggregate capital commitments and any borrowing, debt, guaranty or leverage within such limit is for a non-renewable term of no more than 120 days (guarantees of a qualifying portfolio company's obligations up to the value of a fund's investment in the portfolio company is not subject to this 120 day limit).
- Does not provide its investors with the right, except in extraordinary circumstances, to withdraw, redeem or require the repurchase of such investors' securities, but may entitle holders to receive pro rata distributions.
- Is not registered under Section 8 of the Investment Company Act of 1940 and has not elected to be treated as a business development company under Section 54 of the Investment Company Act of 1940.

"Qualifying investments" are (1) equity securities of a qualifying portfolio company acquired by the fund directly from the qualifying portfolio company (including equity securities issued by the qualifying portfolio company in exchange for such equity securities) and (2) equity securities issued by a company of which the qualifying portfolio is a majority owned subsidiary or a predecessor and acquired by the fund in exchange for an equity security of the qualifying portfolio company the fund acquired directly from the qualifying portfolio company.

A "qualifying portfolio company" is a company that (1) at the time of investment by the fund, is not subject to the reporting requirements under Section 13 or 15(d) of the Securities Exchange Act of 1934, does not have a security listed or traded on any exchange or market operating in a foreign jurisdiction and does not have a control relationship with a company that is such an Exchange Act reporting company or such a foreign traded company, (2) does not borrow or issue debt obligations in connection with the fund's investment and distribute the proceeds of such borrowing or debt to the fund in exchange for such investment and (3) is not a private fund, a commodity pool, or other investment company.

Private Fund Advisers with Less than $150 Million in Assets under Management

Section 203(m) of the Advisers Act requires the SEC to exempt from Adviser Act registration any investment adviser solely to private funds that has less than $150 million in assets under management in the United States. New Rule 203(m)-1 implements this registration exemption. The rule applies differently to U.S. and non-U.S. advisers.

To qualify for this exemption, an adviser with a principal office and place of business in the United States must act solely as an investment adviser to private funds and must manage private fund assets of less than $150 million. In the release adopting new Rule 203(m)-1, the SEC warned that it may view two or more separately formed advisory entities, each with less than $150 million in assets under management, as a single adviser for purposes of determining whether this exemption from registration is available.

An adviser with a principal office and place of business outside of the United States will qualify for this exemption if all of its clients that are United States persons are private funds, the assets it manages at a place of business in the United States are solely those of private funds, and the total value of those assets is less than $150 million. The nature of such a foreign adviser's foreign clients and the amount of assets it manages outside of the United States will not affect the availability of the registration exemption, as long as the foreign adviser does not manage any non-private fund assets at a place of business in the United States.

Foreign Private Advisers

Section 203(m) of the Advisers Act requires the SEC to exempt from Adviser Act registration any investment

Section 203(b)(3) of the Advisers Act provides a registration exemption for foreign private advisers, as defined in Section 202(a)(30) of the Advisers Act. Under Section 202(a)(30), a foreign private adviser is any investment adviser that:

- Has no place of business in the United States.
- Has fewer than 15 clients in the United States, including investors in the United States in private funds it advises.
- Has aggregate assets under management attributable to clients in the United States and investors in the United States in private funds it advises of less than $25 million.
- Does not hold itself out generally to the public in the United States as an investment adviser.

New Rule 202(a)(30)-1 defines the terms relevant to this exemption, and includes a safe harbor for determining the number of clients of a foreign private adviser that is similar to the safe harbor previously provided by rescinded Rule 203(b)(3)-1.

Exempt Private Fund Adviser Reporting

Advisers to private funds which do not register with the SEC under the Advisers Act because of the exemption provided by Section 203(m) of the Advisers Act for advisers to private funds with less than $150 million in assets under management or the exemption provided by Section 203(l) of the Advisers Act for advisers to venture capital funds will be required to file reports with the SEC electronically on Form ADV using the same process used by registered investment advisers. The SEC has revised Form ADV for this purpose, which will require such exempt advisers to provide information about their ownership, other business activities in which they or their affiliates are engaged, and their disciplinary history and the disciplinary history of their clients. Information must also be provided about each private fund they advise, including its size, organization, operational, and investment characteristics, and its auditors, prime brokers, custodians, administrators, and marketers. Once filed, this information will be publicly available.

The new Form ADV must be filed by these exempt private fund advisers between January 1, 2012 and March 30, 2012. Amendments and updates to the Form ADV must be made in the same manner as required of registered investment advisers.

Transition of Mid-Sized Advisers to State Registration

Section 203A(a)(2) of the Advisers Act creates a new category of "mid-sized advisers" with assets under management between $25 million and $100 million and shifts the primary responsibility for their oversight from the SEC to the state securities administrators. With limited exceptions, a mid-sized adviser can no longer register with the SEC and existing SEC registered mid-sized advisers will need to register with their state securities administrators. The following mid-sized advisers are not subject to this required transition to state registration:

- An adviser not required to be registered as an investment adviser with the securities administrator of the state in which it maintains its principal office and place of business or not subject to examination by that securities administrator if so registered. The SEC's adopting release indicates that, based on responses it received from state securities administrators, only Minnesota, New York, and Wyoming do not subject investment advisers to examination. As a result, mid-sized advisers having their principal office in those states will need to be registered with the SEC.
- An adviser to a investment company registered under the Investment Company Act of 1940.
- An adviser to a business development company registered under Section 54 of the Investment Company Act of 1940.
- An adviser who would be required to register with the state securities administrators of 15 or more states.

The rules provide some flexibility for mid-sized advisers with assets under management close to $100 million in determining whether to register with the SEC. Rule 203A-1(a)(1) establishes a $110 million threshold for required registration with the SEC. Once registered with the SEC, an adviser can remain registered until it has assets under management of less than $90 million. These eligibility determinations are made based on the assets under management reflected in an adviser's annual updating amendment to its Form ADV.

A mid-sized adviser which is registered with the SEC on July 21, 2011 must remain registered with the SEC until January 1, 2012, unless an exemption from registration is available. A mid-sized adviser that is registered with the SEC on January 1, 2012 must file an amendment to its Form ADV no later than March 30, 2012. If that amendment indicates that it is no longer eligible for SEC registration, it must file a Form ADV-W to withdraw from SEC registration by June 28, 2012.

A mid-sized adviser registering for the first time may register with either the SEC or the state securities administrator before July 21, 2011. After that date, it must register with the state, unless the adviser is not required to be registered as an investment adviser with the securities administrator of the state in which it maintains its principal office and place of business or unless the adviser would not be subject to examination by that securities administrator if so registered.

Pension Consultants

Pension consultants, which typically do not have assets under management, advising a minimum level of plan assets will still be required to register with the SEC, but amended Rule 203A-2(a) increases the minimum level of such plan assets from $50 million to $200 million. As a result, pension consultants currently registered with the SEC advising plan assets of less than $200 million will be required to withdraw from SEC registration.

Family Offices

The Dodd-Frank Act revised the definition of "investment adviser" in Section 202(a)(11) of the Advisers Act to exclude "family offices," as defined by the SEC. New Rule 202(a)(11)(G)-1 implements this exclusion by providing a definition of family office. Under new Rule 202(a)(11)(G)-1 a family office is a company that:

- Has no clients other than family clients (defined below).
- Is wholly owned by family clients and is exclusively controlled (directly or indirectly) by one or more family members and/or family entities.
- Does not hold itself out to the public as an investment adviser.

Family clients include all lineal descendants of a common ancestor no more than 10 generations removed from the youngest generation, key employees, non-profit and charitable organizations funded exclusively by family clients, estates of family members, key employees, certain former key employees, certain family trusts, and companies wholly owned and operated for the sole benefit of family clients.

Calculation of Assets Under Management

Form ADV has been revised to provide for a uniform method for advisers to calculate assets under management. Under the revisions, advisers must include securities portfolios for which they provide continuous and regular supervisory or management services, including family or proprietary assets, assets managed without compensation and assets of foreign clients.

Assets under management must be calculated on a gross basis, without deduction of indebtedness or other accrued but unpaid liabilities.

Advisers to private funds must include the value of the private fund, regardless of the nature of the assets held by the fund and must include the amount of any uncalled capital commitments. Private fund assets are to be valued at market value or, if market value is not available, fair value.

New Form ADV Disclosures

The revised Form ADV requires information about the private funds advised by an adviser, additional information about an adviser's business, and additional information about an adviser's non-advisory activities and financial industry affiliations.

An adviser will be required to provide information about the size and organizational, operational, and investment characteristics of each private fund it advises, and information about auditors, prime brokers, custodians, administrators, and marketers. This requirement applies to both registered and exempt reporting advisers.

Registered advisers must provide information about the number of their employees, the number of their employees that are registered as investment adviser representatives or are licensed insurance agents, the amount of assets they manage, and the number and types of their clients.

Registered and exempt reporting advisers will need to provide information about the financial services the adviser or related persons provide and information about the related persons and their relationship with the adviser.

Revised Form ADV requires registered advisers to report information on transactions with clients, including whether the adviser or related persons engage in transactions with clients as a principal, otherwise sell securities to clients, or have discretionary authority over client assets. Information is required on an adviser's relationship with broker or dealers recommended to clients or that the adviser uses under its discretionary authority. An adviser that receives soft dollar benefits must report whether it qualifies for the safe harbor under Section 28(e) of the Securities Exchange Act of 1934. An adviser must also report whether it or a related person receives direct or indirect compensation for client referrals.

Each registered adviser must indicate the identity of persons that act as qualified custodians.

Finally, each adviser must indicate whether it has $1 billion or more in total assets on its balance sheet as of the last day of its most recent fiscal year.

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