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Overview of Proposed Rules to Implement "Foreign Private Adviser" and "Private Fund Adviser" Exemptions

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On November 19, 2010, the Securities and Exchange Commission (SEC) proposed new rules under the Investment Advisers Act of 1940, as amended (Advisers Act), to implement various provisions of Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), the Private Fund Investment Advisers Registration Act of 2010 (Advisers Registration Act).[1] The Advisers Registration Act changes take effect on July 21, 2011. The proposed rules, if adopted in their current form, will have far-reaching implications for registered as well as unregistered investment advisers, both in the United States and abroad. The comment period closed on January 24, 2011, with significant comments both supporting parts of the proposed

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rules and recommending changes. The SEC has indicated a desire to adopt the final rules before the July 21, 2011 date that the amendments are to take effect.[2]

This article describes how the proposed rules would define certain terms and requirements related to the Advisers Registration Act's exemptions for foreign private advisers (Foreign Private Adviser Exemption) and "private fund"[3] advisers with less than $150 million in regulatory assets under management (AUM)[4] in the United States (Private Fund Adviser Exemption) and discusses commenters' reactions to the proposals, which may shape the final rules.

Foreign Private Adviser Exemption

The Advisers Registration Act defines a "foreign private adviser" as any investment adviser that:

> (i) Has no place of business in the United States;
>
> (ii) Has, in total, fewer than 15 clients and investors in private funds;
>
> (iii) Has aggregate AUM of less than $25 million attributable to such US clients and investors; and
>
> (iv) Neither holds itself out generally to the public in the United States as an investment adviser, nor advises US registered investment companies or business development companies.[5]

The SEC has proposed Rule 202(a)(30)-1 (Foreign Private Adviser Rule) to define certain key terms for the purposes of the Foreign Private Adviser Exemption.

Definition of "Investor"

Under the Foreign Private Adviser Rule, advisers would generally determine who is a private fund investor for purposes of the fewer than 15 requirement consistently with the manner that they determine whether that person:

> (i) Is included in the 100 person cap for purposes of Section 3(c)(1) of the Investment Company Act; or
>
> (ii) Must be a "qualified purchaser" for purposes Section 3(c)(7) of the Investment Company Act.

However, unlike under the Investment Company Act counting regime, the Foreign Private Adviser Rule would not allow advisers to exclude "knowledgeable employees" (as defined in Investment Company Act Rule 3c-5) or holders of short term paper.[6] Additionally, the Exemptions Release sets forth circumstances where an adviser would "look-through" certain arrangements to count:

> (i) Each beneficial owner of an investor that is a nominee account;
>
> (ii) Each investor in a feeder fund, if the feeder fund is formed or operated for the purpose of investing in the master fund; and
>
> (iii) Each holder of an instrument (such as a total return swap or other structured product) that effectively transfers the risk of investing in the private fund to the holder.[7]

To avoid double counting, the Private Fund Adviser Rule would treat as a single investor any person who is an investor in two or more private funds advised by the adviser and would not count a fund as a client if any investor in the fund is counted as an investor.

Definition of "Clients"

The Foreign Private Adviser Rule, as proposed, includes a safe harbor for counting clients that would be similar to, but narrower than, the safe harbor currently afforded by Advisers Act Rule 203(b)(3)-1 in that the Advisers Registration Act requires that US investors in private funds be counted and that the proposed rule would also require that persons who do not compensate the adviser be counted. In particular, an adviser would treat as a single client a natural person and:

> (i) That person's minor children;

(ii) Any relative, spouse, or relative of the spouse of the person who has the same principal residence;

(iii) All accounts of which the person and/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 and/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.

Similarly, an adviser would treat as a single client:

(i) 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

(ii) Two or more legal organizations that have identical shareholders, partners, limited partners, members or beneficiaries.

Definition of "in the United States"

The term "in the United States" is relevant to all parts of the Foreign Private Adviser Exemption. First, the asset and client/investor thresholds relate to assets and persons "in the United States." Second, a foreign private adviser may not have a place of business "in the United States." As to the former, the Foreign Private Adviser Rule would define "in the United States" in a manner similar to Regulation S under the Securities Act of 1933, as amended (Regulation S), except that any discretionary account that is held for the benefit of a US person by a non-US affiliate of the adviser would be deemed to be "in the United States." Further, a note to the Foreign Private Adviser Rule would clarify that a person that is "in the United States" under the Regulation S definition may be treated as not being "in the United States" if such person was not "in the United States" at the time of becoming a client or "acquir[ing] the securities issued by the fund."[8]

Availability of the Foreign Private Adviser Exemption Rule

Because foreign private advisers are subject to fewer regulatory requirements than advisers relying on the other new exemptions, the Foreign Private Adviser Exemption is likely to be viewed as the most attractive of the three new exemptions.[9] However, as proposed, the Foreign Private Adviser Exemption is so narrow that it would likely be unavailable to most foreign advisers who accept clients or investors in the United States.

The limit on assets attributable to clients and/or investors in the United States presents particular difficulty as the description of the $25 million limit in the proposed rules would not distinguish between such clients' or investors' initial commitment of capital to the adviser's management and subsequent increases to such capital resulting from an adviser's successful asset management. This may force a foreign private adviser to choose between registering with the SEC and terminating a client relationship or expelling an investor when it appears that the asset threshold is in danger of being breached. It is likely, therefore, that the Foreign Private Adviser Exemption will be of most use not to advisers that seek US business but, instead, to advisers who service US persons only as an accommodation. Noting that Congress provided the SEC the option to increase the $25 million AUM threshold to "such higher amount as the [SEC] may, by rule, deem appropriate in accordance with the purposes of the [Advisers Act]," a number of commenters suggested liberalizing the exemption so that it may be of greater use.

Private Fund Adviser Exemption

The Private Fund Adviser Exemption is proposed to implement the mandate, in the Advisers Registration Act, to provide an exemption from registration for any adviser who "acts solely as an investment adviser to private funds and has assets under management in the United States of less than $150 [million]." As

proposed, the Private Fund Adviser Exemption would be implemented differently for US advisers and non-US advisers (that is, advisers whose principal office and place of business is not in the United States). In particular, a US adviser would need to consider all of its accounts when determining both whether the adviser remains below the Regulatory AUM limit and whether the adviser manages solely "qualifying private funds."[10] By contrast, non-US advisers would consider only accounts managed from within the United States or for a US person for these purposes (thus allowing a non-US adviser to continue to service any type of non-US client and at any asset levels, from outside of the United States).[11]

Non-US (as well as US) advisers relying on the Private Fund Adviser Exemption would be required to file certain information with the SEC and would remain subject to limited substantive requirements under the Advisers Act as well as SEC examination authority. In this regard, the SEC's treatment of non-US advisers is not surprising, given the existing "Regulation Lite" approach, under which a non-US adviser to offshore funds has been able to avoid many of the substantive provisions of the Advisers Act but has been required to register with the SEC as an investment adviser.[12] However, in contrast to Regulation Lite, under the proposed rule a non-US adviser could rely on the Private Fund Adviser Exemption while managing any number of US domiciled qualifying private funds together with any number and kind of clients that are not US persons, provided that:

> (i) Without regard to where management activities take place, every client that is a US person is a qualifying private fund; and
>
> (ii) With respect to assets managed from within the United States: (a) all such assets are attributable to qualifying private funds and (b) the total value of such assets does not exceed $150 million.

As a result, this exemption may be available to non-US advisers who do not service US clients other than private funds, but are unable to meet the more restrictive Foreign Private Adviser Exemption because, for example, the adviser's funds have significant numbers of, or assets attributable to, investors in the United States.

Participating Affiliates

Prior to the publication of the Exemptions Release, a few within the industry expressed concern that prior Staff guidance allowing a registered adviser to share resources with unregistered affiliates (the so-called "Participating Affiliates Letters")[13] might not be available following the implementation of the Dodd-Frank Act. Although the SEC did not take a clear stance on how it intends to treat participating affiliates for registration purposes, the Exemptions Release did solicit comments on these arrangements and commenters have suggested an orthodox view that this prior guidance should remain available and have requested that, consistent with the Participating Affiliates Letters, each entity within a global asset management group continue to be able to determine separately its own registration obligations.

Conclusion

The public comment period for the proposed rules ended on January 24, 2011, and the SEC is currently in the process of finalizing the rules. Even if the SEC is able to adopt final rules on the early end of their anticipated timeline, advisers should expect that careful review and consideration on an accelerated schedule will be necessary to make decisions about the availability of these exemptions, the necessity of registration or a filing in connection with reliance on the Private Fund Adviser Exemption or, for non-US advisers, a restructuring of the business.

Notes

1. The proposed rules were presented in two separate releases: *Rules Implementing Amendments to the Investment Advisers Act of 1940*, Release No. IA-3110 (Nov. 19, 2010) (Implementing Release), available at *www.sec.gov/rules/proposed/2010/ia-3110.pdf*, and *Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less*

Than $150 Million in Assets Under Management, and Foreign Private Advisers, Release No. IA-3111 (Nov. 19, 2010) (Exemptions Release), available at *www.sec.gov/rules/proposed/2010/ia-3111.pdf*.

2. The SEC's website (*www.sec.gov*) includes a schedule of past and planned actions to implement required elements of the Dodd-Frank Act. As of the date of this column, that schedule indicates that the SEC plans to adopt final rules between April and July of 2011. Given that each adviser will need to carefully consider the implications of the rules that are ultimately adopted against its own business circumstances in order to determine its status, and how to register or take steps to comply with an exemption, it can be hoped that the SEC will seek to adopt these rules during the early portion of the second quarter.

3. The Advisers Registration Act defines the term "private fund" as an issuer that would be an investment company for purposes of the Investment Company Act of 1940 (the Investment Company Act) but for Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act, which captures most investment funds sold through private placements in the United States, including foreign retail funds sold in the United States on a private placement basis. However, the definition leaves some uncertainty as to other types of pools.

4. Given the increased importance of an adviser's AUM for various regulatory purposes under the Advisers Registration Act, the SEC has proposed a uniform method of calculating "Regulatory AUM" through proposed revisions to Form ADV. The instructions to the Proposed Amended Form ADV would require advisers to calculate their Regulatory AUM based on the securities portfolios for which they provide continuous and regular supervisory or management services, inclusive of proprietary, affiliate and knowledgeable employee assets, assets managed without receiving compensation, and assets of foreign clients, each of which an adviser may currently exclude in calculating its AUM. Additionally, the proposed method of calculating a particular account's contribution to the adviser's Regulatory AUM depends on whether the account is a "private fund."

5. Because the Foreign Private Adviser Exemption will be codified in Section 203(b) of the Advisers Act, advisers relying on the exemption will be exempt from all registration, reporting and recordkeeping requirements of the Advisers Act. However, advisers relying on the Foreign Private Adviser Exemption to avoid registration with the SEC would still be subject to the anti-fraud provisions of Section 206 of the Advisers Act and Rule 206(4)-5 thereunder, the so-called "Pay-to-Play Rule."

6. The proposed rule and the Exemptions Release are silent as to the general treatment of persons who acquire interests in a private fund through gift, bequest or a divorce or separation agreement consistent with Rule 3c-6 under the Investment Company Act. However, the Exemptions Release did indicate that persons acquiring in such a manner from a knowledgeable employee would be counted, suggesting that other "donees" or "transferees" within the meaning of Rule 3c-6 would not be included in the count. Thus, where multiple donees or transferees acquire interests from a single "transferor," only the transferor is included.

7. Previous SEC Staff guidance indicates that the Staff will typically look-through transactions when, in contravention of Section 48(a) of the Investment Company Act and Section 208(d) of the Advisers Act, a transaction is structured for circumventing the requirements of the applicable statute. *See* American Bar Association Section of Business Law (pub. avail. April 22, 1999) (ABA Letter) and Cornish & Carey Commercial, Inc. (pub. avail. June 21, 1996). Although the SEC indicates that its "look-through" interpretations are based on the traditional approach, commenters noted that there are many legitimate reasons for such structures that benefit investors and do not run afoul of Section 48(a) of the Investment Company Act or Section 208(d) of the Advisers Act.

8. As discussed below, the interpretation and use of the phrase "in the United States" differs between the Private Fund Adviser Exemption and the Foreign Private Adviser Exemption. Nonetheless, commenters have requested that the SEC consider applying aspects of the Foreign Private Adviser Rule, especially the clarifying note, to the Private Fund Adviser Exemption.

9. While foreign private advisers are exempt from registration, they would still be subject to the anti-fraud provisions of the Advisers Act and certain (but not all) rules thereunder. By contrast, as discussed below, advisers relying on the Venture Capital Fund Exemption or the Private Fund Adviser Exemption are, in addition to the anti-fraud provisions, subject to public reporting, recordkeeping and other requirements (including being subject to the SEC's general examination authority) that are in excess of those imposed upon foreign private advisers.

10. A "qualifying private fund" would be defined as any private fund that is not registered under the Investment Company Act and has not elected to be treated as a business development company. As noted above, a private fund is defined "as an issuer that would be an investment company . . . but for [S]ection 3(c)(1) or 3(c)(7) of [the Investment Company] Act." Commenters have noted that the requirement that an adviser relying on this exemption advise only qualifying private funds may create confusion or result in application of the Advisers Act in an unintended manner where an adviser manages accounts that could rely on Section 3(c)(1) or 3(c)(7) but could also fall outside of the definition of an investment company or rely on another statutory or regulatory exemption, as might occur with a private issuer that is primarily engaged in investing in certain real estate related assets consistent with the Section 3(c)(5)(C) exception from the Investment Company Act or which is an "Issuer of Asset-Backed Securities" able to rely on Rule 3a-7 under the Investment Company Act. Because these entities are substantially similar to private funds, commenters have suggested that the final rules allow for an adviser that manages these types of entities, either exclusively or in addition to qualifying private funds, be permitted to rely on the Private Fund Adviser Exemption, if the $150 million threshold is not exceeded.

11. This is consistent with the approach currently taken in Rule 203(b)(3)-1(b)(5) under the Advisers Act, except that, unlike Rule 203(b)(3)-1(b)(5), which takes into account only the principal office and place of business of the adviser, the proposed approach would also require an analysis of the location from which services are provided.

12. *See*, ABA Subcommittee on Private Investment Companies (pub. avail. Aug. 19, 2006). Although the SEC has not indicated whether it intends to withdraw Regulation Lite or certain related guidance, as a practical matter, if the proposed rule is adopted in its current form, non-US advisers that qualify for the new Private Fund Adviser Exemption should prefer this exemption to Regulation Lite in that, under the proposed rule, a non-US adviser would enjoy slightly more freedom in structuring its management activities by advising domestic private funds while, arguably, being subject to a slightly reduced regulatory burden in that, as discussed below, an adviser relying on the new exemption would not be considered to be a registered investment adviser nor required to complete and file Form ADV, Part 2 (a narrative brochure describing business activities, fees and conflicts).

13. The Participating Affiliate Letters include, among others: Royal Bank of Canada (pub. avail. June 3, 1998); ABN AMRO Bank, N.V. (pub. avail. Jul. 7, 1997); Murray Johnstone Holdings Limited, (pub. avail. Oct. 7, 1994); Kleinwort Benson Investment Management Limited, (pub. avail. Dec. 15, 1993); Mercury Asset Management plc, (pub. avail. Apr. 16, 1993); and Uniao de Bancos de Brasileiros S.A., (pub. avail. Jul. 28, 1992).