Cooley

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In an open meeting held on June 22, 2011, the Securities and Exchange Commission (the "SEC") adopted final rules[1] (the "Final Rules") that regulate the activities of venture capital, private equity, hedge, real estate and other private fund managers under the Investment Advisers Act of 1940 (the "Advisers Act"). The Final Rules provide an extension of the registration deadline for fund managers that will no longer be exempt from registration as a result of the repeal of the so-called "15 client rule" effective July 21, 2011 under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). In addition, the Final Rules address the definitions of venture capital fund and private fund advisers for purposes of the exemptions enacted by Dodd-Frank and provide rules implementing the reporting requirements for these exempt fund managers (so-called "exempt reporting advisers") and other technical requirements resulting from Dodd-Frank. The SEC also adopted rules exempting certain family offices from regulation as investment advisers and amendments to rules regarding so called "pay to play" practices applicable to registered and unregistered advisers.

This Cooley Alert provides a summary of the highlights of the Final Rules below.

Extension of Registration and Compliance Deadlines

As expected, the Final Rules provide an extension of the registration deadline for advisers that will be required to register as a result of Dodd-Frank until March 30, 2012. The extension applies to advisers that on July 20, 2011 are exempt from registration with the SEC under the "15 client rule" in reliance on Section 203(b)2 of the Advisers Act and that remain compliant with the 15 client rule until registered. As initial applications for registration can take up to 45 days to be approved, the SEC has recommended that advisers required to register should file a complete application, both Part 1 and Part 2 of Form ADV, no later than February 14, 2012 to meet this deadline.

Exemption for Venture Capital Fund Managers

As mandated by Dodd-Frank, the Final Rules provide that a fund manager is exempt from registration if it advises only "venture capital funds" which either meet certain qualifications or are grandfathered. As summarized below, the Final Rules make a number of changes to the earlier definition of a "venture capital fund" included in the proposed rule3, and in particular relax the restrictions on portfolio investments. (For a discussion of the proposed rule, please see our prior Cooley Alert, **Proposed Definition of "Venture Capital Fund" Issued by SEC for Purposes of Exemption from Investment Advisers Act Registration, November 24, 2010**

- **20% basket for non-qualifying investments.** In an important departure from the proposed rule, the SEC has expanded the criteria applicable to a venture capital fund's portfolio investments to include a limited amount of investments other than "qualifying investments" (in general, equity purchased from private companies). Measured at the time of each non-qualifying investment, the fund's non-qualifying investments (excluding short-term investments in cash or cash equivalents) must not exceed 20% of the fund's capital contributions plus uncalled capital. Non-qualifying investments may be valued at either cost or fair value, as long as the methodology is consistently applied. As a result, a "venture capital fund" may hold up to 20% of its committed capital in public companies, securities purchased in secondary transactions, debt instruments, and other non-qualifying investments.
- **Different types of venture transactions.** Except for the 20% basket described above and short-term investments, a venture

capital fund must only invest in "qualifying investments." However, in another departure from the definition in the proposed rules, the nature of "qualifying investments" has been expanded in the Final Rules to include other typical venture capital investments, including recapitalizations, other exchanges, mergers and acquisitions.

- **Use of proceeds to buy out existing shareholders.** The Final Rules eliminate the restriction contained in the proposed rule on the use of a venture capital fund's investment in a qualifying portfolio company to redeem or repurchase outstanding securities of other shareholders.
- **Relaxation of portfolio company leverage limits.** The proposed rule provided that all portfolio company borrowing made "in connection" with a venture fund investment would cause the investment to be non-qualifying. However, under the Final Rules, borrowing or debt placed by a portfolio company "in connection" with a venture capital fund's equity investment causes the investment to fall outside the qualifying investment criteria (and thus count toward the 20% basket) only if the proceeds of the borrowing are distributed to the fund in exchange for its investment.
- **Elimination of management involvement.** The Final Rules eliminate the requirement that the venture capital fund or its adviser is involved in the management of its qualifying portfolio companies.
- **Accommodation of guarantees of portfolio debt.** Like the proposed rule, the Final Rules limit borrowing or issuance of debt (including guarantees of portfolio company debt) by a venture capital fund to 15% of contributed capital plus uncalled capital, with non-renewable terms not to exceed 120 days. However, guarantees by the fund of the debt of qualifying portfolio companies are not subject to the 120-day limit.
- **Cash Management.** While the Final Rules still limit a venture capital fund's cash management arrangements to low yield accounts, the 20% basket described above adds a degree of flexibility to invest in higher yielding opportunities. In addition, money market funds have been added to the list of short-term investments that are not restricted.
- **Other features unchanged.** Other features of the "venture capital fund" definition set forth in the proposed rule were adopted without substantial change in the Final Rules. These features include the general prohibition on investor redemption except in extraordinary circumstances and the requirement that the fund represent to investors and potential investors that it pursues a venture capital strategy.
- **Grandfathering rule unchanged.** The Final Rules' definition of a grandfathered venture capital fund is substantially the same as the original proposal. As adopted, the Final Rules provide that a grandfathered fund includes any fund that completed an initial closing with investors prior to December 31, 2010, will complete its final closing prior to July 22, 2011, and represents itself to investors as a venture capital fund.
- **Application to Non-U.S. fund managers.** The definition of a "venture capital fund" has been expanded in the Final Rules to include funds that are formed and marketed outside the U.S. While any fund manager – domestic or offshore – seeking to rely on the exemption for a venture capital fund adviser must solely advise qualifying or grandfathered venture capital funds, including offshore funds, this expansion allows fund managers to include their offshore fund operations for purposes of meeting this criteria.

Exemption for Private Fund Managers

The SEC also approved Final Rules implementing the exemption from registration of private fund managers with assets of less than $150 million under management in the U.S. The Final Rules are substantially the same as originally proposed, including the distinction between U.S. advisers and foreign advisers, which is based upon the location of the principal place of business from which assets are managed. The Final Rules require that assets under management ("AUM") be measured annually as reported in a private fund adviser's annually updated Form ADV (filed as an exempt reporting adviser, as described below), instead of quarterly as originally proposed. In addition, the methodology used to measure AUM now follows the uniform standards set forth in the newly adopted Form ADV. If the annually reported AUM of an adviser relying on this exemption exceeds $150 million, it has a 90-day transition period to complete its registration as an investment adviser with the SEC. In addition, the definition of a "private fund" was expanded to include any company excluded from the definition of "investment company" under Section 3 of the Investment Company Act (for example certain real estate funds under 3(c)(5)(C)), rather than only those excluded pursuant to Sections 3(c)(1) and 3(c)(7).

Reporting Requirements for Venture Capital and Private Fund Advisers

As originally proposed, the Final Rules require fund managers that remain exempt from registration under either the venture capital fund adviser or private fund adviser exemptions ("exempt reporting advisers") to provide public disclosure on portions of Form ADV. This more abbreviated disclosure includes information such as business description and ownership, funds under management, conflicts of interest and any disciplinary actions taken against the principals. The deadline for initially filing this form by exempt reporting advisers is extended to March 30, 2012.

Amendments to Form ADV applicable to exempt reporting advisers were also adopted in much the same form as contained in the proposed rules. Notably, the Final Rules impose a requirement to disclose any qualified auditor's opinion for any private fund on the FORM ADV.

During the SEC's open meeting, Chairman Shapiro indicated that although the SEC does not intend to routinely examine exempt reporting advisers (including venture capital fund managers), the SEC will maintain authority to examine such advisers. In addition, the SEC has asked its staff to consider and report on the adequacy of the level of reporting by exempt reporting advisers after one year (sometime in 2013).

Although the reporting rules applicable to exempt reporting advisers were adopted by approval of three of the five commissioners, two commissioners dissented on the basis that this regulation, and in particular the public disclosure requirements of exempt reporting advisers, is harmful to capital formation and deployment in the venture capital industry.

Other Rules Adopted

The SEC also adopted Final Rules defining foreign advisers, exempting certain family offices from registration, reallocating regulation of advisers with between $25 million and $100 million in assets under management to the states, and amending the SEC's "pay to play" rules. In addition to those rules summarized in this Alert, the Final Rules adopted covered many technical issues with regard to registration and reporting processes and other matters.

State Regulation Pending

While the SEC's Final Rules provide a degree of certainty regarding the federal regulatory landscape for fund managers, the industry is still awaiting the actions of many state regulators to determine whether fund managers exempt from registration with the SEC (either under the temporary extension of the 15-client rule or under the exemptions for venture capital and private fund managers) will remain exempt from regulation at the state level.

We will be closely working with our clients to help them comply with these new rules and take advantage of any available exemptions. If you have any immediate questions or concerns, please do not hesitate to contact a member of your Cooley team or any of the attorneys listed here.

notes

1 The Final Rules are available at **the SEC's website**. The Final Rules were issued in a series of three separate SEC releases: IA-3220 (Family Offices), IA-3221 (Rules Implementing Amendments to the Investment Advisers Act of 1940) and IA-3222 (Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers).

2 Section 203(b)(3), which was eliminated by Dodd-Frank, exempted any investment adviser from registration if the investment

adviser (i) had fewer than 15 clients in the preceding 12 months, (ii) did not hold itself out to the public as an investment adviser and (iii) did not act as an investment adviser to a registered investment company or a company that has elected to be a business development company

3 The proposed rule relating to the definition of a "venture capital fund" is available at **the SEC's website**.

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