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<u>Via e-mail to: rule-comments@sec.gov</u>

Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090
Attention: Elizabeth M. Murphy, Secretary

Re: File No. S7-37-10;
Release No. IA-3111;
Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150,000,000 in Assets Under Management, and Foreign Private Advisers

Ladies and Gentlemen:

This letter is submitted on behalf of the Committee on Federal Regulation of Securities, in conjunction with the Committee on Private Equity and Venture Capital (together, the "Committees" or "we"), of the Section of Business Law (the "Section") of the American Bar Association (the "ABA"). The letter is in response to the U.S. Securities and Exchange Commission's request for comments in its November 19, 2010 proposing release referenced above (the "Proposing Release").

The comments expressed in this letter represent the views of the Committees only and have not been approved by the ABA's House of Delegates or Board of Governors and therefore do not represent the official position of the ABA. In addition, this letter does not represent the official position of the Section.

I. <u>Introduction</u>

The Commission's proposed rules would implement new exemptions from the registration requirements of the Investment Advisers Act of 1940 (the "Advisers Act") that were enacted as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). The proposed rules would apply to advisers to certain privately offered investment funds and would:

- Define "venture capital fund;"
- Provide for an exemption for advisers with less than $150,000,000 in private fund assets under management in the United States; and
- Clarify the meaning of certain terms included in a new exemption for foreign private advisers.

The Committees' comments are intended to further the goals underlying the proposed rules.

II. <u>Definition of Venture Capital Fund</u>

A. Owns Solely Equity Securities of Qualified Portfolio Companies

Venture capital funds typically make direct investments in startup and early-stage portfolio companies for the purpose of financing business expansion. In certain situations, however, venture capital funds may acquire portfolio company securities directly from other security holders. For example, a venture capital fund may desire to acquire a portion of a company's equity securities directly from its founders, employees, or from "angel" investors who may seek liquidity with respect to their investments. Although the proposed rules provide that up to 20% of a portfolio company's securities may be acquired directly from existing equity holders, we believe that venture capital funds should be provided with more flexibility in acquiring portfolio company securities directly from existing shareholders. In our experience, many such funds would hit the proposed limit in their normal business operations.

Accordingly, the Committees recommend that paragraph (a)(2) of proposed Rule 203(l)-1 be revised to provide that at least 70%, rather than 80%, of each portfolio company's securities in which a fund invests be acquired directly from the portfolio company. We believe this additional flexibility will provide venture capital funds with greater capacity to invest in the securities of portfolio companies. At the same time, 70% would not adversely affect, in any material respect, the primary objective of requiring the most significant portion of the funds' investments to be acquired directly from the investee entities.

B. Provides Significant Managerial Support

We have concerns regarding the requirement that venture capital funds "provide significant managerial assistance to" qualified portfolio companies. The reality is that in most cases investments are made through a syndicate, and only the lead investor makes this offer or demand to provide managerial assistance. Furthermore, smaller and newer funds, which can least afford the added regulatory burdens associated with investment adviser registration, very well may not be in a position to provide management guidance. We do not believe this value-added aspect of venture capital correlates in any way to systemic risk or the need to require investment adviser registration.

Accordingly, the Committees recommend that paragraph (a)(3)(i) of proposed Rule 203(l)-1 be revised to provide that venture capital funds investing as a group or syndicate would be deemed to satisfy the managerial assistance requirement if at least one fund (or its adviser) participating in the group or syndicate provides such assistance.

C. No Leverage

For a number of reasons, venture capital funds may determine to provide guarantees of portfolio company debt in connection with their investments in such companies. We are concerned that the 120-calendar-day limit on guarantees may be unreasonably short and could harm a portfolio company's ability to obtain credit. Among other things, such a short period could hamper the ability of a portfolio company to identify and evaluate the credit arrangements that may be most beneficial to it. Accordingly, the Committees recommend that paragraph (a)(4) of proposed Rule 203(l)-1(a)(4) be revised to increase the time limit on guarantees from 120 to 180 calendar days.

D. No Redemption Rights

We request that the Commission provide guidance clarifying that granting redemption or withdrawal rights for certain types of investors (such as investors subject to the Employee Retirement Income Security Act of 1974 ("ERISA"), state or governmental plan investors, tax-exempt investors, bank holding company investors, etc.) in the event certain ERISA, tax or regulatory changes occur would be considered "extraordinary" for purposes of satisfying paragraph (a)(5) of proposed Rule 203(l)-1. The clarification could be made in the final rule or the adopting release.

E. Definition of Qualifying Portfolio Company

1. Not Publicly Traded

We have concerns relating to the requirement that a qualifying portfolio company may not be publicly traded at the time of a venture capital fund's investment in such company. Although we agree that venture capital funds typically invest in companies that are privately held, there are a number of situations when venture capital funds may determine that it is in their interests, and the interests of their investors, to make follow-on investments in publicly traded portfolio companies.

We believe that the proposed rule should provide a certain degree of flexibility in this regard. Accordingly, the Committees recommend that paragraph (c)(4)(i) of proposed Rule 203(l)-1 be deleted and the definition of "venture capital fund" be amended to permit at least 20% of a venture capital fund's total investment in any one portfolio company be made after that company becomes publicly traded.

2. No Leverage "In Connection With" Investment

We believe that the prohibition on borrowing by portfolio companies "in connection with the private fund's investment" should be clarified. Portfolio companies oftentimes engage in borrowing transactions around the same time as venture capital investments. This may be due to a variety of factors; for example, the portfolio companies may have expended significant efforts to organize their disclosures in a manner consistent with what investors would reasonably expect to have available for review, including the set-up and updating of datarooms. In addition, the borrowing by the portfolio company may arise because the venture capital fund investment has also permitted the portfolio company to focus on other elements of its overall financing plan. The timing of the borrowing may also be merely coincident with the venture capital fund investment, especially if the venture capital fund investment was not conditioned on the borrowing.

Specifically, the Committees recommend that paragraph (c)(4)(ii) of proposed Rule 203(l)-1 be revised to clarify that borrowing is "in connection with a private fund's investment" in a qualifying portfolio company only if the borrowing is extended by the venture capital fund to the qualifying portfolio company or the borrowing is arranged by the venture capital fund. Otherwise, we believe that proposed Rule 203(l)-1 may limit the financing alternatives available to portfolio companies.

3. Capital Used for Operating or Business Expansion Purposes

Although paragraph (a)(2)(i) of proposed Rule 203(l)-1 would permit a venture capital fund to acquire up to 20% of the equity securities of a portfolio company directly from other security holders of such company, paragraph (c)(4)(iii) would flatly prohibit a qualifying portfolio company from accomplishing the same result indirectly through a redemption of shares from its existing security holders. Because the end results of direct and indirect buyouts are similar, we believe that the proposed rule should permit indirect buyouts by qualifying portfolio companies, subject to the limits to be set forth in the final rule with respect to direct buyouts by venture capital funds.

Accordingly, the Committees recommend that paragraph (c)(4)(iii) of proposed Rule 203(l)-1 be revised to permit a qualifying portfolio company to redeem, exchange, or repurchase up to 30% of its securities in connection with a venture capital fund's investment in such company.

4. Not a Private Fund

Although we agree that there is no indication that Congress intended the venture capital exemption to apply to "funds of funds," we believe that the exclusion on investments in other private funds for purposes of the definition of a "qualifying portfolio company" is unduly restrictive. The exclusion of any private fund or pooled investment vehicle from the definition of "qualifying portfolio company" would exclude not only venture capital "funds of funds," but would also unnecessarily discourage venture capital funds from using special purpose vehicles for tax, reporting, or other reasons benefiting a fund's investors. We do not believe that exempting the use of such special purpose vehicles would create loopholes or allow leveraged buyout funds, hedge funds or any other funds that pose systemic risks to take advantage of the venture fund exemption.

Specifically, the Committees recommend that paragraph (c)(4)(iv) of proposed Rule 203(l)-1 be revised to permit venture capital funds to invest indirectly in qualifying portfolio companies through one or more special purpose vehicles.

F. Application to Non-United States Advisers

To the extent that a non-United States fund meets all of the other conditions of proposed Rule 203(l)-1, the Committees recommend that it be treated as a venture capital fund for purposes of the venture capital fund exemption.

III. <u>The Foreign Private Adviser Exemption</u>

Section 203(b)(3) of the Advisers Act establishes a statutory exemption from registration under the Act for "foreign private advisers," which are defined in section 202(a)(30) to mean any investment adviser who:

"(A) has no place of business in the United States;
(B) has, in total, fewer than 15 clients and investors in the United States in private funds advised by the investment adviser;
(C) has aggregate assets under management attributable to clients in the United States and investors in the United States in private funds advised by the investment adviser of less than $25,000,000, or such higher amount as the Commission may, by rule, deem appropriate…; and
(D) neither-
  (i) holds itself out generally to the public in the United States as an investment adviser;" nor
  (ii) acts as-
    (I) an investment adviser to any investment company registered under the Investment Company Act of 1940; nor
    (II) a company that has elected to be a business development company…"

A. *Non-exclusivity of the "foreign private advisers" exemption*

We believe that relatively few offshore advisers will be able to meet the provisions of proposed Rule 203(b)(3) because of the requirements that there be fewer than 15 clients and investors, and less than $25,000,000 aggregate assets under management. We recognize those requirements are statutory, and therefore (except for the $25,000,000 asset threshold) not subject to change by the Commission.

However, we believe the Commission should (because we believe it entirely consistent with the statutory provisions enacted by Dodd-Frank) clearly articulate that an adviser that fails to meet the requirements of Section 203(b)(3) may nonetheless rely on other exemptions from registration under the Act, such as, for example, Section 203(l) or 203(m). Otherwise, a non-United States adviser would be subject to requirements under the Advisers Act that would not apply to United States-based advisers (as described below), and we do not believe that such a result was either intended or is grounded in sound public policy.

B. *$25,000,000 Threshold*

The Commission has explicit statutory authority to increase the $25,000,000 threshold. We recommend it consider exercising that authority. If an offshore adviser has fewer than 15 clients and investors in private funds in the United States, we believe that such an offshore adviser should not be required to register with the Commission at a level of assets under management from United States persons which is less than would be required of a United States-based investment adviser to register ($100,000,000). Although we acknowledge that United States-based advisers are required to register if they manage assets above $25,000,000, if they are not subjected to regulation by a state that also conducts examinations, we believe that offshore advisers are frequently subject to regulation and supervision by regulatory regimes in their home countries.

If the Commission does not believe it would be appropriate to act at this time to increase this threshold under 203(b)(3), we urge it to monitor this issue, to undertake dialogue with foreign regulators with respect to their supervisory regimes over investment advisers, and to consider proposing an increase in the exemption amount in the near future.

C. *Clients*

We generally support the provisions of proposed Rule 202(a)(30)-1 (a) and (b), but suggest the Commission consider the following changes:

1. Spousal Equivalent and Ex-Spouses

The proposed Rule would permit an adviser to treat a person and a spouse as a single client for counting purposes. We recommend the Commission incorporate the concept of "spousal equivalent" in proposed Rule 202(a)(30)-1(ii) in the same manner in which it is included in the Family Office proposed Rule.[1] In addition, although the proposed Rule recognizes that a person and his or her minor children (whether or not living with a natural person) are treated as a single client, we recommend that an ex-spouse with whom such minor children reside should be treated in the same manner if, in this circumstance, the natural person invests for the benefit of the ex-spouse.

2. Persons Not Charged a Fee

We refer to the discussion below with respect to exempt private fund advisers regarding proprietary assets, assets of employees and family members. In general, because the foreign private manager is offshore, we recognize this is not likely to be a large group, but there may be instances where the same policy considerations are relevant. We also recognize that seed capital transactions, in which a United States person invests in the offshore manager, could result in proprietary assets being managed without a fee, and believe that excluding those assets from the threshold would be appropriate.

3. Double-Counting

We support the approach proposed by the Commission to avoid double-counting persons who are clients, but we also recommend that a client who is also an investor should not be counted twice. We believe this to be implicit in the discussion in the Proposing Release but would welcome clarification in the final rule release.

D. *Investors*

We commend the Commission for incorporating longstanding concepts under 3(c)(1) and 3(c)(7) to provide guidance in determining who are investors in a private fund. As a result, we understand that unless a fund investor which is an entity (the "entity investor") is under common control with the fund, or formed or availed of to avoid the provisions of 203(b)(3), the entity investor will not be "looked through" to determine if it has United States persons as investors in determining the number of United States investors in a private fund. This is consistent with longstanding concepts for determining the investors in private funds, and we believe it continues to be the correct standard.

1. Holders of Debt

We respectfully disagree that holders of debt securities (especially short-term debt securities used for financing) should be counted as investors. Funds commonly issue short-term paper for reasons other than providing investment exposure. Short-term debt may be used to

[1] See Release IA-3098 entitled "Family Offices" especially Sec. 275.202(a)(11)(G)-1(d)(3) which states: "Family member means: (i) the founders, their lineal descendents (including by adoption and stepchildren), and such lineal descendents' spouses and *spousal equivalents*; [our emphasis] . . ." Footnote 24 therein for the "spousal equivalent" definition which states: "Spousal equivalent is defined as a cohabitant occupying a relationship generally equivalent to that of a spouse".

finance investment operations or fund redemptions. Holders of such debt securities do not view themselves as making an investment decision in connection with their extension of credit, but rather assess the risk of holding a private fund's short-term paper based on credit risk.

Similarly, in the case of funds that operate on leverage finance with prime brokers, the prime brokers consider themselves subject to credit risk, but not to be making an investment decision when they extend credit to a fund. Whether those who extend credit do so on a short-term basis or for a longer term, they do not consider themselves to be "investors"; rather, they are creditors, and are making a credit rather than an investment decision. We believe the Commission should reflect this consideration in its final rules by not counting holders of conventional debt securities as investors.

On the other hand, we agree that holders of securities which are denominated as debt but function as equity substitutes because they have been structured to deliver to the holder the equivalent of the fund's investment return should be considered investors in the fund.

2. Total Return Swaps

We are concerned by what appears to be assumed on Page 79 of the Proposing Release that any use of a total return swap by a record owner would make the counterparty the beneficial owner of the private fund's securities. We respectfully disagree that this should be assumed to be the case, because investors may be entering into total return swaps for many reasons. For example, they may seek to hedge positions in securities in their portfolio (including an investment in a private fund), and these may vary in terms and duration, and, unlike a direct investment in a fund, involve the credit risk of the counterparty. Such transactions may have many legitimate business objectives, other than those that appear to be assumed in the Proposing Release, as has been determined in court cases.

We recognize, however, that in some cases total return swaps on a single security have been structured to transfer the risk of an investment to a counterparty to permit the counterparty to achieve (or seek to achieve) tax or other benefits which would not have been available had the counterparty invested directly in the private fund. This arrangement is generally put into place at the time the investment is made, and the record holder is making the investment to hedge against its risk to the counterparty. In such a situation, it may be reasonable to consider the counterparty the beneficial owner.

However, we believe that such situations should be viewed in the context of section 767(o) of the Dodd-Frank Act, so that standards of transferring beneficial ownership are consistent. Moreover, as noted below, treatment of total return swaps in this manner (where there is an intent at the time of investment to transfer the incidents of beneficial ownership) will permit issuers to rely on representations made by investors in subscription documents and thereby avoid losing the availability of the exemption provided by 203(b)(3) through no fault of their own, and also to protect them from being deemed to have issued securities without determining that adequate disclosures have been made to the real beneficial owners.

E. *Good-Faith Reliance*

We recommend that an adviser seeking to rely on 203(b)(3) should be entitled to rely in good faith on representations in subscription agreements and certifications of investors that they are the beneficial owners of the investment, or that they are able to make the appropriate representations on behalf of the entities for whom they are subscribing. A similar approach is taken with regard to the application of the private placement exemptions under Regulation D and elsewhere and we believe it would be appropriate to apply the same approach in this context as well.[2] If the Commission were to accept the approach we recommend above with respect to total return swaps, representations regarding their use (or intended use) could be included in subscription documents.

F. *Assets Under Management*

We refer to our comments below relating to exempt private fund advisers for purposes of calculating assets under management, and our recommendation that it be measured annually (or at least quarterly).

G. *Other Provisions*

We support the approach taken in the note to paragraph (c)(2)(i) of proposed Rule 202(a)(30)-1 which looks at the time and place when a person becomes a client or investor for purposes of determining whether the person should be treated as a United States person.

We recognize that Section 202(a)(30) of the statute requires that a foreign private adviser have "no place of business in the United States." Accordingly, we believe that the definition of place of business set forth in Rule 222-1(a) is appropriate insofar as it relates to a place where the adviser "regularly provides investment services, solicits, meets with or otherwise communicates with clients." However, we believe that in practice many foreign advisers, or their affiliates, may have offices that engage in research, back office and/or administrative services, and recommend that the Commission state explicitly in the final rule or final rule release that offices engaged in such activities should not be considered a place of business in the United States for purposes of 202(a)(30), provided that no advisory activities are carried out at such offices.

IV. The Private Fund Adviser Exemption

The Private Fund Adviser Exemption as set forth in proposed Rule 203(m)-1 exempts from registration any adviser whose only clients are private funds and which have less than $150,000,000 in assets under management in the United States. The application of the Private Fund Adviser Exemption operates differently with respect to United States-based advisers that are subject to 203(m)-1(a), as compared to those advisers that are not United States-based, which are subject to 203(m)-1(b).

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[2] See 17 CFR Sec. 230-501(a) and in particular the reference therein to the issuer "*reasonable belief*" [our emphasis] as to accredited investor status.

A. *United States Based Advisers*

1. When Assets Are Calculated

To take advantage of the Private Fund Adviser Exemption, a United States-based adviser must have *only* private funds as clients, and the assets of the private funds which the adviser manages must be less than $150,000,000. The Proposing Release requests comment on how assets under management are to be calculated, and proposed Rule 203(m)1-(c) provides that "private fund assets are calculated as the total value of such assets at the end of each calendar quarter." Although we agree that a quarter end is an appropriate measuring period, we believe a semi-annual or annual measuring period would perhaps be more appropriate, and that a longer measuring period would provide an adviser that is exempt from registration under the Private Fund Adviser Exemption assistance in avoiding issues arising from temporary increases in asset values.

We believe an annual measurement would be most appropriate, especially since advisers exempt from registration because they do not meet the $100,000,000 asset threshold will calculate their assets for this purpose annually, and an annual test for both purposes has a compelling consistency.

2. Transition Period

As stated in the comment letter of the Committee on Federal Regulation of Securities with respect to Release No. IA-3110, we suggest that consideration be given to extending the Transition Rule for registration to 180 days. In our view, a transition period of 90 days may not provide a sufficient opportunity for an adviser to register and to implement all the necessary compliance mechanisms. We believe that a longer period, such as 180 days, would both be more realistic and help to assure that the compliance mechanisms the adviser implements are both appropriate and effective.

3. Net Assets Rather than Total Assets

In addition, we suggest that net assets would be a better indicator than total assets as a measure of when a private fund adviser should be required to register. From an investor protection standpoint, investors tend to think in terms of net assets (the money they have invested, and what they will receive upon a redemption of their interests) rather than gross or total assets.

Although total assets may be an appropriate measure to consider in terms of systemic risk, we believe it extremely unlikely that a net asset limit of $150,000,000 in private funds could be leveraged into total investments that would pose any systemic risk. Moreover, because Exempt Private Fund Advisers would still be subject to such reporting requirements as the Commission determines to be appropriate under Section 203, the use of leverage could, if the Commission so determined, be subject to reporting under such rules.

4. Proprietary Assets

We also believe that there are good public policy reasons to exclude "proprietary assets" from the definition of assets under management. We refer to proprietary assets as those that are invested by the manager and its affiliates and family members (we understand the issues that may arise from defining this term too broadly and recommend that the provisions of proposed Rule 202(a)(30)-1(a)(1), which defines a "client" who is a "natural person," also be used for this purpose), and knowledgeable employees.

In our view, the interests of investors are best aligned with those of the managers when the managers also have their assets invested in the private funds. This seems also to be the view of Congress, as expressed in the Dodd-Frank Act, in connection with the need in some instances for managers to have "skin in the game." If such proprietary assets are calculated as part of assets under management, the managers, in order to qualify for the Private Fund Advisers Exemption, will have an incentive to reduce their personal commitments to the private funds, and manage their own assets individually. We do not believe this result would be in the best interests of the investors, and therefore suggest that "proprietary assets" be excluded from the calculation of assets under management.

We would include within the scope of proprietary assets funds provided by "seed investors" to the manager, which are also invested in the private fund. Should the Commission determine that disclosure of the amount of proprietary assets under management by Exempt Private Fund Advisers would be appropriate, it could require such information be made available under Section 203, and it appears that revised Form ADV, as proposed, would also include that information.

We are not aware of similar policy reasons to exclude other non-fee bearing assets which do not meet the definition of proprietary assets above, although we recognize that in the past such assets were generally not considered to be the subject of an advisory relationship because the manager did not receive compensation.

5. Accounting Standards

We also recommend that the Commission consider using a standard of "fair value" for valuing assets. Moreover, we would suggest that if the Commission adopts our suggestion that net assets be used as the benchmark for the Private Fund Adviser Exemption, private funds should be required to prepare audited annual financial statements in accordance with GAAP (or such other accounting standards acceptable to the Commission), and that such financial statements be required to be maintained by the Exempt Private Fund Adviser under Section 203(m)(2).

6. Single-Investor Private Funds

We believe that a manager who would otherwise qualify as an Exempt Private Fund Adviser should not lose its exemption if, incidental to advising private funds, the manager advises one or more single-investor private funds. As the Commission is aware, there are situations in which institutional investors require that the adviser create a separate fund (consisting of only that investor), rather than invest in a multi-investor private fund or funds managed by the adviser. These single-investor funds are managed in a manner similar to the related multi-investor private fund, have audited financial statements, and are treated as private funds for purposes of the custody rule.

We recommend that the Commission provide guidance that such funds will be considered as private funds if they are established incidental to an institutional investor participating in an investment program run by the adviser that is otherwise limited solely to private funds.

7. Other

In terms of the Exempt Private Fund Adviser Exemption, we do not believe committed capital presents any issue with respect to private equity funds. We therefore recommend that committed capital be treated the same for private equity and venture capital funds.

B. *Non-United States Based Advisers*

As we understand proposed Rule 203(m)-1(b), an investment adviser with its principal office and place of business outside the United States qualifies for the Exempt Foreign Private Adviser exemption from registration if (i) its *only* clients that are United States persons are qualifying private funds, and (ii) if it manages assets from a place of business in the United States, it does so only for private funds with total assets less than $150,000,000.

1. No Size Limitations on Assets under Management

Accordingly, non-United States-based advisers that do not have an office from which they manage assets in the United States will be able to manage United States-based private funds and non-United States-based funds (whether or not they have United States persons as investors) without regard to the size of assets under management or the jurisdiction in which the private funds are organized, and without regard to whether United States persons are investors in such funds. Because the non-United States-based adviser will only have qualifying funds as clients in the United States, it will qualify for the Exempt Private Fund Adviser exemption from registration. We commend the Commission in proposing this approach, because we believe it will provide certainty and is consistent with the operation of a global asset management business. In our view, this approach will avoid the issues associated with conflicting and overlapping regulation. When, in the private fund context, United States investors invest with a non-United States-based investment manager, they understand they are not being afforded the investor protection safeguards of the United States Investment Advisers Act.

However, because such Exempt Private Fund Advisers will remain subject to rulemaking under Section 203 and will be subject to examination, we urge the Commission to propose rules under Section 203(m)(2) consistent with avoiding duplicative and conflicting regulation for those advisers that do not have their principal office or place of business in the United States.

2. Calculation of Assets

Insofar as calculating the threshold amount ($150,000,000) and the time or times when the threshold should be measured, we refer to our comments above with regard to United States-based Exempt Private Fund Advisers.

3. Inherent Limitations on Jurisdiction

On its face, subsection 203(m)(1) directs the Commission to provide an exemption from registration for any adviser of private funds if the adviser "acts solely as an adviser to private funds and has assets under management in the United States of less than $150,000,000." The statute directs that the Commission "shall require investment advisers exempted by reason of this subsection [203(m)(1)] to maintain such records and provide the Commission such annual or other reports as the Commission determines necessary or appropriate…" Although this grant of authority to the Commission is broad, we believe it is inherently limited to situations in which an adviser that does not have its principal office or place of business in the United States ("offshore adviser") is using the jurisdictional means in connection with its business, so as to subject itself to the jurisdiction of the Commission.

For example, an offshore adviser with no assets under management in the United States and no private fund clients presumably does not, as a technical matter, need the exemption from registration provided by Section 203(m)(1). If such an offshore adviser had no United States persons as direct investors in its funds and was not soliciting United States persons to become investors through the use of the jurisdictional means, it would seem that such an offshore adviser would not be subject to Section 203(m) because it has no private funds as clients (it does not serve as investment adviser to any private fund).

Accordingly, such an offshore adviser should not be subject to the reporting requirements of Section 203(m)(2), and any rules the Commission may propose thereunder. This would be the case if private funds (even assuming they were organized in the United States) were indirect investors (for example, through a fund of funds that is not a United States person and that is unaffiliated with the "offshore adviser"), because those indirect investors would not be "clients" of the "offshore adviser." We are assuming for this purpose that the offshore adviser is not promoting the offshore fund of funds as a "feeder" to the funds advised by the offshore adviser, in addition to not being affiliated with the fund of funds which invests in a fund managed by the offshore adviser.

C. *Sub-Advisers*

1. Offshore Sub-Advisers

As we read proposed Rule 203(m)-1, (i) offshore advisers that are engaged to act as sub-advisers to private funds advised by the Exempt Private Fund Advisers (assuming other activities do not otherwise disqualify them) will also be treated as Exempt Private Fund Advisers; and (ii) offshore advisers engaged to act as sub-advisers with respect to private funds advised by

United States investment advisers (both those that are registered and those that qualify as Exempt Private Fund Advisers, again, assuming other activities do not otherwise require registration or disqualify the offshore sub-advisers) will be treated as Exempt Private Fund Advisers. Our interpretation of proposed Rule 203(m)-1 assumes that the principal office and place of business of the offshore sub-advisers are outside the United States, and that each has "no client who is a United States person except for one or more qualifying private funds."

In connection with our interpretation of this provision, we therefore suggest that the Commission should not disqualify a sub-adviser from being able to avail itself of the Exempt Private Fund Adviser exemption because it is retained by, and may be terminated by, the primary adviser to a private fund.

In our view, disqualifying an offshore sub-adviser from being able to avail itself of the Exempt Private Fund Adviser exemption from registration, when such exemption is available to the primary adviser to the private fund, would be inconsistent with the public policy behind the exemption set forth in proposed Rule 203(m)-1. We believe our interpretation is consistent with the Commission's position as set forth in Section II D of the Proposing Release, but suggest it would be helpful for the Commission to clarify that this is the manner in which proposed Rule 203(m)-1 will be interpreted.

2. Reporting and Recordkeeping by Offshore Sub-Advisers

In addition, we believe the Commission should consider whether offshore sub-advisers that, under the foregoing analysis, would be Exempt Private Fund Advisers, should in all cases be subject to reporting, recordkeeping, and examination, pursuant to Sections 203(m) and 203(n). Our concern is that certain offshore advisers that have their principal office and place of business outside the United States and that trade in foreign securities (for example, those that are located in an emerging market and trade securities of companies in that emerging market) will decline to be retained as sub-advisers if such retention will subject them to the rulemaking proposed by the Commission with respect to reporting, recordkeeping and examination pursuant to Section 203(m) and 203(n). This issue arises in a number of different fact patterns, such as:

(i) A United States-based private fund has a registered investment adviser as its primary adviser and wants to select an offshore sub-adviser to invest a portion of its assets in the securities of an entity in an emerging market (say, for example, China). Under such circumstances, is public policy best served by requiring the Chinese-based sub-adviser to be subject to Sections 203(m) and (n) (to which it may not be willing to be subject), which could deprive the United States-based fund of the opportunity to obtain the advise and expertise of that offshore sub-adviser? We believe the Commission could require the registered adviser to maintain such books and records as would allow the Commission to have a complete picture of the registered adviser's operations (from both an investor protection and systemic risk perspective [the latter being rather remote in such a circumstance]) and to not independently apply such requirements to the offshore sub-adviser;

(ii) In the same fact pattern as (i), except that the primary adviser to the private fund is an Exempt Private Fund Adviser; and

(iii) In the same fact pattern as (ii), except that the primary adviser is an offshore investment adviser which qualifies as an Exempt Private Fund Adviser, and the funds are offshore funds which have direct investors who are United States persons.[3]

In the case of scenarios (ii) and (iii), we likewise believe the Commission could structure the recordkeeping, reporting and examination requirements it develops under Sections 203(m) and 203(n) to allow the Commission to obtain sufficient information from both an investor protection and systemic risk perspective. Again, we believe the issue of systemic risk is rather remote in the context of trading in securities of foreign issuers. Exempting such offshore sub-advisers from the provisions of Sections 203(m) and 203(n), with the objective of making available to investors the best possible advice and expertise for trading in foreign markets, would in our view be most consistent with good public policy. We believe such an approach achieves the regulatory requirements of the amendments to the Advisers Act implemented by the Dodd-Frank Act, and provides the greatest latitude to investment advisers to private funds to select appropriate offshore sub-advisers without erecting what we view as unnecessary regulatory barriers.

We propose such an approach be taken only with respect to:

(i) Offshore advisers that are not controlled by, or under common control with, the primary adviser;

(ii) Situations where the offshore adviser is not otherwise (a) required to be registered as an investment adviser with the Commission, or (b) subject to the recordkeeping, reporting or examination provisions of Sections 203(m) and (n);

(iii) Disclosure documents that indicate offshore sub-advisers may be retained to manage a portion of the fund's assets, and that such offshore sub-advisers may neither be registered with the Commission nor subject to the recordkeeping, reporting and examination provisions of Sections 203(m) and (n);

(iv) The primary adviser requiring the offshore sub-adviser to be subject to the same custody rules applicable to the primary adviser; and

(v) Total assets allocated to such an offshore sub-adviser, determined at the time the offshore sub-adviser is retained, do not exceed 10% of the fund's net assets.

This approach would be consistent with correspondence between a subcommittee of the Committee on Federal Securities Regulation (letter from the Subcommittee on Private Investment Entities dated June 23, 2005) (the "2005 Interpretative Letter") and the Staff of the

[3] If the offshore funds do not have direct investors who are United States persons, and the offshore adviser does not use jurisdictional means to solicit United States persons as investors, we believe the provisions of Section 203(m) and (n) would not apply to the offshore adviser, assuming its principal office and place of business are outside the United States and it is not rendering investment advice from an office in the United States.

Commission (response dated December 8, 2005) (the "Staff Response"). In that correspondence, under prior rule-making relating registration of advisers to private funds (in that case, hedge funds), the Staff Response provided relief with respect to the registration of offshore sub-advisers, on certain conditions, which we believe are consistent with those we have proposed above.

D. *Advisers to Private Funds in Liquidation*

Section 7 of the Investment Company Act of 1940 provides an exemption for entities that would otherwise be required to register if the transactions in which they are engaged are incidental to their dissolution. This exemption has been applicable, for example, to liquidating trusts which hold illiquid securities for purposes of disposing of those securities. We recommend that the Commission adopt a similar exemption from the requirements of registration under the Advisers Act for advisers to private funds that are in dissolution or liquidation, or have distributed their securities to liquidating trusts. We believe that the costs of requiring such persons to be registered may be onerous, because such advisers frequently do not have the recurring fee income to support the necessary personnel and systems to maintain the required books and records, and they may be expected to have difficulty in attracting and keeping personnel.

To avoid advisers "gaming" the ability to deregister (or not register), we recommend that (i) advisers otherwise required to be registered would continue to be required to be registered, notwithstanding the fact that they manage private funds in dissolution or liquidation; or (ii) the net assets (or total assets, if the Commission does not accept our recommendation on calculation of assets for meeting the threshold of $150,000,000 for private funds) of funds in dissolution or liquidation not be subtracted from assets of other private funds under management, so, if the adviser has a continuing business advising private funds, the exemption for liquidating trusts, etc. would not be applicable. If the Commission believes that it would require information regarding such advisers, we would propose that they be treated as Exempt Private Fund Advisers, even if the assets under management in this instance are greater than the $150,000,000 threshold, because such an increased amount can be expected to be a temporary phenomenon.

We recognize that investor protection issues would remain in the situation where there is a liquidation of assets over time, and that there is a need to appropriately balance those issues against the costs of imposing the regulatory regime of registration over the fiduciary obligations that already exist under law. In our view, the exemption we have proposed deserves consideration. This concept is recognized in Section 7 of the Investment Company Act, and we believe there is a sufficient public policy basis to apply it as well to Adviser Act registration. Because the Commission has determined in other contexts that funds undergoing liquidation continue to require audited financial statements, we believe that, together with the protections we have suggested above, investors will be adequately protected and have access to the information most meaningful to them.

* * *

The Committees appreciate the opportunity to comment on the Proposing Release and respectfully request that the Commission consider the comments and recommendations set forth above. Members of the Committees are available to discuss these comments should the Commission or the staff so desire.

Very truly yours,

/s/ Jeffrey W. Rubin
Jeffrey W. Rubin, Chair of the Committee
on Federal Regulation of Securities

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