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page one of Form ADV-NR, and any suggestions for reducing this burden. This collection of information has been reviewed by the Office of Management

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## SECURITIES AND EXCHANGE COMMISSION

### 17 CFR Part 275

**[Release No. IA–3111; File No. S7–37–10]**

**RIN 3235–AK81**

# Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Proposed rule.

**SUMMARY:** The Securities and Exchange Commission (the "Commission") is proposing rules that would implement new exemptions from the registration requirements of the Investment Advisers Act of 1940 for advisers to certain privately offered investment funds that were enacted as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). As required by Title IV of the Dodd-Frank Act—the Private Fund Investment Advisers Registration Act of 2010, the new rules would define "venture capital fund" and provide for an exemption for advisers with less than $150 million in private fund assets under management in the United States. The new rules would also clarify the meaning of certain terms included in a new exemption for foreign private advisers.

**DATES:** Comments should be received on or before January 24, 2011.

**ADDRESSES:** Comments may be submitted by any of the following methods:

*Electronic Comments*

• Use the Commission's Internet comment form (*http://www.sec.gov/rules/proposed.shtml*); or

• Send an e-mail to *rule-comments@sec.gov.* Please include File Number S7–37–10 on the subject line; or

• Use the Federal eRulemaking Portal (*http://www.regulations.gov*). Follow the instructions for submitting comments.

*Paper Comments*

• Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549–1090.

All submissions should refer to File Number S7–37–10. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (*http://www.sec.gov/rules/proposed.shtml*). Comments are also available for Web site viewing and printing in the Commission's Public Reference Room, 100 F Street, NE., Washington, DC 20549, on official business days between the hours of 10 a.m. and 3 p.m. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

**FOR FURTHER INFORMATION CONTACT:** Tram N. Nguyen, Daniele Marchesani, or David A. Vaughan, at (202) 551–6787 or *(IArules@sec.gov)*, Division of Investment Management, U.S. Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549–8549.

**SUPPLEMENTARY INFORMATION:** The Commission is requesting public comment on proposed rules 203(l)–1, 203(m)–1 and 202(a)(30)–1 (17 CFR 275.203(l)–1, 275.203(m)–1 and 275.202(a)(30)–1) under the Investment Advisers Act of 1940 (15 U.S.C. 80b) ("Advisers Act").[1]

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## I. Background

On July 21, 2010, President Obama signed into law the Dodd-Frank Act,[2] which amends various provisions of the Advisers Act and requires or authorizes the Commission to adopt several new rules and revise existing rules.[3] Unless otherwise provided for in the Dodd-Frank Act, the amendments become effective on July 21, 2011.[4]

The amendments include the repeal of section 203(b)(3) of the Advisers Act, which exempts any investment adviser from registration if the investment adviser (i) Has had fewer than 15 clients in the preceding 12 months, (ii) does not hold itself out to the public as an investment adviser and (iii) does not act as an investment adviser to a registered investment company or a company that has elected to be a business development company (the "private adviser exemption").[5] Advisers specifically exempt under section 203(b) are not subject to reporting or recordkeeping provisions under the Advisers Act, and are not subject to examination by our staff.[6]

The primary purpose of Congress in repealing section 203(b)(3) was to require advisers to "private funds" to register under the Advisers Act.[7] Private

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[1] Unless otherwise noted, all references to rules under the Advisers Act will be to title 17, part 275 of the Code of Federal Regulations (17 CFR 275).

[2] Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111–203, 124 Stat. 1376 (2010).

[3] In this Release, when we refer to the "Advisers Act," we refer to the Advisers Act as in effect on July 21, 2011.

[4] Section 419 of the Dodd-Frank Act.

[5] 15 U.S.C. 80b-3(b)(3) as in effect before July 21, 2011.

[6] *See* section 204(a) of the Advisers Act. *See also infra* note 30.

[7] *See* S. Rep. No. 111–176, at 71–3 (2010) ("S. Rep. No. 111–176"); H. Rep. No. 111–517, at 866

funds include hedge funds, private equity funds and other types of pooled investment vehicles that are excluded from the definition of "investment company" under the Investment Company Act of 1940 [8] ("Investment Company Act") by reason of sections 3(c)(1) or 3(c)(7) of such Act.[9] Section 3(c)(1) is available to a fund that does not publicly offer the securities it issues [10] and has 100 or fewer beneficial owners of its outstanding securities.[11] A fund relying on section 3(c)(7) cannot publicly offer the securities it issues [12] and generally must limit the owners of its outstanding securities to "qualified purchasers." [13]

Each of these types of private funds advised by an adviser typically qualifies as a single client for purposes of the private adviser exemption.[14] As a result, investment advisers could form up to 14 private funds, regardless of the total number of investors investing in the funds, without the need to register with us.[15] This has permitted the growth of unregistered investment advisers with large amounts of assets under management and significant numbers of investors but without the Commission oversight that registration under the Advisers Act provides.[16] Concern about this lack of Commission oversight led us to adopt a rule in 2004 extending registration to hedge fund advisers,[17] which was vacated by a federal court in 2006.[18] In Title IV of the Dodd-Frank Act ("Title IV"), Congress has now generally extended Advisers Act registration to advisers to hedge funds and many other private funds by eliminating the current private adviser exemption.[19]

In addition to removing the broad exemption provided by section 203(b)(3), Congress created three exemptions from registration under the Advisers Act.[20] These new exemptions apply to: (i) Advisers solely to venture capital funds, without regard to the number of such funds advised by the adviser or the size of such funds; [21] (ii) advisers solely to private funds with less than $150 million in assets under management in the United States, without regard to the number or type of private funds advised; [22] and (iii) non-U.S. advisers with less than $25 million in aggregate assets under management from U.S. clients and private fund investors and fewer than 15 such clients and investors.[23]

## II. Discussion

Today we are proposing three rules that would implement these exemptions.[24] In a separate companion release (the "Implementing Release"),[25] we are proposing rules to implement other amendments made to the Advisers Act by the Dodd-Frank Act, some of which also concern certain advisers that qualify for the exemptions discussed in this Release.[26]

New section 203(l) of the Advisers Act provides that an investment adviser that solely advises venture capital funds is exempt from registration under the Advisers Act and directs the Commission to define "venture capital fund" within one year of enactment.[27] We are proposing new rule 203(l)-1 to provide such a definition, which we discuss below in Section II.A of this Release.

New section 203(m) of the Advisers Act directs the Commission to provide an exemption from registration to any investment adviser that solely advises private funds if the adviser has assets

(2010) ("H. Rep. No. 111–517"). H. Rep. No. 111–517 contains the conference report accompanying the version of H.R. 4173 that was debated in conference, *infra* note 39.

[8] 15 U.S.C. 80a.

[9] Section 202(a)(29) of the Advisers Act defines the term "private fund" as "an issuer that would be an investment company, as defined in section 3 of the Investment Company Act of 1940 (15 U.S.C. 80a-3), but for section 3(c)(1) or 3(c)(7) of that Act."

[10] Interests in a private fund may be offered pursuant to an exemption from registration under the Securities Act of 1933 (15 U.S.C. 77a) ("Securities Act"). Notwithstanding these exemptions, the persons who market interests in a private fund may be subject to the registration requirements of section 15(a) under the Securities Exchange Act of 1934 ("Exchange Act") (15 U.S.C. 78o(a)). The Exchange Act generally defines a "broker" as any person engaged in the business of effecting transactions in securities for the account of others. Section 3(a)(4)(A) of the Exchange Act (15 U.S.C. 78c(a)(4)(A)). *See also Definition of Terms in and Specific Exemptions for Banks, Savings Associations, and Savings Banks Under Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934,* Exchange Act Release No. 44291 (May 11, 2001) [66 FR 27759 (May 18, 2001)], at n.124 ("Solicitation is one of the most relevant factors in determining whether a person is effecting transactions."); *Political Contributions by Certain Investment Advisers,* Investment Advisers Act Release No. 3043 (July 1, 2010) [75 FR 41018 (July 14, 2010)], n.326 ("Pay to Play Release").

[11] *See* section 3(c)(1) of the Investment Company Act (providing an exclusion from the definition of "investment company" for any "issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities.").

[12] *See supra* note 10.

[13] *See* section 3(c)(7) of the Investment Company Act (providing an exclusion from the definition of "investment company" for any "issuer, the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers, and which is not making and does not at that time propose to make a public offering of such securities."). The term "qualified purchaser" is defined in section 2(a)(51) of the Investment Company Act.

[14] *See* rule 203(b)(3)-1(a)(2).

[15] *See* Staff Report to the united states securities and exchange Commission, Implications of the Growth of Hedge Funds, at 21 (2003), *http://www.sec.gov/news/studies/hedgefunds0903.pdf* (discussing section 203(b)(3) of the Advisers Act as in effect before July 21, 2011).

[16] *See generally id.* (noting that the private adviser exemption contributed to growth in the number and size of, and investor participation in, hedge funds).

[17] *See Registration Under the Advisers Act of Certain Hedge Fund Advisers,* Investment Advisers Act Release No. 2333 (Dec. 2, 2004) [69 FR 72054 (Dec. 10, 2004)] ("Hedge Fund Adviser Registration Release").

[18] *Goldstein v. Securities and Exchange Commission,* 451 F.3d 873 (D.C. Cir. 2006) ("*Goldstein*").

[19] Section 403 of the Dodd-Frank Act amends existing section 203(b)(3) of the Advisers Act by repealing the current private adviser exemption and inserting the foreign private adviser exemption. *See infra* Section II.C. Unlike our 2004 rule, which sought to apply only to advisers of "hedge funds," the Dodd-Frank Act requires that, unless another exemption applies, all advisers previously eligible for the private adviser exemption register with us regardless of the type of private funds or other clients the adviser has.

[20] Title IV also created exemptions and exclusions in addition to the three discussed at length in this Release. *See, e.g.,* sections 403 and 409 of the Dodd-Frank Act (exempting advisers to licensed small business investment companies from registration under the Advisers Act and excluding family offices from the definition of "investment adviser" under the Advisers Act). We proposed a rule defining "family office" in a prior release (*Family Offices,* Investment Advisers Act Release No. 3098 (Oct. 12, 2010) [75 FR 63753 (Oct. 18, 2010)]).

[21] *See* section 407 of the Dodd-Frank Act (exempting advisers solely to "venture capital funds," as defined by the Commission).

[22] *See* section 408 of the Dodd-Frank Act (directing the Commission to exempt private fund advisers with less than $150 million in aggregate assets under management in the United States).

[23] *See* section 402 of the Dodd-Frank Act (defining "foreign private adviser" as "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 in accordance with the purposes of this title; 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 [15 U.S.C. 80a]; or a company that has elected to be a business development company pursuant to section 54 of the Investment Company Act of 1940 (15 U.S.C. 80a-53), and has not withdrawn its election.").

[24] The Commission provided the public with an opportunity to present its views on various rulemaking and other initiatives that the Dodd-Frank Act required the Commission to undertake. Public views relating to our rulemaking in connection with the exemptions for certain advisers addressed in this Release are available at *http://www.sec.gov/comments/df-title-iv/exemptions/exemptions.shtml.*

[25] *Rules Implementing Amendments to the Investment Advisers Act of 1940,* Investment Advisers Act Release No. 3110 (Nov. 19, 2010).

[26] *See infra* note 30 and accompanying and following text.

[27] *See supra* note 21.

under management in the United States of less than $150 million.[28] We are proposing such an exemption in a new rule 203(m)–1, which we discuss below in Section II.B of this Release. Proposed rule 203(m)–1 includes provisions for determining the amount of an adviser's private fund assets for purposes of the exemption and when those assets are deemed managed in the United States.

The new exemptions under sections 203(l) and 203(m) provide that the Commission shall require advisers relying on them to provide the Commission with reports and keep records as the Commission determines necessary or appropriate in the public interest or for the protection of investors.[29] These new exemptions do not limit our statutory authority to examine the books and records of advisers relying upon these exemptions.[30] For purposes of this Release we will refer to these advisers as "exempt reporting advisers." In the Implementing Release, we are proposing reporting requirements for exempt reporting advisers.[31]

The third exemption, set forth in amended section 203(b)(3) of the Advisers Act, provides an exemption from registration for certain foreign private advisers. New section 202(a)(30) of the Advisers Act defines "foreign private adviser" as an investment adviser that has no place of business in the United States, has fewer than 15 clients in the United States and investors in the United States in private funds advised by the adviser,[32] and less than $25 million in aggregate assets under management from such clients and investors.[33] As discussed in Section II.C of this Release, in order to clarify the application of this new exemption, we are proposing a new rule 202(a)(30)-1, which would define a number of terms included in the statutory definition of foreign private adviser.[34]

These exemptions are not mandatory. Thus, an adviser that qualifies for any of the exemptions could choose to register (or remain registered) with the Commission, subject to section 203A of the Advisers Act, which generally prohibits from registering with the Commission most advisers that do not have at least $100 million in assets under management.[35] An adviser choosing to avail itself of the exemptions under sections 203(l), 203(m) or 203(b)(3), however, may be subject to registration by one or more state securities authorities.[36]

### A. Definition of Venture Capital Fund

We are proposing a definition of "venture capital fund" for purposes of the new exemption for investment advisers that advise solely venture capital funds.[37] Proposed rule 203(l)-1 would define the term venture capital fund consistently with what we believe Congress understood venture capital funds to be, and in light of other provisions of the federal securities laws that seek to achieve similar objectives.[38]

We understand that Congress sought to distinguish advisers to "venture capital funds" from the larger category of advisers to "private equity funds" for which Congress considered, but ultimately did not provide, an exemption.[39] As a general matter, venture capital funds are long-term investors in early-stage or small companies that are privately held, as distinguished from other types of private equity funds, which may invest in businesses at various stages of development including mature, publicly held companies.[40] Testimony received by Congress characterized venture capital funds as typically contributing substantial capital to early-stage companies [41] and generally not

[28] *See supra* note 22.

[29] *See supra* notes 21 and 22.

[30] Under section 204(a) of the Advisers Act, the Commission has the authority to require an investment adviser to maintain records and provide reports, as well as the authority to examine such adviser's records, unless the adviser is "specifically exempted" from the requirement to register pursuant to section 203(b) of the Advisers Act. Investment advisers that are exempt from registration in reliance on section 203(l) or 203(m) of the Advisers Act are not "specifically exempted" from the requirement to register pursuant to section 203(b), and thus the Commission has authority under section 204(a) of the Advisers Act to require those advisers to maintain records and provide reports and has authority to examine such advisers' records.

[31] *See* Implementing Release, *supra* note 25, at section II.B.

[32] Subparagraph (B) of section 202(a)(30) refers to number of "clients and investors in the United States in private funds," while subparagraph (C) refers to the assets of "clients *in the United States* and investors in the United States in private funds" (emphasis added). We interpret these provisions consistently so that only clients *in the United States* and investors in the United States should be included for purposes of determining eligibility for the exemption under subparagraph (B).

[33] The exemption is not available to an adviser that "acts as (I) an investment adviser to any investment company registered under the [Investment Company Act]; or (II) a company that has elected to be a business development company pursuant to section 54 of [that Act] and has not withdrawn its election." Section 202(a)(30)(D)(ii). We interpret subparagraph (II) to prevent an adviser *that advises* a business development company from relying on the exemption.

[34] Proposed rule 202(a)(30)-1 would define the following terms: (i) "client;" (ii) "investor;" (iii) "in the United States;" (iv) "place of business;" and (v) "assets under management." *See* discussion *infra* in section II.C of this Release. We are proposing rule 202(a)(30)-1 pursuant to section 211(a) of the Advisers Act, which Congress amended to explicitly provide us with the authority to define technical, trade, and other terms used in the Advisers Act. *See* section 406 of the Dodd-Frank Act.

[35] Section 203A(a)(1) of the Advisers Act generally prohibits an investment adviser regulated by the state in which it maintains its principal office and place of business from registering with the Commission unless it has at least $25 million of assets under management, and preempts certain state laws regulating advisers that are registered with the Commission. Section 410 of the Dodd-Frank Act amended section 203A(a) to also prohibit generally from registering with the Commission an investment adviser that has assets under management between $25 million and $100 million if the adviser is required to be registered with, and if registered, would be subject to examination by, the state security authority where it maintains its principal office and place of business. *See* section 203A(a)(2) of the Advisers Act. In each of subparagraphs (1) and (2) of section 203A(a), additional conditions also may apply. *See* Implementing Release, *supra* note 25, at section II.A.

[36] *See* section 203A(b)(1) of the Advisers Act (exempting from state regulatory requirements only advisers registered with the Commission). *See also infra* note 265 (discussing the application of section 222 of the Advisers Act).

[37] *See* proposed rule 203(l)–1.

[38] *See infra* notes 94, 123, 125 (discussing the history of and regulatory framework applicable to business development companies under federal securities laws).

[39] While the Senate voted to exempt private equity fund advisers in addition to venture capital fund advisers, the final Dodd-Frank Act only exempts venture capital fund advisers. *Compare* Restoring American Financial Stability Act of 2010, S. 3217, 111th Cong. § 408 (2010) (as passed by the Senate) *with* Dodd-Frank Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. (2009) (as passed by the House) ("H.R. 4173") *and* Dodd-Frank Act.

[40] *See* Testimony of Trevor Loy, Flywheel Ventures, before the Senate Banking Subcommittee on Securities, Insurance and Investment Hearing, July 15, 2009 ("Loy Testimony"), at 3; Testimony of James Chanos, Chairman, Coalition of Private Investment Companies, July 15, 2009, at 4 ("Chanos Testimony") ("Private investment companies play significant, diverse roles in the financial markets and in the economy as a whole. For example, venture capital funds are an important source of funding for start-up companies or turnaround ventures. Other private equity funds provide growth capital to established small-sized companies, while still others pursue 'buyout' strategies by investing in underperforming companies and providing them with capital and/or expertise to improve results."); Testimony of Mark Tresnowski, General Counsel, Madison Dearborn Partners, LLC, on behalf of the Private Equity Council, before the Senate Banking Subcommittee on Securities, Insurance and Investment, July 15, 2009, at 2 ("Tresnowski Testimony") (stating that private equity firms invest in broad categories of companies, including "struggling and underperforming businesses" and " promising or strong companies"). *See also* Preqin, Private Equity and Alternative Asset Glossary, *http://www.preqin.com/itemGlossary.aspx?pnl=UtoZ* (defining venture capital as "a type of private equity investment that provides capital to new or growing businesses. Venture funds invest in start-up firms and small businesses with perceived, long-term growth potential.").

[41] Loy Testimony, *supra* note 40, at 3; Testimony of Terry McGuire, General Partner, Polaris Venture Partners, and Chairman, National Venture Capital Association, before the U.S. House of Representatives Committee on Financial Services, October 6, 2009, at 3 ("McGuire Testimony") ("Our

leveraged,[42] and thus not contributing to systemic risk, a factor that appears significant to Congress' determination to exempt these advisers.[43] In drafting the proposed rule, we have sought to incorporate this Congressional understanding of the nature of investments of a venture capital fund, and these principles guided our consideration of the proposed venture capital fund definition.

This is not the first time that Congress has included special provisions to the federal securities laws for these types of private funds and the advisers that advise them. In 1980, in an effort to promote capital raising by small businesses,[44] Congress provided exemptions from various requirements in the Investment Company Act and Advisers Act for "business development companies" (or "BDCs").[45] Congress adopted the term BDC to avoid "semantical disagreements" over what constituted a venture capital or small business company,[46] but acknowledged that the purpose of the BDC provisions was to support "venture capital" activity in capital formation for small businesses.[47] The BDC provisions and venture capital exemption reflect many similar policy considerations, and thus in drafting the definition of "venture capital fund," we have looked, in part, to language Congress previously used to describe these types of funds.

As described in more detail below, we propose to define a venture capital fund as a private fund that: (i) Invests in equity securities of private companies in order to provide operating and business expansion capital (*i.e.,* "qualifying portfolio companies," which are discussed below) and at least 80 percent of each company's securities owned by the fund were acquired directly from the qualifying portfolio company; (ii) directly, or through its investment advisers, offers or provides significant managerial assistance to, or controls, the qualifying portfolio company; (iii) does not borrow or otherwise incur leverage (other than limited short-term borrowing); (iv) does not offer its investors redemption or other similar liquidity rights except in extraordinary circumstances; (v) represents itself as a venture capital fund to investors; and (vi) is not registered under the Investment Company Act and has not elected to be treated as a BDC.[48] We also propose to grandfather an existing fund as a venture capital fund if it satisfies certain criteria under the grandfathering provision.[49] An adviser would be eligible to rely on the exemption under section 203(l) of the Advisers Act (the "venture capital exemption") only if it solely advised venture capital funds that met all of the elements of the proposed definition or if it were grandfathered.

1. Qualifying Portfolio Companies

We propose to define a venture capital fund for the purposes of the exemption as a fund that invests in equity securities issued by "qualifying portfolio companies," which we define generally as any company that: (i) Is not publicly traded; (ii) does not incur leverage in connection with the investment by the private fund; (iii) uses the capital provided by the fund for operating or business expansion purposes rather than to buy out other investors; and (iv) is not itself a fund (*i.e.,* is an operating company).[50] In addition to equity securities, the venture capital fund may also hold cash (and cash equivalents) and U.S. Treasuries with a remaining maturity of 60 days or less.[51] We understand each of the criteria to be characteristic of issuers of portfolio securities held by venture capital funds.[52] Moreover, collectively, these criteria would operate to exclude most other private equity funds and hedge funds from the definition. We describe each element of a qualifying portfolio company below.

a. Private Companies

We propose to define a venture capital fund as a fund that invests in equity securities of qualifying portfolio companies and cash and cash equivalents and U.S. Treasuries with a remaining maturity of 60 days or less.[53] At the time of each investment by the venture capital fund, the portfolio company could not be publicly traded nor could it control, be controlled by, or be under common control with, a publicly traded company.[54] Under the proposed definition, a venture capital fund could continue to hold securities of a portfolio company that subsequently becomes public.

Venture capital funds provide operating capital to companies in the early stages of their development with the goal of eventually either selling the company or taking it public.[55] Unlike

job is to find the most promising, innovative ideas, entrepreneurs, and companies that have the potential to grow exponentially with the application of our expertise and venture capital investment. Often these companies are formed from ideas and entrepreneurs that come out of university and government laboratories—or even someone's garage."). *See also* National Venture Capital Association Yearbook 2010, at 7–8 (noting that venture capital is a "long-term investment" and the "payoff [to the venture capital firm] comes after the company is acquired or goes public") ("NVCA Yearbook 2010"); Private Equity Growth Capital Council, Private Equity: Frequently Asked Questions, *http://www.privateequitycouncil.org/just-the-facts/private-equity-frequently-asked-questions/* (noting that venture capital funds focus on "start-up and young companies with little or no track record," whereas buyout and growth funds focus on more mature businesses).

[42] Loy Testimony, *supra* note 40, at 3. *See also* McGuire Testimony, *supra* note 41, at 3–4 ("most limited partnership agreements [of venture capital funds] * * * prohibit [the venture capital fund] from any type of long term borrowing. * * * Leverage is not part of the equation because start-ups do not typically have the ability to sustain debt interest payments and often do not have collateral that lenders desire. In fact most of our companies are not profitable and require our equity to fund their losses through their initial growth period.").

[43] *See* S. Rep. No. 111–176, *supra* note 7, at 74–5 (noting that venture capital funds "do not present the same risks as the large private funds whose advisers are required to register with the SEC under this title [IV]. Their activities are not interconnected with the global financial system, and they generally rely on equity funding, so that losses that may occur do not ripple throughout world markets but are borne by fund investors alone. Terry McGuire, Chairman of the National Venture Capital Association, wrote in congressional testimony that 'venture capital did not contribute to the implosion that occurred in the financial system in the last year, nor does it pose a future systemic risk to our world financial markets or retail investors.'"). *See also* Loy Testimony, *supra* note 40, at 7 (noting the factors by which the venture capital industry is exposed to "entrepreneurial and technological risk not systemic financial risk").

[44] *See* H. Rep. No. 96–1341, at 21–22 (1980) ("1980 House Report").

[45] *See infra* note 123 for a discussion of these definitions.

[46] *See* 1980 House Report, *supra* note 44, at 22.

[47] *See id.,* at 21.

[48] Proposed rule 203(l)–1(a).

[49] Proposed rule 203(l)–1(b).

[50] Proposed rule 203(l)–1(c)(4).

[51] Proposed rule 203(l)–1(a)(2).

[52] *See infra* sections II.A.1.a–II.A.1.e of this Release.

[53] Proposed rule 203(l)–1(a)(2).

[54] Proposed rule 203(l)–1(c)(4)(i); proposed rule 203(l)–1(c)(3) (defining a "publicly traded" company as one that is subject to the reporting requirements under section 13 or 15(d) of the Exchange Act, or has a security listed or traded on any exchange or organized market operating in a foreign jurisdiction). This definition is similar to rule 2a51–1 under the Investment Company Act (defining "public company," for purposes of the qualified purchaser standard, as "a company that files reports pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934") and rule 12g3–2 under the Exchange Act (conditioning a foreign private issuer's exemption from registering securities under section 12(g) of the Exchange Act if, among other conditions, the "issuer is not required to file or furnish reports" pursuant to section 13(a) or section 15(d) of the Exchange Act). Under the proposed rule, securities of a publicly traded company, as defined, would include securities of non-U.S. companies that are listed on a non-U.S. market or non-U.S. exchange. Some securities that are "pink sheets" (*i.e.,* generally over-the-counter securities that are quoted on an electronic quotation system operated by Pink OTC Markets) are not subject to the reporting requirements under sections 13 and 15(d) of the Exchange Act and would not be publicly traded for purposes of the proposed rule.

[55] *See* Chanos Testimony, *supra* note 40, at 4 ("[V]enture capital funds are an important source of funding for start-up companies or turnaround ventures."); NVCA Yearbook 2010, *supra* note 41, at 7–8 (noting that venture capital is a "long-term

Continued

other types of private funds, venture capital funds do not trade in the public markets, but may sell portfolio company securities into the public markets once the portfolio company has matured.[56] As of year-end 2009, U.S. venture capital funds managed approximately $179.4 billion in assets.[57] In comparison, as of year-end 2009, the U.S. publicly traded equity market had a market value of approximately $13.7 trillion,[58] whereas global hedge funds had approximately $1.4 trillion in assets under management.[59] As a consequence, the aggregate amount invested in venture capital funds is considerably smaller, and Congressional testimony asserted that these funds may be less connected with the public markets and may involve less potential for systemic risk.[60] This appears to be a key consideration by Congress that led to the enactment of the venture capital exemption.[61]

We request comment on our proposed approach. We considered more narrow definitions, such as defining a qualifying portfolio company as a "start-up company" or "small company." [62] There appears to be little consensus, however, as to what a start-up company is. A company may be considered a "start-up" business depending on when it was formed as a legal entity,[63] whether it employs workers or paid employment taxes,[64] or whether it has generated revenues.[65] Defining a portfolio company based on any one of these factors may inadvertently exclude too many start-up portfolio companies. For example, solely relying on the age of the company (*e.g.,* first year since incorporation) fails to recognize that many companies may be incorporated for some period of time prior to initiating business operations or remain unincorporated for significant periods of time.[66] Likewise, payment of employment taxes assumes the hiring of employees, despite the fact that many new business ventures are sole proprietorships without employees.[67] Such a test could also have the unintended effect of discouraging hiring. Similarly, a bright-line revenue test set too low could exclude young or new businesses that generate significant revenues more quickly than other companies.[68] This could have the unintended consequence of venture capital funds that seek to fall within the definition investing in less promising, non-revenue generating, young companies.

We also considered defining a qualifying portfolio company as a small company. As in the case of defining "start-up," there is no single definition for what constitutes a "small company." [69] We are concerned that

investment" and the "payoff [to the venture capital firm] comes after the company is acquired or goes public."); George W. Fenn, Nellie Liang and Stephen Prowse, The Economics of the Private Equity Market, December 1995, 22, n.61 and accompanying text ("Fenn *et al.*") ("Private sales" are not normally the most important type of exit strategy as compared to IPOs, yet of the 635 successful portfolio company exits by venture capitalists between 1991–1993 "merger and acquisition transactions accounted for 191 deals and IPOs for 444 deals." Furthermore, between 1983 and 1994, of the 2,200 venture capital fund exits, 1,104 (approximately 50%) were attributed to mergers and acquisitions of venture-backed firms.). *See also* Jack S. Levin, Structuring Venture Capital, Private Equity and Entrepreneurial Transactions, 2000 ("Levin") at 1–2 to 1–7 (describing the various types of venture capital and private equity investment business but stating that "the phrase 'venture capital' is sometimes used narrowly to refer only to financing the start-up of a new business"); Anna T. Pinedo & James R. Tanenbaum, Exempt and Hybrid Securities Offerings (2009), Vol. 1 at 12–2 ("Pinedo") (discussing the role initial public offerings play in providing venture capital investors with liquidity).

[56] *See* Loy Testimony, *supra* note 40, at 5 ("We do not trade in the public markets."). *See also* McGuire Testimony, *supra* note 41, at 11 ("[V]enture capital funds do not typically trade in the public markets and generally limit advisory activities to the purchase and sale of securities of private operating companies in private transactions"); Levin, *supra* note 55, at 1–4 ("A *third* distinguishing feature of venture capital/private equity investing is that the securities purchased are generally privately held as opposed to publicly traded * * * a venture capital/private equity investment is normally made in a privately-held company, and in the relatively infrequent cases where the investment is into a publicly-held company, the [venture capital fund] generally holds non-public securities.") (emphasis in original).

[57] NVCA Yearbook 2010, *supra* note 41, at 9.

[58] Bloomberg Terminal Database, WCAUUS (Bloomberg United States Exchange Market Capitalization).

[59] See Saijel Kishan, *Hedge Funds Hold Investors "Hostage" After Decade's Best Year,* Bloomberg Businessweek, Jan. 20, 2010, available at *http://www.businessweek.com/news/2010–01–20/hedge-funds-hold-investors-hostage-after-decade-s-best-year.html.*

[60] *See supra* note 43; McGuire Testimony, *supra* note 41, at 6 (noting that the "venture capital industry's activities are not interwoven with U.S. financial markets."). *See also* Group of Thirty, Financial Reform: A Framework for Financial Stability, January 15, 2009, at 9 (discussing the need for registration of managers of "private pools of capital that employ substantial borrowed funds" yet recognizing the need to exempt venture capital from registration).

[61] *See supra* note 43.

[62] *See* S. Rep. No. 111–176, *supra* note 7, at 74 (describing venture capital funds as a subset of private investment companies, specializing in long-term equity investments in "small or start-up businesses").

[63] There is no generally accepted definition of a "start-up" entity although it is generally used to refer to new business ventures. *See, e.g.,* U.S. Census Bureau, Business Dynamics Statistics, *available at http://www.ces.census.gov/index.php/bds/bds_overview* (which tracks information on businesses, based on the size and age of the business, and assigns a "birth" year to a business beginning in the year in which it reports positive employment of workers on the payroll); The Kauffman Foundation, *Where Will the Jobs Come From?,* November 2009, at 5 (identifying "start-ups" as those firms younger than one year); Anastasia Di Carlo & Roger Kelly, *Private Equity Market Outlook* 27 (European Investment Fund, Working Paper 2010/005) (defining start-ups as companies that are "in the process of being set up or may have been in business for a short time, but have not sold their product commercially").

[64] *See, e.g.,* The Kauffman Foundation, *An Overview of the Kauffman Firm Survey, Results from the 2004–2008 Data,* May 2010, at 26 ("*Overview of the Kauffman Firm Survey*") (discussing the difficulties of compiling data on new businesses; start-up businesses were generally identified based on several factors: the payment of state unemployment taxes, the payment of Federal Insurance Contributions Act taxes, the existence of a legal entity, use of an employer identification number, and use of a schedule C to report business income on a personal tax return).

[65] *See, e.g.,* NVCA Yearbook 2010, *supra* note 41, at 61, 69, 111 (not defining "start-up" but classifying investments in "start-up/seed" companies and defining the "seed stage" of a company as "the state of a company when it has just been incorporated and its founders are developing their product or service," whereas an "early stage" company is one that is beyond the "seed stage" but has not yet generated revenues). *Cf.* PricewaterhouseCoopers MoneyTree Report Definitions, *https://www.pwcmoneytree.com/MTPublic/ns/nav.jsp?page=definitions* (last visited Sept. 23, 2010) (defining a "seed/start-up" company as one that has a concept or product in development but not yet operational and usually has been in existence for less than 18 months).

[66] According to the Kauffman Survey, in 2004, 36.0% of all start-up companies were sole proprietorships; by 2008, 34.4% of all surviving companies were sole proprietorships. *Overview of the Kauffman Firm Survey, supra* note 64, at 8.

[67] *See, e.g.,* Ying Lowrey, *Startup Business Characteristics and Dynamics: A Data Analysis of the Kauffman Firm Survey,* Aug. 2009, at 6 (Working Paper) (based on a survey sample of businesses started in 2004, reporting that 59% of all start-up companies in 2004 had zero employees; a "start-up" business was any business that met any one of the five following criteria for being a start-up: the payment of state unemployment taxes, the payment of Federal Insurance Contributions Act taxes, the existence of a legal entity, use of an employer identification number, and use of a schedule C to report business income on a personal tax return).

[68] According to the Kauffman Survey, which conducted a longitudinal study of "start-up" businesses that began in 2004, 46.5% of all such "start-up" companies in 2004 had zero revenues; by 2008, 30.2% of the surviving companies in the sample reported zero revenues. In comparison, in 2004, 15.3% of start-up companies reported revenues of more than $100,000 and in 2008, 36.1% of the surviving companies in the survey reported revenues of more than $100,000. *Overview of the Kauffman Firm Survey, supra* note 64, at 9.

[69] Among countries that are members of the Organisation for Economic Co-operation and Development, "small and medium-sized enterprises" ("SMEs") are defined as non-subsidiary, independent firms employing fewer than the number of employees as is set by each country. The definition of SME may be used to determine funding or other programs sponsored by member countries. Although the European Union generally defines SMEs as businesses with fewer than 250 employees, the United States sets the threshold at fewer than 500 employees. Moreover, "small" firms are generally defined as those with fewer than 50 employees, while micro-enterprises have at most 10, or in some cases five, workers. In 2005, the European Union adopted additional tests for small

imposing a standardized metric such as net income, the number of employees, or another single factor test could ignore the complexities of doing business in different industries or regions. As in the case of adopting a revenue-based test, there is the potential that even a low threshold for a size metric could inadvertently restrict venture capital funds from funding otherwise promising young small companies.

Other tests also present concerns. A test adopted by the California Corporations Commission and the U.S. Department of Labor requires that a venture capital company hold at least 50 percent of its assets in "operating companies," which are defined as companies primarily engaged in the production or sale of a product or services other than the investment of capital.[70] Under the California exemption, a venture capital fund could invest in older and more mature companies that qualify as "operating companies" as well as in securities issued by publicly traded companies provided that the venture capital fund obtained management rights in such publicly traded companies.[71] Hence, although the California venture capital exemption is for advisers to so-called "venture capital companies," the rule provides a much broader exemption that would include many types of private equity and other types of private funds and thus does not appear consistent with our understanding of the intended scope of section 203(l).[72] We request comment on any of these approaches or alternative ones that we have not discussed.[73]

We also request comment on our approach to "follow-on" investments.[74] Under our proposed rule, a qualifying portfolio company is defined to include a company that is not publicly traded (or controlled by a publicly traded company) at the time of each fund investment,[75] but would not exclude a portfolio company that ultimately becomes a successful venture capital investment (typically when the company is taken "public"). Under this approach, an adviser could continue to rely on the exemption even if the venture capital fund's portfolio ultimately consisted entirely of publicly traded securities, a result that could be viewed as inconsistent with section 203(l) of the Advisers Act. We believe that our proposed approach would give advisers to venture capital funds sufficient flexibility to exercise their business judgment on the appropriate time to dispose of portfolio company investments—which may occur at a time when the company is privately held or publicly held.[76] Moreover, under the federal securities laws, a person that is deemed to be an affiliate of a publicly traded company may be limited in its ability to dispose of publicly traded securities.[77] Would our proposed approach to follow-on investments accommodate the way venture capital funds typically invest? Are there circumstances in which a venture capital fund would provide follow-on investments in a company that has become public? Should the rule specifically provide that a venture capital fund includes a fund that invests a limited percentage of its capital in publicly traded securities under certain circumstances (*e.g.,* a follow-on investment in a company in which the fund's previous investments were made when the company was private)? If so, what is the appropriate percentage threshold (*e.g.,* 5, 10 or 20 percent)?

We request comment on whether our definition should exclude any venture capital fund that holds any publicly traded securities or a specified percentage of publicly traded portfolio company securities. What percentage

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businesses, defining small business (*i.e.,* 10–49 employees) as those with no more than €10 million in annual revenue and no more than €10 million in assets as evidenced on their annual balance sheet. *See, e.g.,* Organisation for Economic Co-operation and Development, Glossary of Statistical Terms, *http://stats.oecd.org/glossary/detail.asp?ID=3123.*

Under one regulatory framework in the United States, a business may be considered "small" depending on the specified number of employees or the net worth or net income of such business. Separate tests are specified for a business based on various factors, such as the size of the industry, its geographical concentration, and the number of market participants. *See, e.g.,* Small Business Administration, SBA Size Standards Methodology (Apr. 2009) at 8, *http://www.sba.gov/idc/groups/public/documents/sba_homepage/size_standards_methodology.pdf* (noting that the Small Business Administration ("SBA") decided to apply the net worth and net income measures to its Small Business Investment Company ("SBIC") financing program because investment companies typically evaluate businesses using these measures when determining whether or not to invest). For example, under the SBIC program administered by the SBA, SBA loans may be made to SBICs that invest in companies that are "small" (usually defined as having a net worth of $18 million or less and an average after-tax net income for the prior two years of no more than $6 million, although there are specific tests depending on the industry of the company that may be based on net income, net worth or number of employees). The size requirement is codified at 13 CFR 121.301(c)(2). *See* SBA, Investment Program Summary, *http://www.sba.gov/financialassistance/borrowers/vc/sbainvp/index.html.*

[70] Under section 260.204.9 of the California Code of Regulations (the "California VC exemption"), an adviser is exempt from the requirement to register if it provides investment advice only to "venture capital companies," which are generally defined as entities that, on at least one annual occasion (commencing with the first annual period following the initial capitalization), have at least 50% of their assets (other than short-term investments pending long-term commitment or distribution to investors), valued at cost, in "venture capital investments." A venture capital investment is defined as an acquisition of securities in an operating company as to which the adviser has or obtains management rights. *See* Cal. Code Regs. tit. 10, § 260.204.9(a), (b)(3), (b)(4) (2010). An "operating company" is defined to mean any entity "primarily engaged, directly or through a majority owned subsidiary or subsidiaries, in the production or sale (including any research or development) of a product or service other than the management or investment of capital but shall not include an individual or sole proprietorship." *Id.* tit. 10, § 260.204.9(b)(7). "Management rights" is defined as the "right, obtained contractually or through ownership of securities . . . to substantially participate in, to substantially influence the conduct of, or to provide (or offer to provide) significant guidance and counsel concerning, the management, operations or business objectives of the operating company in which the venture capital investment is made." *Id.* tit. 10, § 260.204.9(b)(6). Management rights may be held by the adviser, the fund or an affiliated person of the adviser, and may be obtained either through one person or through two or more persons acting together. *Id.*

The U.S. Department of Labor regulations ("VCOC exemption") are similar to the California VC exemption. The regulations define "operating company" to mean an entity that is "primarily engaged, directly or through a majority owned subsidiary or subsidiaries, in the production or sale of a product or service other than the investment of capital. The term 'operating company' includes an entity that is not described in the preceding sentence, but that is a 'venture capital operating company' described in paragraph (d) or a 'real estate operating company' described in paragraph (e)." 29 CFR 2510.3–101(c)(1). The regulations define a venture capital operating company ("VCOC") as any entity that, as of the date of the first investment (or other relevant time), has at least 50% of its assets (other than short-term investments pending long-term commitment or distribution to investors), valued at cost, invested in venture capital investments. 29 CFR 2510.3–101(d). A venture capital investment is defined as "an investment in an operating company (other than a venture capital operating company) as to which the investor has or obtains management rights" that are "contractual rights * * * to substantially participate in, or substantially influence the conduct of, the management of the operating company." 29 CFR 2510.3–101(d)(3).

[71] *See* Cal. Code Reg. tit. 10, § 260.204.9.

[72] The California VC exemption does not limit permitted investments to companies that are start-up or privately held companies, which were cited as characteristic of venture capital investing in testimony to Congress. *See* McGuire Testimony, *supra* note 41; Loy Testimony, *supra* note 40.

[73] *See* Letter of Keith P. Bishop (July 28, 2009) (recommending elements of the California VC exemption). *Cf.* Letter of P. James (August 21, 2010) (expressing the view that the provision of management services does not distinguish venture capital from private equity). We received these letters in response to our request for public views on rulemaking and other initiatives under the Dodd-Frank Act. *See generally supra* note 24.

[74] *See, e.g.,* Loy Testimony, *supra* note 40, at 3 (discussing the role of follow-on investments); NVCA Yearbook 2010, *supra* note 41, at 34 (statistics comparing initial investments versus follow-on investments made by venture capital funds at Figure 3.15).

[75] *See* proposed rule 203(l)–1(c)(4)(i).

[76] *See supra* note 55.

[77] *See, e.g.,* rule 144 under the Securities Act (17 CFR 230.144) (prohibiting the resale of certain restricted and control securities by "affiliates" unless certain conditions are met).

would be appropriate? What percentage would give venture capital funds sufficient flexibility to dispose of their publicly traded securities? Would 30 or 40 percent of the value of a venture capital fund's assets be appropriate? [78] Should the rule specify that publicly traded securities may only be held for a limited period of time, such as one-year, or that a venture capital fund's entire portfolio may not consist only of publicly traded securities except for a limited period of time, such as one-year or other period?

b. Equity Securities, Cash and Cash Equivalents and Short-Term U.S. Treasuries.

We propose to define venture capital fund for purposes of the exemption as a fund that invests in equity securities of qualifying portfolio companies, cash and cash equivalents and U.S. Treasuries with a remaining maturity of 60 days or less.[79] Under our proposed definition, a fund would not qualify as a venture capital fund for purposes of the exemption if it invested in debt instruments (unless they met the definition of "equity security") of a portfolio company or otherwise lent money to a portfolio company, strategies that are not the typical form of venture capital investing.[80] Congress received testimony that, unlike other types of private funds, venture capital funds "invest cash in return for an equity share of the company's stock." [81] As a consequence, venture capital funds avoid using financial leverage, and leverage appears to have raised systemic risk concerns for Congress.[82] Should our definition of venture capital fund include funds that invest in debt, or certain types of debt, issued by qualifying portfolio companies, or make certain types of loans to qualifying portfolio companies? We understand that some venture capital funds may extend "bridge" financing to portfolio companies in anticipation of a future round of venture capital investment.[83] Such financings may take the form of investment in instruments that are ultimately convertible into a portfolio company's common or preferred stock at a subsequent investment stage and thus would meet the definition of "equity security." [84] Should our definition include any fund that extends bridge financing that does not meet the definition of "equity security" on a short-term limited basis to a qualifying portfolio company? Should our definition be limited to those funds that make bridge loans to a portfolio company that are convertible into equity funding only in the next round of venture capital investing? Under our proposed definition, debt investments or loans with respect to qualifying portfolio companies that did not meet the definition of "equity security" could not be made by a fund seeking to qualify as a venture capital fund. Should we modify the proposed rule so that such investments and loans could be made subject to a limit? If so, what would be an appropriate limit (*e.g.,* 5 or 10 percent) and how should the limit be determined (*e.g.,* as a percentage of the fund's capital commitments)?

We propose to use the definition of equity security in section 3(a)(11) of the Securities Exchange Act of 1934 ("Exchange Act") and rule 3a11–1 thereunder.[85] This definition is broad, and includes common stock as well as preferred stock, warrants and other securities convertible into common stock in addition to limited partnership interests.[86] This definition would include various securities in which venture capital funds typically invest and would provide venture capital funds with flexibility to determine which equity securities in the portfolio company capital structure are appropriate for the fund.[87] We request comment on the use of this definition. Should we consider a more limited definition of equity security? Do venture capital funds typically invest in other types of equity securities that are not covered by the proposed definition?

Under the proposed rule, we define a venture capital fund for purposes of the exemption as a fund that holds cash and cash equivalents or short-term U.S. Treasuries, in recognition of the manner in which venture capital funds operate.[88] A venture capital fund may hold cash funded by its investors until the cash is allocated to an investment opportunity; subsequently, upon liquidation of the investment, the venture capital fund will receive cash as a return on its investment, which is then distributed to the fund's investors.[89] Thus, pending receipt of all

[78] *Cf.* note 94 (discussing limits applicable to BDCs).

[79] Proposed rule 203(l)–1(a)(2).

[80] *See* Loy Testimony, *supra* note 40, at 2, 4; Pinedo, *supra* note 55, Vol. 1 at 12–2; Levin, *supra* note 55, at 1–5 (noting that venture capital funds focus on "common stock or common equivalent securities, with any purchase of subordinated debentures and/or preferred stock generally designed merely to fill a hole in the financing or to provide [the venture capitalist] with some priority over management in liquidation or return of capital"). *See also* Jesse M. Fried and Mira Ganor, *Agency Costs of Venture Capitalist Control in Startups,* 81 N.Y.U. Law Journal 967, 970 (2006) (venture capital funds investing in U.S. start-ups "almost always receive convertible preferred stock"); Fenn *et al.*, *supra* note 55, at 32.

[81] McGuire Testimony, *supra* note 41, at 4; Loy Testimony, *supra* note 40, at 2.

[82] *See infra* section II.A.3 of this Release.

[83] *See, e.g.,* Darian M. Ibrahim, *Debt as Venture Capital,* 4 U. Ill. L. Rev. 1169, 1173, 1206 (2010) ("VCs sometimes [provide] bridge loans to their portfolio companies * * * [A] bridge loan * * * is [essentially] about 'funding to subsequent rounds of equity' rather than relying on the underlying start-up's ability to repay the loan through cash flows."); Alan Olsen, *Venture Capital Financing: Structure and Pricing,* VirtualStreet (July 25, 2010), *available at http://www20.csueastbay.edu/news/2010/07/alan-olsen-venture-capital.html* ("Bridge financing is designed as temporary financing in cases where the company has obtained a commitment for financing at a future date, which funds will be used to retire the debt."); Thomas Flynn, *Venture Capital: Current Trends and Lessons Learned,* Ventures and Intellectual Property Letter (2003), *available at http://www.shipmangoodwin.com/publications/Detail.aspx?pub=194* ("The bridge financing, intended to take the cash strapped company either to the next full round of venture investment or alternatively to a liquidity event or wind-up, has become a familiar fixture in the life cycle of a venture-backed company.").

[84] Provided such financings were structured to satisfy the definition of equity security, we would view such transactions to satisfy the definition of qualifying portfolio company under proposed rule 203(l)–1(c)(4)(ii).

[85] *See* 15 U.S.C. 78c(a)(11) (defining "equity security" as "any stock or similar security; or any security future on any such security; or any security convertible, with or without consideration, into such a security, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right; or any other security which the Commission shall deem to be of similar nature and consider necessary or appropriate, by such rules and regulations as it may prescribe in the public interest or for the protection of investors, to treat as an equity security."); rule 3a11–1 under the Exchange Act (17 CFR 240.3a11–1) (defining "equity security" to include "any stock or similar security, certificate of interest or participation in any profit sharing agreement, preorganization certificate or subscription, transferable share, voting trust certificate or certificate of deposit for an equity security, limited partnership interest, interest in a joint venture, or certificate of interest in a business trust; any security future on any such security; or any security convertible, with or without consideration into such a security, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right; or any put, call, straddle, or other option or privilege of buying such a security from or selling such a security to another without being bound to do so.").

[86] *See* rule 3a11–1 under the Exchange Act (17 CFR 240.3a11–1) (defining "equity security" to include any "limited partnership interest").

[87] Our proposed use of the definition of equity security under the Exchange Act acknowledges that venture capital funds typically invest in common stock and other equity instruments that may be convertible into equity common stock. *See supra* note 80. Our proposed definition does not otherwise specify the types of equity instruments that a venture capital fund could hold in deference to the business judgment of venture capital investors.

[88] Proposed rule 203(l)–1(a)(2)(ii).

[89] "[T]he capital supplied to a venture capital fund consists entirely of equity commitments provided as cash from investors in installments on an as-needed basis. * * * The 'capital calls' for investments generally happen in cycles over the full life of the fund on an 'as needed' basis as investments are identified by the general partners and then as further rounds of investment are made into the portfolio companies." Loy Testimony, *supra* note 40, at 2; Paul A. Gompers & Josh Lerner,

capital commitments from investors or pending distribution of such proceeds to investors, a venture capital fund could hold cash and cash equivalents and short-term U.S. Treasuries.[90] We define "cash and cash equivalents" by reference to rule 2a51–1(b)(7)(i) under the Investment Company Act.[91] Rule 2a51–1, however, is used to determine whether an owner of an investment company excluded by reason of section 3(c)(7) of the Investment Company Act meets the definition of a qualified purchaser by examining whether such owner holds sufficient "investments" (generally securities and other assets held for investment purposes).[92] We do not propose to define a venture capital fund's cash holdings by reference to whether the cash is held "for investment purposes" or to the net cash surrender value of an insurance policy. Furthermore, since rule 2a51–1 does not explicitly include short-term U.S. Treasuries, which we believe would be an appropriate form of cash equivalent for a venture capital fund to hold pending investment in a portfolio company or distribution to investors, our rule would include short-term U.S. Treasuries with a remaining maturity of 60 days or less among the investments a venture capital fund could hold.[93] Should we specify a shorter or longer period of remaining maturity for U.S. Treasuries?

We request comment on whether the proposed rule's provision for cash holdings is too broad or too narrow. Should the rule only specify that cash be held in anticipation of investments, or in connection with the payment of expenses or liquidations from underlying portfolio companies? Are there other types of cash instruments in which venture capital funds typically invest and/or that should be reflected in the proposed rule?

We do not propose to define venture capital fund for purposes of the exemption as one that invests solely in U.S. companies. In contrast, the BDC provisions in the Investment Company Act generally limit the exemption to U.S. companies and require that permitted investments generally be made in U.S. companies.[94] However, as we discuss below, there is no indication in the legislative record that Congress intended the venture capital exemption would be available only to U.S. advisers or to advisers that invest fund assets solely in U.S. companies.[95] Should our proposed definition similarly define a venture capital fund as a fund formed under the laws of the United States and/or that invests exclusively or primarily in U.S. portfolio companies or a sub-set of such companies (*e.g.,* U.S. companies operating in non-financial sectors)? Are venture capital funds that invest in non-U.S. portfolio companies more or less likely to have financial relationships that may pose systemic risk issues, a rationale that was presented and appeared significant to Congress in exempting advisers to venture capital funds?

c. Portfolio Company Leverage

Proposed rule 203(l)–1 would define a qualifying portfolio company for purposes of the exemption as one that does not borrow, issue debt obligations or otherwise incur leverage in connection with the venture capital fund's investments.[96] As a consequence, certain types of funds that use leverage or finance their investments in portfolio companies or the buyout of existing investors with borrowed money (*e.g.,* leveraged buyout funds, which are a different subset of private equity funds) would not meet the proposed rule's definition of a venture capital fund.[97] As discussed in greater detail below, we believe that Congress did not intend the venture capital fund definition to apply to these other types of private equity funds.[98] This definition of qualifying portfolio company would only exclude companies that borrow in connection with a venture capital fund's investment, but would not exclude companies that borrow in the ordinary course of their business (*e.g.,* to finance inventory or capital equipment, manage cash flows, and meet payroll). We would generally view any financing or loan (unless it met the definition of equity security) to a portfolio company that was provided by, or was a condition of a contractual obligation with, a fund or its adviser as part of the fund's investments as being a type of financing that is "in connection with" the fund's investment, although we recognize that other types of financings may also be "in connection with" a fund's investment. Should we provide guidance on other types of financing transactions as being "in connection with" a fund's investment in a qualifying portfolio company? If so, what types of financing transactions should such guidance address? We propose this element of the qualifying portfolio company definition because of the focus on leverage in the Dodd-Frank Act as a potential contributor to systemic risk as discussed by the Senate Committee report,[99] and the testimony

The Venture Capital Cycle, at 459 (MIT Press 2004) ("Gompers & Lerner") ("Venture capitalists can liquidate their position in the company by selling shares on the open market and then paying those proceeds to investors in cash.").

[90] Proposed rule 203(l)–1(a)(2)(ii).

[91] Rule 2a51–1(b)(7) under the Investment Company Act provides that cash and cash equivalents include foreign currencies "held for investment purposes" and "(i) [b]ank deposits, certificates of deposit, bankers acceptances and similar bank instruments held for investment purposes; and (ii) [t]he net cash surrender value of an insurance policy." 17 CFR 270.2a51–1(b)(7).

[92] *See generally* sections 2(a)(51) and 3(c)(7) of the Investment Company Act; 17 CFR 270.2a51(b) and (c).

[93] We have treated debt securities with maturities of 60 days or less differently than debt securities with longer maturities under our rules. In particular, we have recognized that the potential for fluctuation in those shorter-term securities' market value has decreased sufficiently that, under certain conditions, we allow certain open-end investment companies to value them using amortized cost value rather than market value. *See Valuation of Debt Instruments by Money Market Funds and Certain Other Open-End Investment Companies,* Investment Company Act Release No. 9786 (May 31, 1977) [42 FR 28999 (June 7, 1977)]. We believe that the same consideration warrants treating U.S. Treasury securities with a remaining maturity of 60 days or less as more akin to cash equivalents than Treasuries with longer maturities for purposes of the definition of venture capital fund.

[94] *See* sections 2(a)(46) and 2(a)(48) of the Investment Company Act. Under section 55 of the Investment Company Act, a BDC is prohibited from acquiring any assets, except for permitted assets, unless, at the time the acquisition is made, permitted assets "represent at least 70 per centum of the value of [the BDC's] total assets." Permitted assets for this purpose generally mean securities of an "eligible portfolio company," which is defined in section 2(a)(46) of the Investment Company Act.

[95] *See infra* section II.A.8 of this Release.

[96] Proposed rule 203(l)–1(c)(4)(ii) (setting forth this requirement as a condition for the portfolio company to qualify as a "qualifying portfolio company").

[97] A leveraged buyout fund is a private equity fund that will "borrow significant amounts from banks to finance their deals—increasing the debt-to-equity ratio of the acquired companies." U.S. Govt. Accountability Office, Private Equity: Recent Growth in Leveraged Buyouts Exposed Risks that Warrant Continued Attention (2008) ("GAO Private Equity Report"), at 1. A leverage buyout fund in 2005 typically financed a deal with 34% equity and 66% debt. *Id.* at 13. *See also* Fenn *et al., supra* note 55, at 23 (companies that have been taken private in an LBO transaction generally "spend less on research and development, relative to assets, and have a greater proportion of fixed assets; their debt-to-assets ratios are high, above 60%, and are two to four times those of venture-backed firms." Moreover, compared to venture capital backed companies, LBO-private equity backed companies that are taken public typically use proceeds from an IPO to reduce debt whereas new venture capital backed firms tend to use proceeds to fund growth.); Tresnowski Testimony, *supra* note 40, at 2 (indicating that portfolio companies in which private equity funds invest typically have 60% debt and 40% equity).

[98] *See infra* discussion in section II.A.1.d of this Release.

[99] *See* S. Rep. No. 111–176, *supra* note 7, at 74 ("The Committee believes that venture capital funds, a subset of private investment funds specializing in long-term equity investment in small or start-up businesses, do not present the same risks as the large private funds whose advisers are required to register with the SEC under this title."); *id.* at 75 (concluding that private funds that use limited or no leverage at the fund level engage in

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before Congress that stressed the lack of leverage in venture capital investing.[100] Should we use a test other than whether the loan is "in connection with" the fund's investments? For example, should the test be whether the portfolio company currently intends to borrow at the time of the fund's investment? Should the test depend only on how the portfolio company uses the proceeds of borrowing, such as by excluding companies that use proceeds to buyout investors or return capital to a fund?

Venture capital has been described as investing in companies that cannot borrow from the usual lending sources.[101] Should we define a qualifying portfolio company as a company that does not incur certain specified types of borrowing or other forms of leverage? Would such a definition narrow the current range of portfolio companies in which venture capital funds typically invest?

d. Capital Used for Operating and Business Purposes

Under proposed rule 203(l)–1, a venture capital fund is defined as a fund that holds equity securities of qualifying portfolio companies, and at least 80 percent of each company's equity securities owned by the venture capital fund were acquired directly from each such qualifying portfolio company.[102] This element reflects the distinction between venture capital funds that provide capital to portfolio companies for operating and business purposes (in exchange for an equity investment) and leveraged buyout funds, which acquire controlling equity interests in operating companies through the "buy out" of existing security holders. Hence, in addition to the definitional element that a venture capital fund is one that does not redeem or repurchase securities from other shareholders (*i.e.*, a "buyout"), a related criterion in the rule specifies that a qualifying portfolio company is one that does not distribute company assets to other security holders in connection with the venture capital fund's investment in the company (which could be an indirect buyout).[103]

One of the distinguishing features of venture capital funds is that, unlike many hedge funds and private equity funds, they invest capital directly in portfolio companies for the purpose of funding the expansion and development of the company's business rather than buying out existing security holders, otherwise purchasing securities from other shareholders, or leveraging the capital investment with debt financing.[104] Testimony received by Congress and our research suggest that venture capital funds provide capital to many types of businesses at different stages of development,[105] generally with the goal of financing the expansion of the company[106] and helping it progress to the next stage of its development through successive tranches of investment (*i.e.*, "follow-on" investments) if the company reaches agreed-upon milestones.[107]

In contrast, private equity funds that are identified as buyout funds typically provide capital to an operating company in exchange for majority or complete ownership of the company,[108] generally achieved through the buyout of existing shareholders or other security holders and financed with debt incurred by the portfolio company,[109] and compared to venture capital funds, hold the investment for shorter periods of time.[110] As a result of the use of the capital provided and the incurrence of this debt, following the buyout fund investment, the operating company may carry debt several times its equity and may devote significant levels of its cash flow and corporate earnings to repaying the debt financing, rather than investing in capital improvement or business operations.[111]

activities that do not pose risks to the wider markets through credit or counterparty relationships).

[100] *See* Loy Testimony, *supra* note 40, at 6 (noting that "many venture capital funds significantly limit borrowing"). *See also* McGuire Testimony, *supra* note 41, at 7 ("Not only are our partnerships run without debt but our portfolio companies are usually run without debt as well.").

[101] *See* Loy Testimony, *supra* note 40, at 3. *See also* James Schell, Private Equity Funds: Business Structure and Operations (2010), at § 1.03[1] ("Schell") ("Venture Capital Funds provide investment capital to business enterprises early in their development cycle at a time when access to conventional financing sources is non-existent or extremely limited.").

[102] Proposed rule 203(l)–1(a)(2)(i).

[103] Proposed rule 203(l)–1(c)(4)(iii).

[104] *See* Loy Testimony, *supra* note 40, at 2 ("Although venture capital funds may occasionally borrow on a short-term basis immediately preceding the time when the cash installments are due, they do not use debt to make investments in excess of the partner's capital commitments or 'lever up' the fund in a manner that would expose the fund to losses in excess of the committed capital or that would result in losses to counter parties requiring a rescue infusion from the government."). *See also infra* notes 109–111; Mark Heesen & Jennifer C. Dowling, National Venture Capital Association, *Venture Capital & Adviser Registration,* materials submitted in connection with the Commission's Government-Business Forum on Small Business Capital Formation ("Heesen") (summarizing the differences between venture capital funds and buyout and hedge funds), *available at http://www.sec.gov/info/smallbus/2010gbforumstatements.htm.*

[105] *See, e.g.,* McGuire Testimony, *supra* note 41, at 1; NVCA Yearbook 2010, *supra* note 41; PricewaterhouseCoopers/National Venture Capital Association MoneyTree Report, Q4 2009/Full-year 2009 Report (providing data on venture capital investments in portfolio companies); Schell, *supra* note 101, at § 1.03[1]; Gompers & Lerner, *supra* note 89, at 178, 180 table 8.2 (displaying percentage of annual venture capital investments by stage of development and classifying "early stage" as seed, start-up, or early stage and "late stage" as expansion, second, third, or bridge financing).

[106] *See* McGuire Testimony, *supra* note 41, at 1; Loy Testimony, *supra* note 40, at 3 ("Once the venture fund is formed, our job is to find the most promising, innovative ideas, entrepreneurs, and companies that have the potential to grow exponentially with the application of our expertise and venture capital investment."). *See also* William A. Sahlman, *The Structure and Governance of Venture-Capital Organizations,* Journal of Financial Economics 27 (1990), at 473, 503 ("Sahlman") (noting venture capitalists typically invest more than once during the life of a company, with the expectation that each capital investment will be sufficient to take the company to the next stage of development, at which point the company will require additional capital to make further progress).

[107] *See* Sahlman, at 503; Loy Testimony, *supra* note 40, at 3 ("[W]e continue to invest additional capital into those companies that are performing well; we cease follow-on investments into companies that do not reach their agreed upon milestones.").

[108] GAO Private Equity Report, *supra* note 97, at 8 ("A private equity-sponsored LBO generally is defined as an investment by a private equity fund in a public or private company (or division of a company) for majority or complete ownership.").

[109] *See* Annalisa Barrett *et al.*, Prepared by the Corporate Library Inc., under contract for the IRRC Institute, What is the Impact of Private Equity Buyout Fund Ownership on IPO Companies' Corporate Governance?, at 7 (June 2009) ("Barrett *et al.*") ("In general, VC firms provide funding to companies in early stages of their development, and the money they provide is used as working capital for the firm. Buyout firms, in contrast, work with mature companies, and the funds they provide are used to compensate the firm's existing owners."); Ieke van den Burg and Poul Nyrup Rasmussen, Hedge Funds and Private Equity: A Critical Analysis (2007), at 16–17 ("van den Burg"); Sahlman, *supra* note 106, at 517. *See also* Tax Legislation: CRS Report, Taxation of Hedge Fund and Private Equity Managers, Tax Law and Estate Planning Course Handbook Series, Practicing Law Institute (Nov. 2, 2007) at 2 (noting that in a leveraged buyout "private equity investors use the proceeds of debt issued by the target company to acquire all the outstanding shares of a public company, which then becomes private").

[110] Unlike venture capital funds, which generally invest in portfolio companies for 10 years or more, private equity funds that use leveraged buyouts invest in their portfolio companies for shorter periods of time. *See* Loy Testimony, *supra* note 40, at 3 (citing venture capital fund investments periods in portfolio companies of five to 10 years or longer); van den Burg, at 19 (noting that LBO investors generally retain their investment in a listed company for 2 to 4 years or even less after the company goes public). *See also* Paul A. Gompers, *The Rise and Fall of Venture Capital,* Business And Economic History, vol. 23, no. 2, Winter 1994, at 17 ("Gompers") (stating that "an LBO investment is significantly shorter than that of a comparable venture capital investment. Assets are sold off almost immediately to meet debt burden, and many companies go public again (in a reverse LBO) in a very short period of time").

[111] *See* Barrett *et al.*, *supra* note 109. *See also* Fenn *et al.*, *supra* note 55, at 23 (when comparing venture capital backed companies that are taken public to LBO-private equity backed companies that are taken public, the common use of proceeds from an IPO are used by LBO-private equity backed companies to reduce debt whereas new firms use proceeds to fund growth).

We believe that these differences (*i.e.*, the use of buyouts and associated leverage) distinguish venture capital funds from buyout private equity funds for which Congress did not provide an exemption.[112] Under our proposed rule, an exempt adviser relying on section 203(l) of the Advisers Act would not be eligible for the exemption if it advised these types of private equity funds that in effect acquire a majority of the equity securities of portfolio companies directly from other security holders.[113] Correspondingly, we also propose to define a qualifying portfolio company for purposes of the exemption as one that does not redeem or repurchase outstanding securities in connection with a venture capital fund's investment.[114] Because at least 80 percent of each portfolio company's equity securities in which the fund invests must be acquired directly from the portfolio company, a venture capital fund relying on the exemption could purchase the remainder of the securities directly from existing shareholders (*i.e.*, a "buyout"). Under our proposed definition, however, a company that achieves an indirect buyout of its security holders, such as through the complete recapitalization or restructuring of the portfolio company capital structure would not be a qualifying portfolio company.[115] The 80 percent test is not intended to preclude conversions of directly acquired securities into other equity securities. Similarly, we would not view a capital reorganization intended merely to simplify a qualifying portfolio company's capital structure and outstanding securities without any change in the existing beneficial owners' rights, priority, or economic terms as breaching the 80 percent condition.

We propose to define a venture capital fund by reference to ownership of equity securities of a qualifying portfolio company, wherein at least 80 percent of the securities owned were acquired directly from the company, in order to give venture capital funds relying on the exemption some flexibility to acquire securities from a portfolio company founder or "angel" investor who may seek liquidity from his or her initial investment.[116] We adopted this 80 percent threshold because we understand that many venture capital funds currently are managed in a manner that seeks to rely on provisions of the tax code providing favorable tax treatment for directly acquired equity securities of issuers that satisfy certain conditions.[117] Thus, using this threshold in our definition may not result in substantial changes to either investment strategies employed, or the compliance programs currently used, by venture capital advisers. Is our assumption that venture capital funds do not generally acquire portfolio company securities directly from existing shareholders correct? Is 80 percent the appropriate threshold? Should the threshold be set lower? Should direct acquisitions of equity securities be increased to 90 percent or 100 percent in order to more effectively prevent advisers to funds engaged in activities that are not characteristic of venture capital funds from relying on the exemption?

In contrast to leveraged buyout fund financing, venture capital received by a portfolio company is devoted to developing the company's business rather than repurchasing the securities of other shareholders or making payments to fund debt financing through the portfolio company. We request comment on this criterion. Does the definition's focus on a portfolio company's use of capital received from a venture capital fund impose any unnecessary burdens on the company's operation or business? Rather than define a venture capital fund by reference to the manner in which it acquires equity securities (or the manner in which qualifying portfolio companies may indirectly facilitate a buyout), should the proposed rule instead define the manner in which proceeds from a venture capital investment may be used? For example, should the rule specify that proceeds of borrowings or other financings not be used to finance the acquisition of equity securities by a venture capital fund or otherwise distribute company assets to equity owners? Would defining qualifying portfolio company in this manner facilitate compliance or would this approach make it easier for a company to achieve a "buyout" and thereby circumvent the intended scope of the exemption, given the fungibility of cash and the privately negotiated nature of typical venture capital transactions? We do not intend that a venture capital fund would not meet the proposed definition if it acquired equity securities from a portfolio company in connection with a capital reorganization intended to simplify the company's capital structure without changing the existing beneficial owners' rights, priority, or economic terms. Are there other capital reorganizations that would be consistent with the intent of our proposed rule but that would prevent a venture capital fund from satisfying the proposed definition?

e. Operating Companies

Proposed rule 203(l)–1 would define the term qualifying portfolio company for the purposes of the exemption to exclude any private fund or other pooled investment vehicle.[118] There is no indication that Congress intended the venture capital exemption to apply to funds of funds. Without this definition, a venture capital fund could circumvent the intended scope of the exemption by investing in other pooled investment vehicles that are not themselves subject to the definitional criteria under our proposed rule. For example, a venture capital fund could circumvent the intent of the proposed rule by incurring off-balance sheet leverage or indirectly investing in companies that may be publicly traded. Our proposed exclusion would be similar to the approach of other definitions of "venture capital" discussed above, which limit

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[112] *See supra* notes 39, 42, 43, 99 and accompanying text.

[113] Proposed rule 203(l)–1(a)(2)(i).

[114] Proposed rule 203(l)–1(c)(4)(iii).

[115] For example, concurrently with the issuance of new securities to the venture capital fund, a portfolio company could redeem existing shareholders and use proceeds from the venture capital fund investment to pay such shareholders redemption proceeds. Similarly, existing shareholders may receive new securities that are subordinated to the securities issued to the venture capital fund in exchange for tendering their outstanding securities, partially funded with investments received from the venture capital fund. In each of these examples, the fund becomes a majority owner of the company by "buying out" the existing owners with investment capital initially provided by the fund.

[116] *See* NVCA Yearbook 2010, *supra* note 41, at 57 (defining "angel" as "a wealthy individual that invests in companies in relatively early stages of development"). *See also* Fenn *et al.*, *supra* note 55, at 2 (defining angel capital as "investments in small, closely held companies by wealthy individuals, many of whom have experience operating similar companies [and] * * * may have substantial ownership stakes and may be active in advising the company, but they generally are not as active as professional managers in monitoring the company and rarely exercise control.").

[117] *See* Int. Rev. Code § 1202(e)(1)(A) (26 U.S.C. 1202) ("IRC 1202") (which permits partial exclusion from income tax gain on directly acquired equity securities of certain issuers that, among other things, devote at least 80% of their assets to the conduct of their business as specified in IRC 1202). Under our proposed rule, at least 80% of the portfolio company securities owned by a venture capital fund must be acquired directly from the portfolio company, which in turn cannot redeem or repurchase existing security holders in connection with such venture capital fund investment. Thus we presume that venture capital funding proceeds (or at least 80% of such proceeds) will be used for operating and business expansion purposes, which is similar to the requirements under IRC 1202.

[118] Proposed rule 203(l)–1(c)(4)(iv). For this purpose, pooled investment vehicles include investment companies, investment companies relying on rule 3a–7 under the Investment Company Act and commodity pools.

investments to operating companies and thus would exclude investments in other private funds or securitized asset vehicles.[119] We request comment on this definitional element. Under the proposed definition, a venture capital fund would not invest in another private fund, a commodity pool or other "investment companies." Should the proposed definition specifically identify other types of pooled investment vehicles (*e.g.*, real estate funds or structured investment vehicles) in which a fund seeking to satisfy the proposed definition could not invest?

1. Management Involvement

To qualify as a venture capital fund under our proposed definition, the fund or its investment adviser would: (i) Have an arrangement under which it offers to provide significant guidance and counsel concerning the management, operations or business objectives and policies of the portfolio company (and, if accepted, actually provides the guidance and counsel) or (ii) control the portfolio company.[120] Because a key distinguishing characteristic of venture capital investing is the assistance beyond the mere provision of capital, we propose that advisers seeking to rely on the rule have a significant level of involvement in developing a fund's portfolio companies.[121] Managerial assistance generally takes the form of active involvement in the business, operations or management of the portfolio company, or less active forms of control of the portfolio company, such as through board representation or similar voting rights.[122] We also acknowledge that the nature of managerial assistance may evolve over time as the needs of qualifying portfolio companies change, and hence the proposed rule does not specify that managerial assistance has a fixed character.

We have modeled the proposed approach to managerial assistance in part on existing provisions under the Advisers Act and the Investment Company Act dealing with BDCs, which were added over the years to ease the regulatory burdens on venture capital and other private equity investments.[123] In 1980, when Congress first introduced BDCs into the Advisers Act and Investment Company Act, it acknowledged that the purpose of the BDC provisions was to support "venture capital" activity in capital formation for small business, and described BDCs as principally investing in and providing managerial assistance to small, growing and financially troubled businesses.[124] Because Congress modeled the definition of BDC under the Advisers and Investment Company Acts on the capital formation activities of venture capital funds, both definitions under such Acts incorporate the requirement to make available significant managerial assistance to portfolio companies.[125]

Congress did not use the existing BDC definitions when determining the scope of the venture capital exemption,[126] and the primary policy considerations that led to the adoption of the BDC exemptions differed from those under the Dodd-Frank Act. However, we believe these provisions are instructive because they reflect many of the same characteristics of venture capital and private equity fund activity presented in testimony before Congress in connection with the Dodd-Frank Act.[127] Although Congress viewed BDC activities as typical of "venture capital" investing,[128] the BDC provisions are complex. Hence, we are proposing a modified version of the definition of "making available significant managerial assistance" in order to simplify the language and to reduce the potential for confusion that might arise in interpreting the meaning of the term.

[119] *See* California VC exemption, *supra* notes 70–72; *see also* VCOC exemption under 29 CFR 2510.3–101(d), *supra* note 70.

[120] Proposed rule 203(l)–1(a)(3). Under section 202(a)(12) of the Advisers Act, "control" is defined to mean "the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of an official position with such company."

[121] *See* McGuire Testimony, *supra* note 41, at 1 ("[W]e build companies by actively partnering with each entrepreneur and management team to help propel their ideas into market leading businesses. We do this by providing a small amount of capital and a large amount of operating expertise and strategic counsel over a long period of time. While providing capital is the first order of business, it is the least time consuming of all our activities. We also recruit and attract employees at all levels [for the portfolio company]. We identify and structure strategic partnerships. We raise additional equity to help the [portfolio] company make it to the next milestone. And, we're available 24/7 to support great teams, solve problems, identify opportunities and detect 'land mines.' * * * We provide access to [our] expertise and network at all stages of a [portfolio] company's development and across all strategic areas of the business."). *See also* Levin, *supra* note 55, at 1–3 (noting that the "*first* feature distinguishing venture capital/private equity investing is the VC professional's active involvement in identifying the investment, negotiating and structuring the transaction, and monitoring the portfolio company after the investment has been made. Often, the VC professional will serve as a board member and/or financial advisor to the portfolio company. Hence, venture capital/private equity investing is significantly different from passive selection and retention of stock and debt investments by a money manager.") (emphasis in original); Sahlman, *supra* note 106, at 508 (noting that venture capitalists typically play a role in the operation of the company, help to establish tactics and strategy, work with suppliers and customers, and often assume more direct control by changing management and sometimes taking over day-to-day operations themselves). *See also* Fenn *et al.*, *supra* note 55, at 32–33 for a discussion of various control mechanisms available to venture capital and private equity funds, including preferred stock ownership, representation on the board and various contractual covenants.

[122] *See generally supra* note 121. *See also* Alan T. Frankel, *et al., Venture Capital: Financial and Tax Considerations,* The CPA Journal (Aug. 2003) at 1 (noting that the "VC will also monitor the portfolio company after the investment has been made. Oftentimes, the VC will serve as a board member or financial and strategic advisor to the portfolio company.").

[123] The term "business development company" was first introduced into the Investment Company Act and the Advisers Act in 1980 as part of the Small Business Investment Incentive Act of 1980 ("Small Business Act"), and was amended as part of the National Securities Markets Improvement Act of 1996, Public Law 104–290, 110 Stat. 3416 (1996) ("NSMIA"). Congress introduced an alternative regulatory framework applicable to BDCs, which was designed to remove "unnecessary disincentives" for BDCs to provide capital to small businesses, while also preserving protection for investors and preventing fraud and abuse. *See* 1980 House Report, *supra* note 44, at 21–22.

In the Small Business Act, Congress modeled the definition of a BDC under section 202(a)(22) of the Advisers Act on the capital formation activities of venture capital funds. Congress recognized that the principal activity of a BDC is to invest in and provide managerial assistance to small, growing and financially troubled companies. *See* 1980 House Report, *supra* note 44, at 21. *See also infra* note 129 (definition of "making available significant managerial assistance" by a BDC under section 2(a)(47) of the Investment Company Act).

[124] *See* 1980 House Report, *supra* note 44, at 21.

[125] *See* section 202(a)(22) of the Advisers Act; section 2(a)(48)(B) of the Investment Company Act. Generally, a BDC under the Advisers Act is any company that meets the definition of BDC under the Investment Company Act, except that certain requirements were modified for "private" BDCs under the Advisers Act. *See also Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles,* Investment Advisers Act Release No. 2576 (Dec. 27, 2006) [72 FR 400 (Jan. 4, 2007)] ("Accredited Natural Person Release"), at n.69 (discussing the difference between the term BDC under the Investment Company Act and the Advisers Act). In 1996, as part of NSMIA, Congress sought to encourage greater investment in small businesses by giving BDCs more flexibility, and therefore expanded the class of eligible portfolio companies in which BDCs could invest without being required to provide "managerial assistance." *See* S. Rep. No. 104–293, at 13 (1996).

[126] We have looked to the BDC definition to define a venture capital fund before. In 2006, we proposed to impose a qualification standard for all investors of private investment funds, excluding venture capital funds, which we proposed to define by reference to section 202(a)(22) of the Advisers Act. *See* Accredited Natural Person Release, *supra* note 125 (proposing to define the term "accredited natural person" as any natural person who satisfies the requirements in Regulation D as an accredited investor and who also owns investments of at least $2.5 million). We sought additional comment on this proposal in a subsequent release but a rule has not been adopted. *See Revisions of Limited Offering Exemptions in Regulation D,* Securities Act Release No. 8828 (Aug. 3, 2007) [72 FR 45116 (Aug. 10, 2007)].

[127] *See generally* Loy Testimony, *supra* note 40; McGuire Testimony, *supra* note 41.

[128] *See* 1980 House Report, *supra* note 44, at 21–2.

We request comment on the approach to managerial assistance in the definition of venture capital fund. As we have noted above, Congressional testimony asserted that a key characteristic of venture capital funds is the provision of managerial assistance. Is this true in the industry generally? We request comment on the description of managerial assistance in proposed rule 203(l)–1. Is this description easier to understand and apply than the definition in section 2(a)(47) of the Investment Company Act? [129] As under the definition of BDC in the Advisers and Investment Company Acts, the proposed definition specifies the fund or its adviser need only offer assistance. Should the rule specify that the fund or its adviser actually provide assistance? If so, what if a portfolio company that initially accepts the offer of assistance later refuses any actual or further assistance? We understand that when venture capital funds invest as a group, there may be an understanding among the funds and the portfolio company that while all fund advisers may be available to provide managerial assistance if necessary, one adviser is generally expected to provide most, if not all, of the assistance to the portfolio company. Is that understanding correct? Under proposed rule 203(l)–1, venture capital funds that invest as a group would only satisfy the definition if each venture capital fund (or its adviser) offered (and, if accepted, provided) managerial assistance or exercised control.[130] Should the rule specify how managerial assistance or control is to be determined in the case of venture capital funds that invest as a group if only one fund (or its adviser) provides the assistance? Should the rule specify the extent to which each fund (or its adviser) must offer or provide managerial assistance or adopt the approach of other regulatory definitions of "venture capital" funds, which impose strict numerical investment or ownership tests for determining whether a venture capital fund exercises supervision or influence over the operation or business of the operating company? [131] Does the fact that the assistance need only be offered render the condition so readily met that the criterion should be removed from the rule? Should our rule provide guidance on what constitutes "control" under our proposed definition? For example, instructions to Form ADV provide a presumption of control if a person has the power to vote 25 percent or more of a corporation's voting securities, or a person acts as manager of a limited liability company.[132] Should the proposed rule rely on similar or different presumptions?

Our proposed rule provides that when a fund controls the qualifying portfolio company, an offer to provide managerial assistance is not required. As in the case of "managerial assistance" as defined in the BDC provisions, the proposed rule presumes that when a fund acquires control, it is likely to be exercised. Should the rule specify that in all cases managerial assistance includes both the offer of assistance as well as the exercise of control? We request comment on whether venture capital funds (or their advisers) typically have the personnel to provide significant managerial assistance to all of their portfolio companies or only a subset. Would the requirement to offer and potentially provide managerial assistance to all of a fund's portfolio companies result in potential demands on a fund or its adviser that could not be satisfied if all or a significant subset of a fund's portfolio companies accepted the offer? Alternatively, does the proposed definition provide a venture capital fund (including those that invest as a group) with sufficient flexibility to determine the scope of any managerial assistance or control it may seek to offer (or provide) to a portfolio company?

2. Limitation on Leverage

Under proposed rule 203(l)–1, the definition of a venture capital fund for purposes of the exemption would be limited to a private fund that does not borrow, issue debt obligations, provide guarantees or otherwise incur leverage, in excess of 15 percent of the fund's capital contributions and uncalled committed capital, and any such borrowing, indebtedness, guarantee or leverage is for a non-renewable term of no longer than 120 calendar days.[133] Under the proposed definition, a fund could borrow and still be a venture capital fund provided it did not borrow or otherwise use leverage in excess of the specified threshold.

By specifying that loans be non-renewable, we would avoid the transformation of short-term debt into long-term debt without full repayment to the lender. Should the rule specify other borrowing or financing terms or conditions that would nevertheless avoid this type of transformation? Do venture capital funds use lines of credit repeatedly but pay the outstanding amounts in full before drawing down additional credit? Should loans of this nature be included in the definition? Under our proposed definition, it would be possible for a venture capital fund to issue commercial paper on a short-term basis to potential investors because the proposed definition does not specify which types of instruments a venture capital fund issues. Should the proposed rule specifically exclude commercial paper from debt issuances to avoid the potential that a venture capital fund could convert short-term debt into long-term debt by continuing to roll over its commercial paper issuances? [134] This criterion regarding

[129] Section 2(a)(47) of the Investment Company Act states:

"'Making available significant managerial assistance' by a business development company means—

(A) Any arrangement whereby a business development company, through its directors, officers, employees, or general partners, offers to provide, and, if accepted, does so provide, significant guidance and counsel concerning the management, operations, or business objectives and policies of a portfolio company;

(B) the exercise by a business development company of a controlling influence over the management or policies of a portfolio company by the business development company acting individually or as part of a group acting together which controls such portfolio company; or

(C) with respect to a small business investment company licensed by the Small Business Administration to operate under the Small Business Investment Act of 1958, the making of loans to a portfolio company.

For purposes of subparagraph (A), the requirement that a business development company make available significant managerial assistance shall be deemed to be satisfied with respect to any particular portfolio company where the business development company purchases securities of such portfolio company in conjunction with one or more other persons acting together, and at least one of the persons in the group makes available significant managerial assistance to such portfolio company, except that such requirement will not be deemed to be satisfied if the business development company, in all cases, makes available significant managerial assistance solely in the manner described in this sentence."

In contrast to section 2(a)(47) of the Investment Company Act, our proposed definitional approach to managerial assistance does not specifically define managerial assistance by referring to a fund's directors, officers, employees, or general partners or address how managerial assistance is determined for funds that invest as a group.

[130] According to one study, funds focusing on later-stage companies and middle-market buyout investing tend to invest alongside other funds, whereas venture capital funds focusing on early stage companies tend to invest individually in portfolio companies. *See* Fenn *et al., supra* note 55, at 31.

[131] *See supra* note 70 and accompanying text (discussing the California VC exemption and the VCOC exemption).

[132] *See Amendments to Form ADV,* Investment Advisers Act Release No. 3060 (July 28, 2010) [75 FR 49234 (Aug. 12, 2010)] ("Form ADV Release").

[133] Proposed rule 203(l)–1(a)(4). Similarly, our proposed rule would exclude from the definition of "qualifying portfolio company" a company that borrowed in connection with the venture capital fund's investments in the company. Proposed rule 203(l)–1(c)(4)(ii). *See supra* section II.A.1 of this Release.

[134] We note that because commercial paper issuers often refinance the repayment of maturing commercial paper with newly issued commercial

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leverage at the venture capital fund level is in addition to the conditions relating to a qualifying portfolio company's debt issuances in connection with the venture capital fund's investment.[135] Under this condition, a venture capital fund seeking to satisfy the definitional criteria could not avoid the borrowing element at the portfolio company level by incurring such leverage at the venture capital fund level.

Congress cited the implementation of trading strategies that use financial leverage by certain private funds as creating a potential for systemic risk.[136] In testimony before Congress, the venture capital industry identified the lack of financial leverage in venture capital funds as a basis for exempting advisers to venture capital funds [137] in contrast to other types of private funds such as hedge funds, which may engage in trading strategies that may contribute to systemic risk and affect the public securities markets.[138] For this reason, our proposed rule is designed to address concerns that financial leverage may contribute to systemic risk by excluding funds that incur more than a limited amount of leverage from the definition of venture capital fund.[139]

We also understand that venture capital funds generally do not rely on short-term financing,[140] which has been identified as another potential systemic risk factor.[141] Should we increase or reduce the 15 percent threshold for short-term borrowing? If so, what is the appropriate threshold (*e.g.,* 20, 10, or 5 percent)? Or should we define a venture capital fund as a private fund that does not borrow at all or otherwise incur any financial leverage? Would even the limited ability to engage in short-term borrowing or other forms of leverage encourage venture capital funds to incur other investment risks different from those typically associated with venture capital investing today? To the extent that venture capital funds use short-term leverage or borrowing, 90 days has been cited as typical.[142] Would a 120-day period, as specified in our proposed rule, create other investment risks for venture capital funds? Our proposed rule refers specifically to borrowing but also is designed to give venture capital funds the flexibility to issue debt (which is also a form of borrowing) for short-term purposes. Should the rule refer specifically to additional forms of borrowing not already identified? Do any or many venture capital funds borrow in excess of 120 days? Should the 15 percent limit not apply when a fund borrows in order to invest in a qualifying portfolio company and is repaid with capital called from the fund's investors? Would the 120-day limit alone achieve a similar result?

Our proposed rule specifies that the 15 percent calculation must be determined based on the fund's aggregate capital contributions and uncalled capital commitments. Unlike most registered investment companies or hedge funds, venture capital funds rely on investors funding their capital commitments from time to time in order to acquire portfolio companies.[143] A capital commitment is a contractual obligation to acquire an interest in, or provide the total commitment amount over time to, a fund, when called by the fund. Accordingly, advisers to venture capital funds manage the fund in anticipation of all investors fully funding their commitments when due and typically have the right to penalize investors for failure to do so.[144] Venture

paper, they may face roll-over risk, *i.e.,* the risk that investors may not be willing to refinance maturing commercial paper. These risks became particularly apparent for issuers of asset-backed commercial paper beginning in August 2007. At that time, structured investment vehicles ("SIVs"), which are off-balance sheet funding vehicles sponsored by financial institutions, issued commercial paper to finance the acquisition of long-term assets, including residential mortgages. As a result of problems in the residential home mortgage market, short-term investors began to avoid asset-backed commercial paper tied to residential mortgages, regardless of whether the securities had substantial exposure to sub-prime mortgages. Unable to roll over their commercial paper, SIVs suffered severe liquidity problems and significant losses. *See Money Market Fund Reform,* Investment Company Act Release No. 28807 (June 30, 2009) [74 FR 32688 (July 8, 2009)] ("Money Market Fund Reform Release") at nn.37–39 and preceding and accompanying text; Marcin Dacperczyk and Philipp Schnabl, When Safe Proved Risky: Commercial Paper During the Financial Crisis of 2007–2009 (Nov. 2009).

[135] *See* proposed rule 203(l)–1(c)(4)(ii); *supra* section II.A.1.c of this Release. Because private equity funds often engage in leveraged buy-out transactions in which the portfolio company, rather than the fund, incurs debt, our proposed definition would exclude leveraged buy-out funds.

[136] *See, e.g.,* section 115 of the Dodd-Frank Act (enumerating prudential standards for addressing systemic risks, including risk-based capital requirements, leverage limits, liquidity requirements, resolution plan and credit exposure report requirements, concentration limits, a contingent capital requirement, enhanced public disclosures, short-term debt limits, and overall risk management requirements). *See also* G20 Working Group 1, Enhancing Sound Regulation and Strengthening Transparency, at iii–iv (March 25, 2009) ("G20 Working Group Report"), at iii (noting contribution to "market turmoil" when "the financial system developed new structures and created new instruments, some with embedded leverage." Further, "[w]hile the build-up of leverage and the underpricing of credit risk were recognized in advance of the turmoil, their extent was under-appreciated and there was no coordinated approach to assess the implications of these systemic risks * * *"); International Monetary Fund, Lessons of the Global Crisis for Macroeconomic Policy, February 19, 2009, at 6 (noting how "[l]everage * * * increases lender exposure by magnifying the impact of a price adjustment on borrowers' balance sheets and, thus on banks' losses and capital."). *See generally* Department of Treasury, Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation, June 2009, *available at http://www.financialstability.gov/docs/regs/FinalReport_web.pdf.*

[137] *See* McGuire Testimony, *supra* note 41, at 7 ("Venture capital firms do not use long term leverage, rely on short term funding, or create third party or counterparty risk * * * [F]rom previous testimony submitted by the buy-out industry, the typical capital structure of the companies acquired by a buyout fund is approximately 60% debt and 40% equity. In contrast, borrowing at the venture capital fund level, if done at all, typically is only used for short-term capital needs (pending drawdown of capital from its partners) and does not exceed 90 days. Not only are our partnerships run without debt but our portfolio companies are usually run without debt as well."); Loy Testimony, *supra* note 40, at 2 ("Although venture capital funds may occasionally borrow on a short-term basis immediately preceding the time when the cash installments are due, they do not use debt to make investments in excess of the partner's capital commitments or 'lever up' the fund in a manner that would expose the fund to losses in excess of the committed capital or that would result in losses to counter parties requiring a rescue infusion from the government.").

[138] *See* S. Rep. No. 111–176, *supra* note 7, at 74–75.

[139] In proposing an exemption for advisers to private equity funds, which would have required the Commission to define the term private equity fund, the Senate Banking Committee noted the difficulties in distinguishing some private equity funds from hedge funds and expected the Commission to exclude from the exemption private equity funds that raise significant potential systemic risk concerns. S. Rep. No. 111–176, *supra* note 7, at 75. *See also* G20 Working Group Report, *supra* note 136, at 7 (noting that unregulated entities such as hedge funds may contribute to systemic risks through their trading activities).

[140] *See* Loy Testimony, *supra* note 40, at 7 ("[V]enture capital firms do not generally rely on short-term funding. In fact, quite the opposite is true."); Schell, *supra* note 101, at § 1.03[6] ("Venture Capital Funds rarely have the ability to borrow money, other than short-term loans to cover Partnership Expenses or to 'bridge' Capital Contributions."); Heesen, *supra* note 104, at 17.

[141] *See, e.g.,* Financial Crisis Inquiry Commission, Preliminary Staff Report, Shadow Banking and the Financial Crisis (May 4, 2010).

[142] *See* McGuire Testimony, *supra* note 41, at 7.

[143] Schell, *supra* note 101, at § 1.03[8] ("The typical Venture Capital Fund calls for Capital Contributions from time to time as needed for investments."); *id.* at § 2.05[2] (stating that "[venture capital funds] begin operation with Capital Commitments but no meaningful assets. Over a specific period of time, the Capital Commitments are called by the General Partner and used to acquire Portfolio Investments.").

[144] *See* Loy Testimony, *supra* note 40, at 5 ("[Limited partners] make their investment in a venture fund with the full knowledge that they generally cannot withdraw their money or change their commitment to provide funds. Essentially they agree to "lock-up" their money for the life of the fund."). *See also* Stephanie Breslow & Phyllis Schwartz, Private Equity Funds, Formation and Operation 2010 ("Breslow & Schwartz"), at § 2:5.6 (discussing the various remedies that may be imposed in the event an investor fails to fund its contractual capital commitment, including, but not limited to, "the ability to draw additional capital from non-defaulting investors;" "the right to force a sale of the defaulting partner's interests at a price determined by the general partner;" and "the right

capital funds are subject to investment restrictions, and calculate fees payable to an adviser, as a percentage of the total capital commitments of investors, regardless of whether or not the capital commitment is ultimately funded by an investor.[145] Venture capital fund advisers typically report and market themselves to investors on the basis of aggregate capital commitment amounts raised for prior or existing funds.[146] These factors would lead to the conclusion that, in contrast to other types of private funds, such as hedge funds, which trade on a more frequent basis, a venture capital fund would view the fund's total capital commitments as the primary metric for managing the fund's assets and for determining compliance with investment guidelines. Hence, we believe that calculating the leverage threshold to include uncalled capital commitments is appropriate, given that capital commitments are already used by venture capital funds themselves to measure investment guideline compliance.

The proposed 15 percent threshold would be determined based on the venture capital fund's aggregate capital commitments. In practice, this means that a venture capital fund relying on the exemption could leverage an investment transaction up to 100 percent when acquiring equity securities of a particular portfolio company as long as the investment amount does not exceed 15 percent of the fund's total capital commitments, albeit on a short-term basis that did not exceed 120 days. Should the 15 percent calculation be determined with respect to the total investment amount for each portfolio company? Would this standard be easier to apply?

Our proposed rule defines a venture capital fund by reference to a maximum of 15 percent of borrowings based on our understanding that venture capital funds typically would not incur borrowings in excess of 10 to 15 percent of the fund's total capital contributions and uncalled capital commitments.[147] We believe that imposing a maximum at the upper range of borrowings typically used by venture capitals may accommodate existing practices of the vast majority of industry participants.

3. No Redemption Rights

Proposed rule 203(l)-1 would define a venture capital fund as a fund that issues securities that do not provide investors redemption rights except in "extraordinary circumstances" but that do entitle investors generally to receive *pro rata* distributions.[148] Unlike hedge funds, venture capital funds do not typically permit investors to redeem their interests during the life of the fund,[149] but rather distribute assets generally as investments mature.[150] Although venture capital funds typically return capital and profits to investors only through *pro rata* distributions, such funds may also provide extraordinary rights for an investor to withdraw from the fund under foreseeable but unexpected circumstances or rights to be excluded from particular investments due to regulatory or other legal requirements.[151] These events may be "foreseeable" because they are circumstances that are known to occur (*e.g.,* changes in law, corporate events such as mergers) but are unexpected in their timing or scope. Thus, withdrawal or exclusion rights might be triggered by a change in the tax law after an investor invests in the fund, or the enactment of laws that may prohibit an investor's participation in the fund's investment in particular countries or industries.[152] The trigger events for these rights are typically beyond the control of the adviser and fund investor (*e.g.,* tax and regulatory changes).

For these purposes, for example, a fund that permits quarterly or other periodic withdrawals would be considered to have granted investors redemption rights in the ordinary course even if those rights may be subject to an initial lock-up or suspension or restrictions on redemption. Is the phrase "extraordinary circumstances" sufficiently clear to distinguish the investor liquidity terms of venture capital funds, as they operate today, from hedge funds? Congressional

to take any other action permitted at law or in equity").

[145] *See, e.g.,* Breslow & Schwartz, *supra* note 144, at § 2:5.7 (noting that a cap of 10% to 25% of remaining capital commitments is a common limitation on follow-on investments). *See also* Schell, *supra* note 101, at § 1.01 (noting that capital contributions made by the investors are used to "make investments * * * in a manner consistent with the investment strategy or guidelines established for the Fund."); *id.* at § 1.03 ("Management fees in a Venture Capital Fund are usually an annual amount equal to a fixed percentage of total Capital Commitments."); *see also* Dow Jones, *Private Equity Partnership Terms and Conditions,* 2007 edition ("Dow Jones Report") at 15.

[146] *See, e.g.,* NVCA Yearbook 2010, *supra* note 41, at 16; John Jannarone, *Private Equity's Cash Problem,* Wall St. J., June 23, 2010, *http://online.wsj.com/article/SB10001424052748704853404575323073059041024.html#printMode.*

[147] *See* Loy Testimony, *supra* note 40, at 6 ("[M]any venture capital funds significantly limit borrowing such that all outstanding capital borrowed by the fund, together with guarantees of portfolio company indebtedness, does not exceed the lesser of (i) 10–15% of total limited partner commitments to the fund and (ii) undrawn limited partner commitments.").

[148] Proposed rule 203(l)–1(a)(5) (limiting venture capital funds to funds that "[o]nly issue[] securities the terms of which do not provide a holder with any right, except in extraordinary circumstances, to withdraw, redeem or require the repurchase of such securities but may entitle holders to receive distributions made to all holders pro rata").

[149] *See* Schell, *supra* note 101, at § 1.03[7] (venture capital fund "redemptions and withdrawals are rarely allowed, except in the case of legal compulsion"); Breslow & Schwartz, *supra* note 144, at § 2:14.2 ("the right to withdraw from the fund is typically provided only as a last resort").

[150] Loy Testimony, *supra* note 40, at 2–3 ("As portfolio company investments are sold in the later years of the [venture capital] fund—when the company has grown so that it can access the public markets through an initial public offering (an IPO) or when it is an attractive target to be bought—the liquidity from these 'exits' is distributed back to the limited partners. The timing of these distributions is subject to the discretion of the general partner, and limited partners may not otherwise withdraw capital during the life of the venture [capital] fund."). *Id.* at 5 (Investors "make their investment in a venture [capital] fund with the full knowledge that they generally cannot withdraw their money or change their commitment to provide funds. Essentially they agree to 'lock-up' their money for the life of the fund, generally 10 or more years as I stated earlier."). *See also* Dow Jones Report, *supra* note 145, at 60 (noting that an investor in a private equity or venture capital fund typically does not have the right to transfer its interest).

[151] *See* Hedge Fund Adviser Registration Release, *supra* note 17, at n.240 and accompanying text ("Many partnership agreements provide the investor the opportunity to redeem part or all of its investment, for example, in the event continuing to hold the investment became impractical or illegal, in the event of an owner's death or total disability, in the event key personnel at the fund adviser die, become incapacitated, or cease to be involved in the management of the fund for an extended period of time, in the event of a merger or reorganization of the fund, or in order to avoid a materially adverse tax or regulatory outcome. Similarly, some investment pools may offer redemption rights that can be exercised only in order to keep the pool's assets from being considered 'plan assets' under ERISA [Employee Retirement Income Security Act of 1974]."). *See, e.g.,* Breslow & Schwartz, *supra* note 144, at § 2:14.1 ("Private equity funds generally provide for mandatory withdrawal of a limited partner [*i.e.,* investor] only in the case where the continued participation by a limited partner in a fund would give rise to a regulatory or legal violation by the investor or the fund (or the general partner [*i.e.,* adviser] and its affiliates). Even then, it is often possible to address the regulatory issue by excusing the investor from particular investments while leaving them otherwise in the fund.").

[152] *See, e.g.,* Breslow & Schwartz, *supra* note 144, at § 2:14.2 ("The most common reason for allowing withdrawals from private equity funds arises in the case of an ERISA violation where there is a substantial likelihood that the assets of the fund would be treated as 'plan assets' of any ERISA partner for purposes of Title I of ERISA or section 4975 of the Code."). *See also* Schell, *supra* note 101, at § 9.04[3] ("Exclusion provisions allow the General Partner to exclude a Limited Partner from participation in any or all investments if a violation of law or another material adverse effect would otherwise occur."); *id.* at Appendix D–31 (attaching model limited partnership agreement providing "The General Partner at any time may cancel the obligations of all Partners to make Capital Contributions for Portfolio Instruments if * * * changes in applicable law * * * make such cancellation necessary or advisable. * * * ").

testimony cited an investor's inability to withdraw from a venture capital fund as a key characteristic of venture capital funds and a factor for reducing their potential for systemic risk.[153] Although a fund prohibiting redemptions would be a venture capital fund for purposes of the exemption, the rule does not specify a minimum period of time for an investor to remain in the fund. Should the rule define when withdrawals by investors would be "extraordinary?" Should the rule specify minimum investment periods for investors? Could venture capital funds provide investors with "extraordinary" rights to redeem that could effectively result in redemption rights in the ordinary course? [154] Should we address this potential for circumvention of the definition by establishing a maximum amount that may be redeemed during any period of time (*e.g.,* 10 percent of an investor's total capital commitments)? Would such a limit constrain investors in a way so as to prevent them from complying with other legal or regulatory requirements?

4. Represents Itself as a Venture Capital Fund

Proposed rule 203(l)–1 would limit the definition of venture capital fund for the purposes of the exemption to a private fund that represents itself as being a venture capital fund to its investors and potential investors.[155] A private fund could satisfy this definitional element by, for example, describing its investment strategy as venture capital investing or as a fund that is managed in compliance with the elements of our proposed rule. Without this element, a fund that did not engage in typical venture capital activities could be treated as a venture capital fund simply because it met the other elements specified in our proposed rule (because for example it only invests in short term Treasuries, controls portfolio companies, does not borrow, does not offer investors redemption rights, and is not a registered investment company).[156] We believe that only funds that do not significantly differ from the common understanding of what a venture capital fund is,[157] and that are actually offered to investors as venture capital funds, should qualify for the exemption. Thus, an adviser to a venture capital fund that is otherwise relying on the exemption could not identify the fund as a hedge fund or multi-strategy fund (*i.e.,* venture capital is one of several strategies used to manage the fund) or include the fund in a hedge fund database or hedge fund index.

We request comment on a venture capital fund's representations regarding itself as a criterion under the proposed definition. Is our criterion inconsistent with current practice? Does the proposed criterion regarding venture capital fund representations adequately address our concern that advisers should not be eligible for the exemption if they advise funds that otherwise meet the definitional criteria in the rule but engage in activities that do not constitute venture capital investing?

5. Is a Private Fund

We propose to define a venture capital fund for the purposes of the exemption as a private fund, which is defined in the Advisers Act,[158] and exclude from the proposed definition funds that are registered investment companies (*e.g.,* mutual funds) or have elected to be regulated as BDCs.[159] There is no indication that Congress intended this exemption to apply to advisers to these publicly available funds,[160] referring to venture capital funds as a "subset of private investment funds." [161] We request comment on this requirement and whether it appropriately reflects the expectation of Congress.

6. Other Factors

We request comment on whether the proposed rule should include other elements that were described in testimony as characteristic of venture capital funds or that distinguish venture capital funds from other types of private equity or private funds.[162] For example, testimony presented to Congress indicated that venture capital funds typically have capital contributions from their advisers, generally up to five percent of the fund's total capital commitments.[163] Congress also received testimony that venture capital funds are generally not open to retail investors,[164] have long investment periods, generally of at least ten years,[165] and contribute to the U.S. economy by creating jobs, fostering competition and facilitating innovation.[166]

Are any of these characteristics appropriate to include as elements in the definition? If so, which elements should be included and what would be appropriate thresholds for application? Do venture capital advisers typically invest in the funds they manage? Should we modify the proposed rule to include as a condition that advisers relying on the exemption under section 203(l) would invest in the venture capital fund at a specified minimum threshold? If so, what is an appropriate investment threshold—less than one percent, one percent, three percent, five percent, or somewhere in between? Should the proposed rule be modified to specify that venture capital funds have a minimum term, for example, of 10

[153] *See supra* notes 149–150 and accompanying text.

[154] For example, a private fund's governing documents may provide that investors do not have any right to redeem without the consent of the general partner. In practice, if the general partner typically permits investors to redeem or transfer their otherwise non-redeemable, non-transferable interests on a periodic basis, then the fund would not be considered to have issued securities that "do not provide a holder with any right, except in extraordinary circumstances, to withdraw."

[155] Proposed rule 203(l)–1(a)(1).

[156] We also note that a fund that represents to investors that it is one type of fund while pursuing a different type of fund strategy may raise concerns under rule 206(4)–8 of the Advisers Act.

[157] *See* Gompers, *supra* note 110, at 6–7.

[158] *See* section 202(a)(29) of the Advisers Act.

[159] Proposed rule 203(l)–1(a)(6).

[160] Legislative history does not indicate that Congress addressed this matter, nor does testimony before Congress suggest that this was contemplated. *See, e.g.,* McGuire Testimony, *supra* note 41, at 3 (noting that venture capital funds are not directly accessible by individual investors); Loy Testimony, *supra* note 40, at 2 ("Generally * * * capital for the venture fund is provided by qualified institutional investors such as pension funds, universities and endowments, private foundations, and to a lesser extent, high net worth individuals."). *See generally supra* note 158 (definition of "private fund").

[161] *See* S. Rep. No. 111–176, *supra* note 7, at 74 (describing venture capital funds as a subset of "private investment funds").

[162] *See, e.g.,* Heesen, *supra* note 104 (generally describing characteristics that distinguish venture capital funds from hedge funds and buyout funds).

[163] *See* Loy Testimony, *supra* note 40, at 2 ("[g]enerally, 95 to 99 percent of capital for the venture fund is provided by * * * investors * * * and we supply the rest of the capital for the fund from our own personal assets"); McGuire Testimony, *supra* note 41, at 3. Industry data confirm that such investments are typical in the venture capital industry. *See, e.g.,* Dow Jones Report, *supra* note 145, at 23–24 (showing that, in a survey of 110 North American general partners, at least 83% contributed at least 1% of venture capital fund capital). We note that certain investors perceive an investment in the fund as aligning the interest of investors and advisers. *See* Institutional Limited Partners Association Private Equity Principles, September 9, 2009, at 3 (recommending that the "general partner should have a substantial equity interest in the fund to maintain a strong alignment of interest with the limited partners, and a high percentage of the amount should be in cash as opposed to being contributed through the waiver of the management fee."); Mercer Investment Consulting, Inc., Key Terms and Conditions for Private Equity Investing, 1996 at 13 ("Many limited partners view the 1% standard as an inadequate sharing of risk * * * .").

[164] *See* McGuire Testimony, *supra* note 41, at 3 ("Venture capital funds are not sold directly to retail investors like mutual funds."); Loy Testimony, *supra* note 40, at 2 ("Generally, 95 to 99 percent of capital for the venture fund is provided by qualified institutional investors such as pension funds, universities and endowments, private foundations, and to a lesser extent, high net worth individuals.").

[165] *See* Loy Testimony, *supra* note 40, at 2; McGuire Testimony, *supra* note 41, at 3.

[166] *See* Loy Testimony, *supra* note 40, at 4; McGuire Testimony, *supra* note 41, at 5.

years? Should the proposed rule be modified to specify that a venture capital fund is one that does not have retail investors? If so, how should "retail investor" be defined? Should "retail investor" exclude persons who are not "qualified clients" for purposes of the Advisers Act?[167]

7. Application to Non-U.S. Advisers

Neither the statutory text of section 203(l) nor the legislative reports gives an indication of whether Congress intended the exemption to be available to advisers that operate principally outside of the United States but that invest in U.S. companies or solicit U.S. investors.[168] Testimony before Congress presented by members of the U.S. venture capital industry discussed the industry's role primarily in the U.S. economy including its lack of interconnection with the U.S. financial markets and "interdependence" with the world financial system.[169] Nevertheless, we expect that venture capital funds with advisers operating principally outside of the United States may seek to access the U.S. capital markets by investing in U.S. companies or soliciting U.S. investors; investors in the United States may also have an interest in venture capital opportunities outside of the United States. We request comment on whether the proposed rule should specify that an adviser with its principal office and place of business outside of the United States (a "non-U.S. adviser") is eligible to rely on the exemption even if it advises funds that do not meet our proposed definition of venture capital fund.

A non-U.S. adviser currently may rely on the private adviser exemption, if it meets the conditions of current section 203(b)(3) of the Advisers Act, including advising no more than 14 clients.[170] We have permitted such an adviser to count only clients that are residents of the United States,[171] and for this purpose permitted the adviser to treat a private fund incorporated outside of the United States as a non-resident of the United States, even if some or all of the investors in the private fund are residents of the United States.[172] A non-U.S. adviser may rely on the venture capital exemption if all of its clients, whether U.S. or non-U.S., are venture capital funds. In effecting the new venture capital exemption, should we specifically provide that a non-U.S. adviser may avail itself of the exemption even if it advises clients other than venture capital funds, provided such clients are non-United States persons, under the definition we propose for purposes of the other exemptions discussed below? [173] If we take this approach, should the non-U.S. adviser be able to rely on the venture capital exemption if it advises these other clients from within the United States?

If a non-U.S. adviser must advise solely venture capital funds (even those advisers that principally operate outside of the United States) our proposed definition may have the result of subjecting non-U.S. advisers to United States regulatory oversight because they advise funds offered only outside the United States. Under our proposed rule, only a private fund as defined under section 202(a)(29) may be a venture capital fund.[174] A non-U.S. fund that uses U.S. jurisdictional means in the offering of the securities it issues and relies on sections 3(c)(1) or 3(c)(7) would be a private fund.[175] A non-U.S. fund that does not make such a U.S. offering would not be a private fund and therefore could not qualify as a venture capital fund, even if operated as a venture capital fund in a manner that would otherwise meet the criteria under our proposed definition. If we adopt the approach we are proposing today, should we allow an adviser to treat such a non-U.S. fund as a private fund and, to the extent that the fund meets all of the other conditions of our proposed definition, as a venture capital fund for purposes of the exemption? If so, under what conditions? For example, should a non-U.S. fund be a private fund under the proposed rule if the non-U.S. fund would be deemed a private fund upon conducting a private offering in the United States in reliance on sections 3(c)(1) or 3(c)(7)?

8. Grandfathering Provision

We propose to include in the definition of "venture capital fund" any private fund that: (i) Represented to investors and potential investors at the time the fund offered its securities that it is a venture capital fund; (ii) has sold securities to one or more investors prior to December 31, 2010; and (iii) does not sell any securities to, including accepting any additional capital commitments from, any person after July 21, 2011 (the "grandfathering provision").[176] The grandfathering provision thus would include any fund that has accepted capital commitments by the specified dates even if none of the commitments has been called.[177] As a result, any investment adviser that solely advises private funds that meet the definitions in either proposed rule 203(l)–1(a) or (b) would be exempt from registration.

We believe that most funds previously sold as venture capital funds likely would satisfy all or most of the conditions in the proposed rule.

[167] Rule 205–3 generally defines a qualified client as any person who has at least $750,000 under management with an adviser immediately after entering into the contract or who has a net worth of more than $1,500,000 at the time the contract is entered into.

[168] *See* section 203(l) of the Advisers Act; H. Rep. No. 111–517, *supra* note 7, at 867; S. Rep. No. 111–176, *supra* note 7, at 74–75.

[169] *See* Loy Testimony, *supra* note 40, at 4–5; McGuire Testimony, *supra* note 41, at 5–6.

[170] *See supra* note 5 and accompanying text.

[171] *See* rule 203(b)(3)–1(b)(5).

[172] *See* rule 203(b)(3)–1(a)(2). *See also* ABA Subcommittee on Private Investment Companies, SEC Staff No-Action Letter (Aug. 10, 2006) ("ABA Letter"). In the ABA Letter, Commission staff expressed the view that the substantive provisions of the Advisers Act do not apply to offshore advisers with respect to such advisers' dealings with offshore funds and other offshore clients to the extent described in prior staff no-action letters and the Hedge Fund Adviser Registration Release, *supra* note 17. The staff took the position, however, that an offshore adviser registered with the Commission under the Advisers Act must comply with the Advisers Act and the Commission's rules thereunder with respect to any U.S. clients (and any prospective U.S. clients) it may have.

[173] *See* proposed rule 203(m)–1(e)(8); proposed rule 202(a)(30)–1(c)(2)(i).

[174] *See* proposed rule 203(l)–1(a).

[175] An issuer that is organized under the laws of the United States or of a state is a private fund if it is excluded from the definition of an investment company for most purposes under the Investment Company Act pursuant to sections 3(c)(1) or 3(c)(7). Section 7(d) of the Investment Company Act prohibits a non-U.S. fund from using U.S. jurisdictional means to make a public offering, absent an order permitting registration. A non-U.S. fund may conduct a private U.S. offering without violating section 7(d) only if the fund complies with either section 3(c)(1) or 3(c)(7) with respect to its U.S. investors (or some other available exemption or exclusion). Consistent with this view, a non-U.S. fund is a private fund if it makes use of U.S. jurisdictional means to, directly or indirectly, offer or sell any security of which it is the issuer and relies on either section 3(c)(1) or 3(c)(7). *See* Hedge Fund Adviser Registration Release, *supra* note 17, at n.226; *Offer and Sale of Securities to Canadian Tax-Deferred Retirement Savings Accounts,* Securities Act Release No. 7656 (Mar. 19, 1999) [64 FR 14648 (Mar. 26, 1999)], at nn.10, 20, 23; *Statement of the Commission Regarding Use of Internet Web Sites to Offer Securities, Solicit Securities Transactions or Advertise Investment Services Offshore,* Securities Act Release No. 7516 (Mar. 23, 1998) [63 FR 14806 (Mar. 27, 1998)], at n.41. *See also* Dechert LLP, SEC Staff No-Action Letter (Aug. 24, 2009) at n.8; Goodwin, Procter & Hoar LLP, SEC Staff No-Action Letter (Feb. 28, 1997) ("Goodwin Procter Letter"); Touche Remnant & Co., SEC Staff No-Action Letter (Aug. 27, 1984).

[176] Proposed rule 203(l)–1(b).

[177] *See also Electronic Filing and Revision of Form D,* Securities Act Release No. 8891(Feb. 6, 2008) [73 FR 10592 (Feb. 27, 2008)], at section VIII, Form D, General Instructions—When to File (noting that a Form D is required to be filed within 15 days of the first sale of securities which would include "the date on which the first investor is irrevocably contractually committed to invest"), n.159 ("a mandatory capital commitment call would not constitute a new offering, but would be made under the original offering").

Nevertheless, we recognize that investment advisers currently seeking to sponsor new funds before the adoption of the final version of proposed rule 203(l)–1 will continue to face uncertainty regarding the precise terms of the definition and hence uncertainty regarding their eligibility for the new exemption. Thus, our proposed rule presumes that a fund that has commenced its offering (*i.e.,* has initially sold securities by December 2010) and that also concludes its offering by the effective date of Title IV of the Dodd-Frank Act (*i.e.,* July 21, 2011) is unlikely to have been structured to circumvent the intended scope of the exemption. Moreover, requiring existing venture capital funds to modify their investment conditions or characteristics, liquidate portfolio company holdings or alter the rights of investors in the funds in order to satisfy the proposed definition of a venture capital fund would likely be impossible in many cases and yield unintended consequences for the funds and their investors.

Thus, we propose that an investment adviser may treat any existing private fund as a venture capital fund for purposes of section 203(l) of the Advisers Act if the fund meets the elements of the grandfathering provision. The current private adviser exemption does not require an adviser to identify or characterize itself as any type of adviser (or impose limits on advising any type of funds). Accordingly, we believe that advisers have not had an incentive to mis-characterize existing venture capital funds that have already been marketed to investors. As we note above, a fund that “represents” itself to investors as a venture capital fund is typically one that discloses it pursues a venture capital investing strategy and identifies itself as such. We do not expect funds identifying themselves as “private equity” or “hedge” would be able to rely on this exemption.

We request comment on this grandfathering provision. Should we include other conditions in addition to the fund representing itself as a venture capital fund? For example, should a fund seeking to be grandfathered also provide that its investors do not have any redemption rights except in extraordinary circumstances,[178] not incur leverage except on a short-term basis,[179] limit the securities that it acquires from portfolio companies to equity securities,[180] or provide significant managerial assistance to the portfolio companies in which the fund invests? [181] Should the grandfathering provision be modified to exclude other types of funds, such as funds of venture capital funds or publicly available venture capital funds? [182] We understand that venture capital funds may be in the planning and initial offering stage for a considerable period of time.[183] Should funds that have their first sale of securities within a period of time such as 180 days after the final rule is adopted be able to rely on the proposed grandfathering provision? Does our grandfathering provision unnecessarily encourage the formation of new funds before December 31, 2010, and therefore should the grandfathering provision only apply to funds in existence on the date of this proposal or some other time before December 31, 2010? Would the dates specified in the grandfathering provision significantly shorten the fundraising periods for venture capital funds? Should we specify a date later than December 31, 2010 or earlier than July 21, 2011? Do venture capital fund advisers need more time or flexibility to determine eligibility for the grandfathering provision? Alternatively, would exempt advisers consider registering with the Commission in order to retain flexibility to raise capital for new venture capital funds without regard to the grandfathering provision?

### *B. Exemption for Investment Advisers Solely to Private Funds With Less Than $150 Million in Assets Under Management*

Section 203(m) of the Advisers Act directs the Commission to exempt from registration any investment adviser solely to private funds that has less than $150 million in assets under management in the United States.[184] We are proposing a new rule 203(m)–1 that would provide the exemption and address several interpretive questions raised by section 203(m). We will refer to this exemption as the “private fund adviser exemption.”

#### 1. Advises Solely Private Funds

Proposed rule 203(m)–1 would, like section 203(m) of the Advisers Act, limit an adviser relying on the exemption to advising “private funds” as that term is defined in that Act.[185] An adviser that acquires a different type of client would have to register under the Advisers Act unless another exemption is available. An adviser could advise an unlimited number of private funds, provided the aggregate value of the adviser’s private fund assets is less than $150 million.

In the case of an adviser with a principal office and place of business outside of the United States (a “non-U.S. adviser”), we propose to provide the exemption as long as *all* of the adviser’s clients that are United States persons are qualifying private funds.[186] As a consequence, a non-U.S. adviser could enter the U.S. market and take advantage of the exemption without regard to the type or number of its non-U.S. clients. Under this approach, a non-U.S. adviser would not lose the private fund adviser exemption as a result of its business activities outside the United States. Recognizing that non-U.S. activities of non-U.S. advisers are less likely to implicate U.S. regulatory interests and in consideration of general principles of international comity, our rules have taken a similar approach by permitting a non-U.S. adviser to count only clients that are U.S. persons when determining whether it has 14 or fewer clients, and is thus eligible for the private adviser exemption.[187]

We request comment on our proposed application of the statute to non-U.S. advisers. Should we, alternatively, interpret section 203(m) as denying the private fund adviser exemption to a non-U.S. adviser that has other types of clients outside of the United States? This interpretation would have the effect of treating non-U.S. and U.S. advisers equally with respect to the types of clients they may have, but could also have the result of requiring many non-U.S. advisers to register because of the scope and nature of their non-U.S. advisory business, an outcome which the “assets under management in the United States” limitation in section 203(m) suggests was not a consideration relevant to the scope of the exemption.

[178] *See* proposed rule 203(l)–1(a)(5); *supra* discussion in section II.A.4 of this Release.

[179] *See* proposed rule 203(l)–1(a)(4); *supra* discussion in section II.A.3 of this Release.

[180] *See* proposed rule 203(l)–1(a)(1); *supra* discussion in section II.A.1.b of this Release.

[181] *See* proposed rule 203(l)–1(a)(3); *supra* discussion in section II.A.2 of this Release.

[182] *See supra* discussion in sections II.A.1.e and II.A.6 of this Release.

[183] *See* Breslow & Schwartz, *supra* note 144, at § 2:4.1 (private equity fundraising may take six to 12 months following the initial closing, depending upon whether the adviser has an existing investor base or a successful performance record).

[184] Section 408 of the Dodd-Frank Act, which is codified in section 203(m) of the Advisers Act. *See supra* note 22.

[185] *See* proposed rule 203(m)–1(a) and (b). A “private fund” includes a private fund that invests in other private funds.

[186] Proposed rule 203(m)–1(b)(1).

[187] Rule 203(b)(3)–1(b)(5) (“If you have your principal office and place of business outside the United States, you are not required to count clients that are not United States residents, but if your principal office and place of business is in the United States, you must count all clients.”). *See infra* note 207.

Under such an approach, moreover, the exemption would be unavailable to a non-U.S. adviser unless all of the non-U.S. funds it manages are offered to investors in the United States (and therefore meet the definition of "private fund").[188] If we adopt this alternative approach, should the exemption apply to a non-U.S. adviser even if not all of the non-U.S. funds it manages are offered in the United States?

2. Private Fund Assets

Under proposed rule 203(m)–1, an adviser would have to aggregate the value of all assets of private funds it manages in the United States to determine if the adviser remains below the $150 million threshold.[189] Proposed rule 203(m)–1 would require advisers to calculate the value of private fund assets by reference to Form ADV, under which we propose to provide a uniform method of calculating assets under management for regulatory purposes under the Advisers Act.[190] In the case of a sub-adviser, it would have to count only that portion of the private fund assets for which it has responsibility.[191]

In addition to assets appearing on a private fund's balance sheet, advisers would include any uncalled capital commitments, which are contractual obligations of an investor to acquire an interest in, or provide the total commitment amount over time to, a private fund, when called by the fund.[192] Advisers to private funds that use capital commitments seek investments early in the life of the fund in anticipation of all investors fully paying in these capital commitments during the life of the fund, and fees payable to the adviser are calculated as a percentage of total capital commitments.[193] Many of these types of private funds are managed following investment guidelines and restrictions that are determined as a percentage of overall capital commitments, rather than as a percentage of current net asset value.[194] We request comment on whether the method for calculating the relevant assets under management should deviate from the method in the proposed amendments to Form ADV instructions by, for example, excluding proprietary assets, assets managed without compensation, or uncalled capital commitments.

Under proposed rule 203(m)–1, each adviser would have to determine the amount of its private fund assets quarterly, based on the fair value of the assets at the end of the quarter.[195] We propose that advisers use the fair value of private fund assets in order to ensure that, for purposes of this exemption, advisers value private fund assets on a meaningful and consistent basis. Use of the cost basis (*i.e.,* the value at which the assets were originally acquired), for example, could under certain circumstances understate significantly the value of appreciated assets, and thus result in advisers availing themselves of the exemption. Use of the fair valuation method by all advisers, moreover, would result in more consistent asset calculations and reporting across the industry and, therefore, in a more coherent application of the Advisers Act's regulatory requirements and of our staff's risk assessment program.

We understand that many, but not all, private funds value assets based on their fair value in accordance with U.S. generally accepted accounting principles ("GAAP") or other international accounting standards.[196] Some private funds do not use fair value methodologies, which may be more difficult to apply when the fund holds illiquid or other types of assets that are not traded on organized markets.[197] Would the proposed approach result in advisers valuing their private fund assets in a generally uniform manner and in comparability of the valuations? We are not proposing to require advisers to determine fair value in accordance with GAAP. Should we adopt such a requirement? If not, should we specify that advisers may only determine the fair value of private fund assets in accordance with a body of accounting principles used in preparing financial statements? We understand that GAAP does not require some funds to fair value certain investments. Should we provide for an exception from the proposed fair valuation requirement with respect to any of those investments?

Should we adopt a different approach altogether and allow advisers to use a method other than fair value? Are there other methods that would not understate the value of fund assets? Should the rule permit advisers to rely exclusively on the method set forth in a fund's governing documents, or the method used to report the value of assets to investors or to calculate fees (or other compensation) for investment advisory services? What method should apply if a fund uses different methods for different purposes? Should we modify the proposed rule to require that the valuation be derived from audited financial statements or subject to review

[188] *See supra* note 174–175 and accompanying paragraph.

[189] Proposed rule 203(m)–1(c).

[190] *See* proposed rules 203(m)–1(a)(2); 203(m)–1(b)(2); 203(m)–1(e)(1) (defining "assets under management" to mean "regulatory assets under management" in proposed item 5.F of Form ADV, Part 1A); 203(m)–1(e)(4) (defining "private fund assets" to mean the assets under management attributable to a qualifying private fund). This uniform method of calculation would be used to determine whether an adviser qualifies to register with the Commission rather than the states, as well as to determine eligibility for the private fund adviser exemption and the foreign private adviser exemption discussed in this Release. Under the proposed Form ADV instructions, advisers would include in their "regulatory assets under management" any proprietary assets, assets managed without receiving compensation, and assets of non-U.S. clients, all of which an adviser may currently exclude, as well as, in the case of private funds, uncalled capital commitments. Moreover, the adviser could not deduct liabilities, such as accrued fees and expenses or the amount of any borrowing. *See* Implementing Release, *supra* note 25, at section II.A.3 (discussing the rationale underlying the proposed new instructions for calculating assets under management under Form ADV).

[191] *See* proposed Form ADV: Instructions for Part 1A, instr. 5.b(2).

[192] *See* proposed Form ADV: Instructions for Part 1A, instr. 5.b(1).

[193] *See supra* notes 143–145.

[194] *Id.*

[195] *See* proposed rule 203(m)–1(c); *supra* note 190; proposed Form ADV: Instructions for Part 1A, instr. 5.b(4). As discussed in the Implementing Release, we are proposing to require advisers to value private fund assets using fair value when calculating their assets under management for several purposes under the Advisers Act. *See* Implementing Release, *supra* note 25, at section II.A.3. A fund's governing documents may provide for a specific process for calculating fair value (*e.g.,* that the general partner, rather than the board of directors, determines the fair value of the fund's assets). An adviser would be able to rely on such a process also for purposes of calculating its assets under management.

[196] *See, e.g.,* Comment Letter of National Venture Capital Association (July 28, 2009), at 2 (the "vast majority of venture capital funds provide their LPs [*i.e.,* investors] quarterly and audited annual financial reports. These reports are prepared under generally accepted accounting principles, or GAAP, and audited under the standards established for all investment companies, including the largest mutual fund complexes."); Comment Letter of Managed Funds Association (July 28, 2009), at 3 (a "substantial proportion of hedge fund managers, whether or not they are registered with the Commission, provide independently audited financial statements of the [hedge] fund to investors."). These comment letters were submitted in connection with the Commission's proposed amendments to the custody rule, *Custody of Funds or Securities of Clients by Investment Advisers,* Investment Advisers Act Release No. 2876 (May 20, 2009) [74 FR 25354 (May 27, 2009)], and are available on the Commission's Internet Web site at *http://www.sec.gov/comments/s7–09–09/s70909.shtml.*

[197] Those assets include, for example, "distressed debt" (such as securities of companies or government entities that are either already in default, under bankruptcy protection, or in distress and heading toward such a condition) or certain types of emerging market securities that are not readily marketable. *See* Gerald T. Lins *et al.,* Hedge Funds and Other Private Funds: Reg and Comp § 5:22 (2009) ("At any given time, some portion of a hedge fund's portfolio holdings may be illiquid and/or difficult to value. This is particularly the case for certain types of hedge funds, such as those focusing on distressed securities, activist investing, etc.").

by auditors or another independent third party?

As discussed above, we are proposing that funds value assets no less frequently than quarterly, although such values are not subject to quarterly reporting to us.[198] As a consequence, short-term market value fluctuations would not affect the availability of the exemption between the ends of calendar quarters. We request comment on our proposed quarterly calculation. Should compliance with the $150 million threshold be determined more or less frequently than quarterly? For purposes of reporting on proposed amendments on Form ADV, registered investment advisers (and exempt reporting advisers) would be required to report their regulatory assets under management annually.[199] Should the availability of the exemption under proposed rule 203(m)–1 be conditioned on annual valuation rather than quarterly valuation?

3. Assets Managed in the United States

Under proposed rule 203(m)–1, all of the private fund assets of an adviser with a principal office and place of business in the United States would be considered to be "assets under management in the United States," even if the adviser has offices outside of the United States.[200] A non-U.S. adviser, however, would need only count private fund assets it manages from a place of business in the United States toward the $150 million asset limit under the exemption.[201]

Rule 203(m)–1 would deem all of the assets managed by an adviser to be managed "in the United States" if the adviser's "principal office and place of business" is in the United States. We would look to an adviser's principal office and place of business as the location where the adviser controls, or has ultimate responsibility for, the management of private fund assets, and therefore as *the* place where all the advisers' assets are managed, although day-to-day management of certain assets may also take place at another location. This approach is similar to the way we have identified the location of the adviser for regulatory purposes under our current rules,[202] which define an adviser's principal office and place of business as the location where it "directs, controls and coordinates" its global advisory activities, regardless of the location where some of the advisory activities might occur.[203] For most advisers, this approach would avoid difficult attribution determinations that would be required if assets are managed by teams located in multiple jurisdictions, or if portfolio managers located in one jurisdiction rely heavily on research or other advisory services performed by employees located in another jurisdiction.

We considered but decided not to propose an approach that would presume that a non-U.S. adviser to private funds offered in the United States would have no assets managed from a location in the United States if its principal office and place of business is not "in the United States."[204] Such an interpretation of the statute would treat U.S. advisers the same as non-U.S. advisers, but would seem to ignore the fact that day-to-day management of some assets of the private fund does in fact take place "in the United States," even though that management is ultimately controlled from outside of the United States. Moreover, it would permit an adviser engaging in substantial advisory activities in the United States to escape our regulatory oversight merely because the adviser's principal office and place of business is outside the United States. This consequence seems at odds not only with section 203(m), but also with the "foreign private adviser" exemption discussed below in which Congress specifically set forth circumstances under which a non-U.S. adviser may be exempt provided it does not have any place of business in the United States, among other conditions.[205]

We request comment on our proposed approach, which is similar to the way we have administered the current private adviser exemption in section 203(b)(3) of the Advisers Act with respect to non-U.S. advisers. Under that exemption (as discussed above), an adviser with a principal office and place of business outside of the United States need only count clients that are residents of the United States towards the 14 client limit.[206] As with other Commission rules that adopt a territorial approach, the private adviser exemption is available to a non-U.S. adviser (regardless of its non-U.S. advisory activities) in recognition of the fact that non-U.S. activities of non-U.S. advisers are less likely to implicate U.S. regulatory interests and in consideration of general principles of international comity.[207] This approach to the exemption is designed to encourage the participation of non-U.S. advisers in the

[198] The proposed frequency of the calculation is consistent with section 2(a)(41)(A) of the Investment Company Act, which specifies the valuation of the assets of an issuer for purposes of determining whether it meets the definition of investment company under section 3 of that Act.

[199] *See* proposed rules 204–1(a) and 204–4(a) and proposed General Instruction 3 to Form ADV. *See* Implementing Release, *supra* note 25, at section II.B.3. *See also* Form ADV Release, *supra* note 132, at 15 ("Advisers must update the amount of their assets under management annually (as part of their annual updating amendment) and make interim amendments only for material changes in assets under management when they are filing an 'other than annual amendment' for a separate reason.").

[200] Proposed rule 203(m)–1(a). The proposed rule also would define the United States to have the same meaning as in rule 902(l) of Regulation S under the Securities Act, which is "the United States of America, its territories and possessions, any State of the United States, and the District of Columbia." Proposed rule 203(m)–1(e)(7).

[201] Proposed rule 203(m)–1(b). Any assets managed from a U.S. place of business for clients other than private funds would make the exemption unavailable. We understand that others have supported a jurisdictional approach to regulation, which focuses on the primary market in which an adviser conducts its business. *See, e.g.,* G20 Working Group Report, *supra* note 136, at 16; Testimony of W. Todd Groome, Chairman, The Alternative Investment Management Association, before the House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, May 7, 2009, at 3. These commenters propose an approach that looks to the location where the primary business is conducted, which is similar to our territorial approach.

[202] *See* rule 203A–3(c); rule 222–1. Both rules define "principal place of business" of an investment adviser as the executive office of the investment adviser from which the officers, partners or managers of the investment adviser direct, control and coordinate the activities of the investment adviser.

[203] *See* proposed rule 203(m)–1(e)(3) (defining "principal office and place of business" as the adviser's executive office from which the officers, partners, or managers of the adviser direct, control, and coordinate the adviser's activities); proposed rule 203(m)–1(e)(2) (defining "place of business," by reference to proposed rule 222–1(a), as (i) an office where the investment adviser regularly provides investment advisory services, solicits, meets with, or otherwise communicates with clients, and (ii) any other location that it holds out to the general public as a place where those activities take place).

[204] Under our proposed rule, assets under management for purposes of the exemption are those assets for which the adviser provides "continuous and regular supervisory or management services." *See* proposed rule 203(m)–1(e)(1); proposed Form ADV: Instructions for Part 1A, instr. 5.b(3). For a non-U.S. adviser, the assets for which the adviser provides such services from a place of business in the United States would count towards the $150 million asset threshold under the exemption. *See* proposed rule 203(m)–1(b)(2). *See also supra* note 203 for the definition of "place of business" under proposed rule 203(m)–1(e)(2).

[205] *See* section II.C of this Release.

[206] Rule 203(b)(3)–1(b)(5) (adviser with principal office and place of business outside of the United States not required to count clients that are not United States residents, but adviser with principal office and place of business is in the United States must count all clients). Our staff has taken the position that under the existing private adviser exemption, a non-U.S. adviser need not count its non-U.S. clients, including an offshore fund, even if there are U.S. investors in the fund. *See* ABA Letter, *supra* note 172, at 2 and discussion *infra* section II.C.1 of this Release.

[207] *See, e.g.,* Regulation S (adopting a territorial approach to offers and sales of securities); rule 15a–6 under the Exchange Act (17 CFR 240.15a–6) (providing an exemption from U.S. registration for non-U.S. broker-dealers who limit their activities and satisfy certain conditions).

U.S. market by applying the U.S. securities laws in a manner that does not impose U.S. regulatory and operational requirements on an adviser's non-U.S. advisory business.[208]

Should we adopt a different approach that more broadly applies the availability of the private fund adviser exemption to U.S. advisers? We could treat U.S. and non-U.S. advisers alike, in which case a U.S. adviser could exclude assets it manages through non-U.S. offices. Under the proposed rule, would some or most advisers with non-U.S. branch offices re-organize those offices as subsidiaries in order to avoid attributing assets managed to the non-U.S. office? We understand that U.S. advisers that manage private fund assets in a non-U.S. country typically do so through one or more separate subsidiaries organized in such non-U.S. jurisdictions.[209] If so, the proposed rule may have a limited effect on multi-national advisory firms, which for tax or business reasons keep their non-U.S. advisory activities separate from their U.S. advisory activities. Is this understanding correct? Such U.S. advisers would not generally have to count the assets managed by the non-U.S. affiliates under the proposed rule.[210] Should our rule determine "private fund assets" on an aggregated basis if, for example, U.S. and non-U.S. affiliates share advisory duties for a private fund, or if one affiliate provides subadvisory services to another affiliate?

Alternatively, should we interpret "assets under management in the United States" by reference to the source of the assets (*i.e.,* U.S. private fund investors)? Under this approach, a non-U.S. adviser would count the assets of private funds attributable to U.S. investors towards the $150 million threshold, regardless of the location where it manages the private funds. We note that this approach could have the result that fewer non-U.S. advisers would be eligible for the exemption if there are significant assets of U.S. investors in those funds that the advisers manage from a non-U.S. location. This approach could also mean that a U.S. adviser managing assets from, for example, an office in New York City, could manage substantially in excess of $150 million in assets of one or more private funds as long as the investors in those funds were not U.S persons.

Do commenters view either of these alternatives, separately or in combination with our proposed approach, as more closely reflecting the intent of Congress in using the term "assets under management in the United States" and our regulatory interests? Would either alternative approach be easier for advisers to comply with than the one we are proposing to adopt? Would it be easier for investors to understand the rationale for why an adviser is eligible for the exemption under the proposed approach or either of the alternative approaches?

4. United States Person

Under proposed rule 203(m)–1(b), a non-U.S. adviser could not rely on the exemption if it advised any client that is a United States person other than a private fund.[211] We propose to define a "United States person" generally by incorporating the definition of a "U.S. person" in our Regulation S.[212] Regulation S looks generally to the residence of an individual to determine whether the individual is a United States person,[213] and also addresses the circumstances under which a legal person, such as a trust, partnership or a corporation, is a United States person.[214] Regulation S generally treats legal partnerships and corporations as Unites States persons if they are organized or incorporated in the United States, and trusts by reference to the residence of the trustee.[215] It treats discretionary accounts generally as United States persons if the fiduciary is a resident of the United States.[216]

We are proposing to incorporate Regulation S because it would provide a well-developed body of law that would, in our view, appropriately address many of the questions that will arise under rule 203(m)–1. Moreover, managers to private funds and their counsel must today be familiar with the definition of "U.S. person" under Regulation S in order to comply with other provisions of the federal securities laws.[217] We ask comment on the proposed use of the Regulation S definition of U.S. person. Should we use a different definition of United States person? We have previously suggested that advisers may rely on an alternative to Regulation S for certain types of clients.[218] Would that approach be less prone to abuse or circumvention or provide greater clarity?

Proposed rule 203(m)–1 contains a special rule for discretionary accounts maintained outside of the United States for the benefit of United States persons.[219] Under the proposed rule, an adviser must treat a discretionary or other fiduciary account as a United States person if the account is held for the benefit of a United States person by a non-U.S. fiduciary who is a related person of the adviser. An adviser could not rely on the exemption if it established discretionary accounts for the benefit of U.S. clients with an offshore affiliate that would then delegate the actual management of the account back to the adviser.[220] We request comment on this special rule. Does our proposed rule adequately

[208] *See generally* Division of Investment Management, SEC, *Protecting Investors: A Half Century of Investment Company Regulation,* May 1992, at 223–227 (recognizing that non-U.S. advisers that registered with the Commission were arguably subject to all of the substantive provisions of the Advisers Act with respect to their U.S. and non-U.S. clients, which could result in inconsistent regulatory requirements or practices imposed by the regulations of their local jurisdiction and the U.S. securities laws; in response, advisers could form separate and independent subsidiaries but this could result in U.S. clients having access to a limited number of advisory personnel and reduced access by the U.S. subsidiary to information or research by non-U.S. affiliates).

[209] *See, e.g.,* James D. Rosener, *Legal Considerations for Establishing Operations in the United States,* Pepper Hamilton LLP, June 25, 2002, *http://www.pepperlaw.com/publications_article.aspx?ArticleKey=186* (creating separate subsidiaries offers benefits, including the ability to offset profits from one subsidiary against losses in another); *see also* Edward F. Greene, et al., U.S. Regulation of the International Securities and Derivatives Markets, § 11.02[2].

[210] *See infra* note 270.

[211] Proposed rule 203(m)–1(b)(1).

[212] Proposed rule 203(m)–1(e)(8).

[213] 17 CFR 230.902(k)(1)(i).

[214] *See, e.g.,* 17 CFR 230.902(k)(1) and (2).

[215] 17 CFR 230.902(k)(1)(ii) and (iv).

[216] 17 CFR 230.902(k)(1)(vii).

[217] For instance, our staff has generally taken the interpretive position that an investor that is not a U.S. person under Regulation S is not a U.S. person when determining whether a non-U.S. private fund meets the counting or qualification requirements that apply to U.S. beneficial owners or owners of a private fund under sections 3(c)(1) or 3(c)(7) of the Investment Company Act. We understand that many U.S. and non-U.S. advisers currently follow our staff's guidance and rely on this definition when determining whether a pooled investment vehicle qualifies as a private fund. *See* Goodwin Procter Letter, *supra* note 175; ABA Letter, *supra* note 172. Advisers apply the Regulation S definition of "U.S. person" also for other purposes. *See infra* note 259.

[218] In connection with adopting rule 203(b)(3)–2 under the Advisers Act, we previously noted that commenters had suggested that we incorporate the definition of U.S. person from Regulation S. Pending our reconsideration of the use of the Regulation S definition, we indicated at the time that we would not object if advisers identified U.S. persons by looking: "(i) In the case of individuals to their residence, (ii) in the case of corporations and other business entities to their principal office and place of business, (iii) in the case of personal trusts and estates to the rules set out in Regulation S, and (iv) in the case of discretionary or non-discretionary accounts managed by another investment adviser to the location of the person for whose benefit the account is held." *See* Hedge Fund Adviser Registration Release, *supra* note 17, at n.201. We reconsidered the use of Regulation S and concluded it is appropriate as modified in our proposed rule.

[219] Proposed rule 203(m)–1(e)(8).

[220] Under Regulation S, a discretionary account maintained by a non-U.S. fiduciary (such as an investment adviser) is not a "U.S. person" even if the account is owned by a U.S. person. *See* rule 902(k)(1)(vii); rule 902(k)(2)(i).

address the concern that an adviser could avoid the limitation of the exemption through non-U.S. discretionary accounts?

5. Transition Rule

We propose to include in proposed rule 203(m)–1 a provision giving an adviser one calendar quarter (three months) to register with the Commission after becoming ineligible to rely on the exemption due to an increase in the value of its private fund assets.[221] Because qualification for the exemption depends on remaining below the $150 million threshold on a quarterly basis, an adviser could exceed the limit based on market fluctuations without any new investments from existing or new investors. This three month period would enable the adviser to take steps to register and otherwise come into compliance with the requirements of the Advisers Act applicable to registered investment advisers, including the adoption and implementation of compliance policies and procedures.[222] It would be available only to an adviser that has complied with all applicable Commission reporting requirements.[223] We are not required to provide the safe harbor, and we do not believe it would be appropriate for an adviser to rely on it if the adviser has failed to comply with its reporting requirements. We request comment on this transition period. Is the calendar quarter period sufficient? Should the transition period be longer, such as two calendar quarters, or shorter, such as 30 days? If the adviser determines to expand its advisory business to manage assets other than private funds (*e.g.,* separate accounts), should the transition period also be available? Should a transition period be available at all?

*C. Foreign Private Advisers*

Section 403 of the Dodd-Frank Act replaces the current private adviser exemption from registration under the Advisers Act with a new exemption for a "foreign private adviser," as defined in new section 202(a)(30).[224] The new exemption is codified as amended section 203(b)(3).

Under section 202(a)(30), a foreign private adviser is any investment adviser that: (i) Has no place of business in the United States; (ii) has, in total, fewer than 15 clients in the United States and investors in the United States in private funds advised by the investment adviser; (iii) 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 million; [225] and (iv) does not hold itself out generally to the public in the United States as an investment adviser.[226] Section 202(a)(30) provides the Commission with authority to increase the $25 million threshold "in accordance with the purposes of this title." [227]

We are proposing a new rule, 202(a)(30)–1, which would define certain terms in section 202(a)(30) for use by advisers seeking to avail themselves of the foreign private adviser exemption. Because eligibility for the new foreign private adviser exemption, like the current private adviser exemption, is determined, in part, by the number of clients an adviser has, we propose to include in rule 202(a)(30)–1 the safe harbor rules and many of the client counting rules that appear in rule 203(b)(3)–1, as currently in effect.[228] In addition, we propose to define other terms used in the definition of "foreign private adviser" in section 202(a)(30), including: (i) "investor;" (ii) "in the United States;" (iii) "place of business;" and (iv) "assets under management." [229]

1. Clients

For purposes of the definition of "foreign private adviser," proposed rule 202(a)(30)–1 would include the safe harbor for counting clients currently in rule 203(b)(3)–1, as modified to account for its use in the foreign private adviser context and to eliminate a provision allowing advisers not to count those clients from which they receive no compensation. We note, however, that the foreign private adviser exemption provides a much more limited exemption in this regard than our current rule 203(b)(3)–1 because section 202(a)(30) requires an adviser to also count the number of "investors" of an issuer that is a "private fund" (a term that is defined in section 202(a)(29)) managed by the adviser.[230]

Specifically, proposed rule 202(a)(30)–1, like current rule 203(b)(3)–1, would allow an adviser to treat as a single client a natural person and: (i) That person's minor children (whether or not they share the natural person's principal residence); (ii) any relative, spouse, or relative of the spouse of the natural person who has the same principal residence; (iii) all accounts 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; 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.[231] Proposed rule 202(a)(30)–1 would also retain other provisions of rule 203(b)(3)–1 that permit an adviser to 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

[221] Proposed rule 203(m)–1(d). In effect, an adviser would register by the end of the calendar quarter following the quarter-end date at which private fund assets equaled or exceeded $150 million. If, however, on the succeeding calendar quarter end date, private fund assets have declined below $150 million, then registration would not be required.

[222] *See* rule 206(4)–7.

[223] *See* proposed rule 203(m)–1(d); *see also, e.g.,* proposed rule 204–4 under the Advisers Act (discussed in the Implementing Release, *supra* note 25, at section II.B).

[224] Section 402 of the Dodd-Frank Act (providing a definition of "foreign private adviser," to be codified at section 202(a)(30) of the Advisers Act). *See supra* note 23 and accompanying text.

[225] Subparagraph (B) of section 202(a)(30) refers to the number of "clients and investors in the United States in private funds," while subparagraph (C) refers to assets of "clients *in the United States* and investors in the United States in private funds" (emphasis added). We interpret these provisions consistently so that only clients *in the United States* and investors in the United States should be counted for purposes of subparagraph (B).

[226] In addition, the exemption is not available to an adviser that "acts as (I) an investment adviser to any investment company registered under the [Investment Company Act]; or (II) a company that has elected to be a business development company pursuant to section 54 of [that Act] and has not withdrawn its election." Section 202(a)(30)(D)(ii). We interpret subparagraph (II) to prevent an adviser *that advises* a business development company from relying on the exemption.

[227] Section 202(a)(30)(C).

[228] Rule 203(b)(3)–1, as currently in effect, provides a safe harbor for determining who may be deemed a single client for purposes of the private adviser exemption. We would not, however, carry over from rule 203(b)(3)-1 a provision that distinguishes between advisers whose principal places of business are inside or outside of the United States. Under the definition of "foreign private adviser," an adviser may not have any place of business in the United States. *See* section 402 of the Dodd-Frank Act (defining "foreign private adviser"); rule 203(b)(3)–1(b)(5). We would also not include rule 203(b)(3)–1(b)(7), which specifies that a client who is an owner of a private fund is a resident where the client resides at the time of the client's investment in the fund. The provision was vacated by *Goldstein. See supra* note 18. As discussed below, we are proposing to include another, similar, provision in rule 202(a)(30)–1, which would apply to both clients and investors for purposes of the foreign private adviser exemption. *See infra* note 257 and accompanying text.

[229] Proposed rule 202(a)(30)–1(c).

[230] *See supra* note 9.

[231] Proposed rule 202(a)(30)–1(a)(1). If a client relationship involving multiple persons does not fall within the rule, the question of whether the relationship may appropriately be treated as a single "client" must be determined on the basis of the facts and circumstances involved.

that have identical shareholders, partners, limited partners, members, or beneficiaries.[232]

We would not include the "special rule" providing advisers with the option of not counting as a client any person for whom the adviser provides investment advisory services without compensation.[233] As noted above, we propose to require advisers to include the assets of such clients in their "regulatory assets under management," [234] and we propose the same approach with respect to counting clients.[235]

Finally, we propose to add a provision that would avoid double-counting private funds and their investors by advisers.[236] This provision would specify that an adviser need not count a private fund as a client if the adviser counted any investor, as defined in the rule, in that private fund as an investor in that private fund for purposes of determining the availability of the exemption.[237]

We are proposing to include the current rule 203(b)(3)–1 safe harbor for counting clients in proposed rule 202(a)(30)–1 because we believe that application of this provision (as we propose to modify it) will operate to effect the purposes of the foreign private adviser exemption. Congress replaced the private adviser exemption with the foreign private adviser exemption, both of which require advisers to count clients. As Congress was aware of rule 203(b)(3)–1's counting guidelines when it incorporated a limitation on the number of "clients" in the definition of "foreign private adviser," we believe it would be consistent with Congress's amendment to preserve generally the method for counting clients, together with the requirement to count clients.

We request comment generally on our approach to counting "clients" in proposed rule 202(a)(30)–1 and on each of the specific proposed provisions. Is it appropriate to derive the definition of "client" in proposed rule 202(a)(30)–1 from rule 203(b)(3)–1's definition? Are there alternative approaches we should consider instead? Is including the "special rules" in proposed rule 202(a)(30)–1 appropriate? Are there any that are not appropriate in this context and should not be included in the proposed rule? In particular, should we have maintained the special rule allowing an adviser not to count as a client any person for whom the adviser provides investment advisory services without compensation, even though such person may be treated as a client for other purposes (*e.g.,* reporting on Form ADV)? Should we modify the proposed rule that allows an adviser not to count a private fund as a client if it counts any investor in that private fund by also providing that an adviser may avoid counting as a client any person it counts as an investor? Finally, are there any further modifications to the definition that we should make?

2. Private Fund Investor

Section 202(a)(30) provides that a "foreign private adviser" eligible for the new registration exemption cannot have more than 14 clients "or investors in the United States in private funds" advised by the adviser. We propose to define "investor" in a private fund in rule 202(a)(30)–1 as any person who would be included in determining the number of beneficial owners of the outstanding securities of a private fund under section 3(c)(1) of the Investment Company Act, or whether the outstanding securities of a private fund are owned exclusively by qualified purchasers under section 3(c)(7) of that Act.[238] In order to avoid double-counting, an adviser would be able to treat as a single investor any person who is an investor in two or more private funds advised by the investment adviser.[239]

The term "investor" is not currently defined under the Advisers Act or the rules under the Advisers Act. Defining the term as proposed would ensure consistent application of the statutory provision and prevent, for example, non-U.S. advisers from circumventing the limitations in section 203(b)(3) by using nominee accounts that would aggregate investors into a single nominal investor for purposes of the counting requirement of section 202(a)(30). Under section 203(b)(3), an adviser relying on the foreign private adviser exemption may only have advisory relationships with private funds with a limited number of U.S. investors. Advisers should not be able to avoid this limitation by setting up intermediate accounts through which investors may access a private fund and not be counted for purposes of the exemption.

Defining investors by reference to sections 3(c)(1) and 3(c)(7) of the Investment Company Act may best achieve these purposes. Funds and their advisers must determine who is a beneficial owner for purposes of section 3(c)(1) or whether an owner is a qualified purchaser for purposes of section 3(c)(7).[240] Typically, a prospective investor in a private fund must complete a subscription agreement that includes representations or confirmations that it is qualified to invest in the fund and whether it is a U.S. person. This information is designed to allow the adviser (on behalf of the fund) to make the above determination. Therefore, an adviser seeking to rely on the foreign private adviser exemption will have ready access to this information.

More important, defining the term "investor" by reference to sections 3(c)(1) and 3(c)(7) appears to appropriately limit the ability of a non-U.S. adviser to avoid application of the registration provisions of the Advisers Act. For example, under the proposed rule, holders of both equity and debt securities would be counted as

[232] Proposed rule 202(a)(30)–1(a)(2). In addition, proposed rule 202(a)(30)–1(b)(1) through (3) would retain the following related "special rules": (1) An adviser must count a shareholder, partner, limited partner, member, or beneficiary (each, an "owner") of a corporation, general partnership, limited partnership, limited liability company, trust, or other legal organization, as a client if the adviser provides investment advisory services to the owner separate and apart from the legal organization; (2) an adviser is not required to count an owner as a client solely because the adviser, on behalf of the legal organization, offers, promotes, or sells interests in the legal organization to the owner, or reports periodically to the owners as a group solely with respect to the performance of or plans for the legal organization's assets or similar matters; and (3) any general partner, managing member or other person acting as an investment adviser to a limited partnership or limited liability company must treat the partnership or limited liability company as a client.

[233] *See* rule 203(b)(3)–1(b)(4).

[234] In the Implementing Release, we are proposing to adopt a uniform method for calculating assets under management for purposes of registration pursuant to which an adviser would count assets that are managed without compensation. In this Release, we propose to apply the proposed method of calculation to the foreign private adviser exemption and the private fund adviser exemption. *See infra* section II.C.5 of this Release; Implementing Release, *supra* note 25, at section II.A.3.

[235] As discussed in the Implementing Release, our proposed changes to the method of calculating assets under management would remove the option of excluding certain assets from an adviser's calculation in order to avoid registration with the Commission and regulatory requirements associated with registration. *See* Implementing Release, *supra* note 25, nn.44–50 and accompanying and following text. Allowing an adviser not to count as clients persons in the United States that do not compensate the adviser would similarly allow certain advisers to avoid registration through reliance on the foreign private adviser exemption despite the fact that the adviser provides advisory services to such persons.

[236] *See* proposed rule 202(a)(30)–1(b)(4).

[237] *See* proposed rule 202(a)(30)–1(b)(4); 202(a)(30)–1(c)(1). *See also infra* section II.C.2 of this Release (discussing the definition of investor).

[238] *See* proposed rule 202(a)(30)–1(c)(1); *supra* notes 8–13 and accompanying text. Under the proposed rule, knowledgeable employees with respect to the private fund (and certain persons related to them) and beneficial owners of short-term paper issued by the private fund would also count as investors. *See infra* note 246 and accompanying text.

[239] *See* proposed rule 202(a)(30)–1(c)(1), at note to paragraph (c)(1).

[240] *See supra* notes 11 and 13.

investors.[241] Advisers, moreover, would have to "look though" nominee and similar arrangements to the underlying holders of private fund-issued securities to determine whether they have fewer than 15 clients and private fund investors in the United States.[242]

Under the proposed rule, an adviser would determine the number of investors in a private fund based on facts and circumstances and in light of the applicable prohibition not to do indirectly, or through or by any other person, what is unlawful to do directly.[243] In the following circumstances, for example, an adviser relying on the exemption would have to count as an investor a person who is not the nominal owner of a private fund's securities. First, the adviser to a master fund in a master-feeder arrangement would have to treat as investors the holders of the securities of any feeder fund formed or operated for the purpose of investing in the master fund rather than the feeder funds, which act as conduits.[244] Second, an adviser would need to count as an investor any holder of an instrument, such as a total return swap, that effectively transfers the risk of investing in the private fund from the record owner of the private fund's securities. The record owner of private fund securities could enter into a total return swap transaction to transfer to a third party any profits or losses that the record owner could incur as a result of its investment in the private fund. Thus, even though the record owner would remain the nominal owner of private fund securities, the associated risks of an investment in the securities would have been transferred to the third party who has made the determination to invest in the private fund indirectly through the record owner. In such a case, the third party would be counted as a beneficial owner under section 3(c)(1), or be required to be a qualified purchaser under section 3(c)(7).[245] Accordingly, the third party would be counted as an investor in the private fund for purposes of the foreign private adviser exemption.

We are also proposing to treat as investors beneficial owners (i) who are "knowledgeable employees" with respect to the private fund, and certain other persons related to such employees (we refer to these, collectively, as "knowledgeable employees"); [246] and (ii) of "short-term paper" [247] issued by the private fund,[248] even though these persons are not counted as beneficial owners for purposes of section 3(c)(1), and knowledgeable employees are not required to be qualified purchasers under section 3(c)(7).[249] We are proposing to count knowledgeable employees as investors under the same approach we take with our proposal that advisers count in their calculation of assets under management assets they manage without being compensated, which often include assets of knowledgeable employees.[250] Under our proposed rule, holders of short-term paper, like other debt holders, would also be counted as investors because a private fund's losses directly affect these holders' interest in the fund just as they affect the interest of other debt holders in the fund.[251]

We request comment on our definition of "investor." Does the term require further definition? Does our definition of "investor" appropriately reflect Congress's intent in providing an exemption for foreign private advisers? Under our proposal, advisers would not be able to consolidate investors for counting purposes in the same manner they would be able to consolidate clients under certain circumstances. Should we consider extending to investors the "special rules" for counting clients under proposed rule 202(a)(30)–1? Would this lead to either under-counting or over-counting of investors? Is it appropriate to count as a single investor a person that invests in two or more private funds advised by the adviser? Is it appropriate to treat as investors beneficial owners who are "knowledgeable employees" with respect to the private fund, and of short-term paper issued by the fund?

3. In the United States

Section 202(a)(30)'s definition of "foreign private adviser" employs the term "in the United States" in several contexts including: (i) Limiting the number of—and assets under management attributable to—an adviser's "clients" "in the United States" and "investors" "in the United States" in private funds advised by the adviser; (ii) exempting only those advisers without

[241] Sections 3(c)(1) and 3(c)(7) of the Investment Company Act refer to beneficial owners and owners, respectively, of "securities" (which is broadly defined in section 2(a)(36) of that Act to include debt and equity).

[242] Proposed rule 202(a)(30)–1(c)(1). *See generally* sections 3(c)(1) and 3(c)(7) of the Investment Company Act.

[243] *See* section 208(d) of the Advisers Act.

[244] A "master-feeder fund" is an arrangement in which one or more funds with identical investment objectives ("feeder funds") invest all of their assets in a single fund ("master fund") with the same investment objective and strategies. We have taken the same approach within our rules that expressly require a private fund to "look-through" any investor that is formed for the specific purpose of investing in a private fund. *See* rule 2a51–3(a) under the Investment Company Act (17 CFR 270.2a51–3(a)) (a company is not a qualified purchaser if it is "formed for the specific purpose of acquiring the securities" of an investment company that is relying on section 3(c)(7) of the Investment Company Act, unless each of the company's beneficial owners is also a qualified purchaser). *See also Privately Offered Investment Companies,* Investment Company Act Release No. 22597 (Apr. 3, 1997) [62 FR 17512 (Apr. 9, 1997)] ("NSMIA Release") (explaining that rule 2a51–3(a) would limit the possibility that "a company will be able to do indirectly what it is prohibited from doing directly [by organizing] * * * a 'qualified purchaser' entity for the purpose of making an investment in a particular Section 3(c)(7) Fund available to investors that themselves did not meet the definition of 'qualified purchaser.' ").

[245] As noted above, we have recognized that in certain circumstances it is appropriate to "look through" an investor (*i.e.,* attribute ownership of a private fund to another person who is the ultimate owner). *See, e.g.,* NSMIA Release, *supra* note 244 ("The Commission understands that there are other forms of holding investments that may raise interpretative issues concerning whether a Prospective Qualified Purchaser 'owns' an investment. For instance, when an entity that holds investments is the 'alter ego' of a Prospective Qualified Purchaser (as in the case of an entity that is wholly owned by a Prospective Qualified Purchaser who makes all the decisions with respect to such investments), it would be appropriate to attribute the investments held by such entity to the Prospective Qualified Purchaser.").

[246] *See* proposed rule 202(a)(30)–1(c)(1)(A) (referencing rule 3c–5 under the Investment Company Act (17 CFR 270.3c–5(b)), which excludes from the determinations under sections 3(c)(1) and 3(c)(7) of that Act any securities beneficially owned by knowledgeable employees of a private fund; a company owned exclusively by knowledgeable employees; and any person who acquires securities originally acquired by a knowledgeable employee through certain transfers of interests, such as a gift or a bequest).

[247] *See* proposed rule 202(a)(30)–1(c)(1)(B) (referencing the definition of "short-term paper" contained in section 2(a)(38) of the Investment Company Act, which defines "short-term paper" to mean "any note, draft, bill of exchange, or banker's acceptance payable on demand or having a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof payable on demand or having a maturity likewise limited; and such other classes of securities, of a commercial rather than an investment character, as the Commission may designate by rules and regulations.")

[248] *See* proposed rule 202(a)(30)–1(c)(1).

[249] *See* section 3(c)(1) of the Investment Company Act; rule 3c–5(b) under the Investment Company Act.

[250] *See supra* note 190. As discussed above, our proposed changes to the method of calculating assets under management would preclude some advisers from excluding certain assets from their calculation in order to avoid registration with the Commission and regulatory requirements associated with registration. Allowing an adviser not to count as investors persons that do not compensate the adviser, such as knowledgeable employees, would similarly allow certain advisers to avoid registration by relying on the foreign private adviser exemption.

[251] Various types of investment vehicles make significant use of short-term paper for financing purposes so holders of this type of security are, in practice, exposed to the investment results of the security's issuer. *See* Money Market Fund Reform Release, *supra* note 134, at nn. 37–39 and preceding and accompanying text (discussing how money market funds were exposed to substantial losses during 2007 as a result of exposure to debt securities issued by structured investment vehicles).

a place of business "in the United States"; and (iii) exempting only those advisers that do not hold themselves out to the public "in the United States" as an investment adviser.[252] We are proposing to define "in the United States" to provide clarification of the term for all of the above purposes as well as provide specific instruction as to the relevant time for making the related determination.

Proposed rule 202(a)(30)–1 defines "in the United States" generally by incorporating the definition of a "U.S. person" and "United States" under Regulation S.[253] In particular, we would define "in the United States" in proposed rule 202(a)(30)–1(c)(2) to mean: (i) With respect to any place of business located in the "United States," as that term is defined in Regulation S;[254] (ii) with respect to any client or private fund investor in the United States, any person that is a "U.S. person" as defined in Regulation S,[255] except that any discretionary account or similar account that is held for the benefit of a person "in the United States" by a non-U.S. dealer or other professional fiduciary is deemed "in the United States" if the dealer or professional fiduciary is a related person of the investment adviser relying on the exemption; and (iii) with respect to the public in the "United States," as that term is defined in Regulation S.[256] In addition, we are proposing to add a note to paragraph (c)(2)(i) specifying that for purposes of that definition, a person that is "in the United States" 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, in the case of an investor in a private fund, at the time the investor acquires the securities issued by the fund.[257] We believe that without this note this rule might be burdensome because an adviser would have to monitor the location of clients and investors on an ongoing basis, and might have to choose between registering with us or terminating the relationship with any client that moved to the United States, or redeeming the interest in the private fund of any investor that moved to the United States.

We believe that the use of Regulation S is appropriate for purposes of the foreign private adviser exemption because Regulation S provides more specific rules when applied to various types of legal structures.[258] Advisers, moreover, already apply the Regulation S definition of U.S. person with respect to both clients and investors for other purposes and therefore are familiar with the definition.[259] The proposed references to Regulation S with respect to a place of business "in the United States" and the public in the "United States" would also allow us to maintain consistency across our rules.

Similar to our approach in proposed rule 203(m)–1(e)(8),[260] we treat as persons "in the United States" for purposes of the foreign private adviser, certain persons that would not be considered "U.S. persons" under Regulation S. We are proposing to treat as a U.S. person discretionary accounts owned by a U.S. person and managed by a non-U.S. affiliate of the adviser in order to discourage non-U.S. advisers from creating such discretionary accounts with the goal of circumventing the exemption's limitation with respect to persons in the United States.[261]

We request comment on the definition of "in the United States" in proposed rule 202(a)(30)–1(c)(2). Is our definition appropriate as it relates to a "place of business?" Is it appropriate as it relates to "clients" and "investors in a private fund?" Is it appropriate as it relates to the "public?" Is it necessary to define "in the United States" for purposes of the definition of "foreign private adviser" in new section 202(a)(30)? Is our understanding of non-U.S. advisers' application of the Regulation S definition correct? Since private funds already rely on the Regulation S definition of U.S. person to determine which investors must qualify to invest in the fund, would adopting a different definition increase regulatory burdens associated with determining eligibility for the proposed exemption?[262] Are there alternatives that would better reflect the intent of Congress in creating a new category of "foreign private advisers" and providing them with an exemption from registration? Is our proposed note regarding the relevant time for determining whether a person is "in the United States" appropriate? If not, how should we modify it?

4. Place of Business

Proposed rule 203(a)(30)–1, by reference to proposed rule 222–1,[263] defines "place of business" to mean any office where the investment adviser regularly provides advisory services, solicits, meets with, or otherwise communicates with clients, and any location held out to the public as a place where the adviser conducts any such activities.[264] We believe this definition appropriately identifies a location where an adviser is doing business for purposes of section 202(a)(30) of the Advisers Act and thus provides a basis for an adviser to determine whether it can rely on the exemption in section 203(b)(3) of the Advisers Act for foreign private advisers. Because both the Commission and the state securities authorities use this definition to identify an unregistered foreign adviser's place of business for purposes of determining regulatory jurisdiction,[265] it appears to be logical as well as efficient to use the rule 222–1(a) definition of "place of

[252] *See* section 402 of the Dodd-Frank Act.

[253] Proposed rule 202(a)(30)–1(c)(2). As discussed above, we are also proposing to reference Regulation S's definition of a "U.S. person" for purposes of the definition of "United States person" in rule 203(m)–1. *See* sections II.B.3 and II.B.4 of this Release (discussing proposed rules 203(m)–1(e)(7) through (8)).

[254] *See* 17 CFR 230.902(l).

[255] *See* 17 CFR 230.902(k).

[256] *See* 17 CFR 230.902(l).

[257] Proposed rule 202(a)(30)–1, at note to paragraph (c)(2)(i) ("A person that is in the United States 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, in the case of an investor in a private fund, at the time the investor acquires the securities issued by the fund.").

[258] *See supra* notes 214–216 and accompanying text. *See also* Letter of Paul, Hastings, Janofsky & Walker LLP (Oct. 29, 2010) ("Paul Hastings Letter") (addressing the foreign private adviser exemption in response to our request for public views, and recommending that we rely on a modified Regulation S definition of "U.S. person" for purposes of defining "in the United States" with respect to clients and investors). *See generally supra* note 24.

[259] Many non-U.S. advisers identify whether a client is a "U.S. person" under Regulation S in order to determine whether such client may invest in certain private funds and certain private placement offerings exempt from registration under the Securities Act. With respect to "investors," our staff has generally taken the interpretive position that an investor that does not meet that definition is not a U.S. person when determining whether a non-U.S. private fund meets the section 3(c)(1) and 3(c)(7) counting or qualification requirements. *See supra* note 217. Many non-U.S. advisers, moreover, currently determine whether a private fund investor is a "U.S. person" under Regulation S for purposes of the safe harbor for offshore offers and sales.

[260] *See supra* discussion in section II.B.4 of this Release regarding the definition of United States persons and the treatment of discretionary accounts.

[261] *See supra* notes 219–220 and accompanying paragraph.

[262] *See supra* note 217 and accompanying and following text.

[263] Rule 222–1(a) (defining "place of business" of an investment adviser as: "(1) An office at which the investment adviser regularly provides investment advisory services, solicits, meets with, or otherwise communicates with clients; and (2) Any other location that is held out to the general public as a location at which the investment adviser provides investment advisory services, solicits, meets with, or otherwise communicates with clients.").

[264] Proposed rule 202(a)(30)–1(c)(3).

[265] Under section 222(d) of the Advisers Act, a state may not require an adviser to register if the adviser does not have a "place of business" within, and has fewer than six clients resident in, the state.

business" for purposes of the foreign private adviser exemption.

We request comment on our definition of "place of business" as it relates to the definition of "foreign private adviser." Is this definition of "place of business" appropriate in this context? Do commenters recommend any alternative definitions?

5. Assets Under Management

For purposes of rule 202(a)(30)–1 we propose to define "assets under management" by reference to the calculation of "regulatory assets under management" for Item 5 of Form ADV.[266] As discussed above, in Item 5 of Form ADV we are proposing to implement a uniform method of calculating assets under management that can be used for several purposes under the Advisers Act, including the foreign private adviser exemption.[267] Because the foreign private adviser exemption is also based on assets under management, we believe that all advisers should use the same method for calculating assets under management to determine if they are required to register or may be eligible for the exemption. We believe that uniformity in the method for calculating assets under management would result in more consistent asset calculations and reporting across the industry and, therefore, in a more coherent application of the Advisers Act's regulatory requirements and of our staff's risk assessment program.[268]

We request comment on our definition of "assets under management" as it relates to the definition of "foreign private adviser." Is this definition of "assets under management" appropriate in this context? Are there any special considerations relevant to foreign private advisers? Do commenters recommend any alternative definitions? Should assets under management be calculated at a particular point of time? Should we, as proposed, require foreign private advisers to calculate assets under management consistent with the proposed "regulatory assets under management" calculation for Form ADV? Or should we require a different calculation? For example, should foreign private advisers be permitted to exclude proprietary assets or assets they manage without compensation?

*D. Subadvisory Relationships and Advisory Affiliates*

We generally interpret advisers as including subadvisers,[269] and therefore believe it is appropriate to permit subadvisers to rely on each of the new exemptions, provided that subadvisers satisfy all terms and conditions of the applicable proposed rules. We are aware that in many subadvisory relationships a subadviser has contractual privity with a private fund's primary adviser rather than the private fund itself. Although both the private fund and the fund's primary adviser may be viewed as clients of the subadviser, we would consider a subadviser eligible to rely on section 203(m) if the subadviser's services to the primary adviser relate solely to private funds and the other conditions of the exemptions are met. Similarly, a subadviser may be eligible to rely on section 203(l) if the subadviser's services to the primary adviser relate solely to venture capital funds and the other conditions of the rule are met.

We anticipate that an adviser with advisory affiliates will encounter interpretative issues as to whether it may rely on any of the exemptions discussed in this Release without taking into account the activities of its affiliates. The adviser, for example, might have advisory affiliates that are registered or that provide advisory services that are inconsistent with an exemption on which the adviser may seek to rely.[270] We request comment on whether any proposed rule should provide that an adviser must take into account the activities of its advisory affiliates when determining eligibility for an exemption. For example, should the rule specify that the exemption is not available to an affiliate of a registered investment adviser?[271]

## III. Request for Comment

The Commission requests comment on the proposed rules in this Release. We also request suggestions for additional changes to existing rules, and comments on other matters that might have an effect on the proposals contained in this Release. Commenters are requested to provide empirical data to support their views.

## IV. Paperwork Reduction Act Analysis

The proposed rules do not contain a "collection of information" requirement within the meaning of the Paperwork Reduction Act of 1995.[272] Accordingly, the Paperwork Reduction Act is not applicable.

## V. Cost-Benefit Analysis

The Commission is sensitive to the costs and benefits imposed by its rules. We have identified certain costs and benefits of the proposed rules, and we request comment on all aspects of this cost-benefit analysis, including identification and assessment of any costs and benefits not discussed in this analysis. We seek comment and data on the value of the benefits identified. We also welcome comments on the accuracy of the cost estimates in this analysis, and request that commenters provide data that may be relevant to these cost estimates. In addition, we seek estimates and views regarding these benefits and costs for advisers solely to venture capital funds, private fund advisers with less than $150 million in aggregate assets under management and foreign private advisers as well as any other costs or benefits that may result from the adoption of the proposed rules. Where possible, we request commenters

[266] *See* proposed rule 202(a)(30)–1(c)(4); instructions to Item 5.F of Form ADV, Part 1A. As discussed above, we are proposing to take the same approach under proposed rule 203(m)–1. *See supra* section II.B.2 of this Release.

[267] *See supra* note 190 and accompanying text.

[268] *Id. See also* Letter of Shearman and Sterling LLP (Nov. 3, 2010) ("Shearman & Sterling Letter") (in response to our request for public views, arguing that "[w]hile each [exemption related asset threshold established by the Dodd-Frank Act] serves a different purpose, it appears to us that any steps that might be taken in the way of harmonization will facilitate both compliance with the requirements by the industry and their administration by the Commission and its Staff," and suggesting that as an example, we raise the assets under management threshold under the foreign private adviser exemption to $150 million in line with the assets threshold under the private fund adviser exemption). *See generally supra* note 24.

[269] *See, e.g.,* Pay to Play Release, *supra* note 10, at n.391–94 and accompanying and following text; Hedge Fund Adviser Registration Release, *supra* note 17, at n.243.

[270] Generally, a separately formed advisory entity that operates independently of an affiliate may be eligible for an exemption if it meets all of the criteria set forth in the relevant rule. However, the existence of separate legal entities may not by itself be sufficient to avoid integration of the affiliated entities. The determination of whether the advisory businesses of two separately formed affiliates may be required to be integrated is based on the facts and circumstances. Our staff has taken this position in Richard Ellis, Inc., SEC Staff No-Action Letter (Sept. 17, 1981) (discussing the staff's views of factors relevant to the determination of whether a separately formed advisory entity operates independently of an affiliate).

[271] We have received a number of letters requesting interpretative guidance on whether and to what extent certain prior staff positions would apply to the new exemptions provided by the Dodd-Frank Act. *See, e.g.,* Letter of Katten Muchin Rosenman LLP (Sept. 14, 2010); Letter of TA Jones (Sept. 25, 2010); Letter of Ropes & Gray LLP (Nov. 1, 2010) in response to our solicitation for public views. *See generally supra* note 24. We acknowledge that such determinations will depend on the particular facts and circumstances of non-U.S. advisers. Advisers should consider whether they may avail themselves of either the foreign private adviser exemption or the private fund adviser exemption as proposed in this Release, and are encouraged to submit comment letters addressing with particularity and specificity interpretative issues that may not be addressed in our proposed rules.

[272] 44 U.S.C. 3501.

provide empirical data to support any positions advanced.

As discussed above, we are proposing rules 203(l)–1, 203(m)–1 and 202(a)(30)–1 to implement certain provisions of the Dodd-Frank Act. As a result of the Dodd-Frank Act's repeal of the private adviser exemption, some advisers that previously were eligible to rely on that exemption will be required to register under the Advisers Act unless these advisers are eligible for a new exemption. Thus, the benefits and costs associated with registration are attributable to the Dodd-Frank Act. The Commission has discretion, however, to adopt rules to define the terms used in the Advisers Act, and we undertake below to discuss the benefits and costs of the defined terms that we are proposing.

*A. Definition of Venture Capital Fund*

Our proposed rule is designed to: (i) implement the directive from Congress to define the term venture capital fund in a manner that reflects Congress' understanding of what venture capital funds are, and as distinguished from other private equity funds and hedge funds; and (ii) facilitate the transition to the new exemption. Our proposal would define the term venture capital fund consistently with what we believe Congress understood venture capital funds to be, and in light of other provisions of the federal securities laws that seek to achieve similar objectives.[273]

Using these characteristics as our model, we propose to define a venture capital fund as a private fund that: (i) Invests in equity securities of private companies in order to provide operating and business expansion capital (*i.e.,* "qualifying portfolio companies") and at least 80 percent of each company's equity securities owned by the fund were acquired directly from the qualifying portfolio company; (ii) directly, or through its investment advisers, offers or provides significant managerial assistance to, or controls, the qualifying portfolio company; (iii) does not borrow or otherwise incur leverage (other than limited short-term borrowing); (iv) does not offer its investors redemption or other similar liquidity rights except in extraordinary circumstances; (v) represents itself as a venture capital fund to investors; and (vi) is not registered under the Investment Company Act and has not elected to be treated as a BDC.[274]

We propose to define a "qualifying portfolio company" as any company that: (i) Is not publicly traded; (ii) does not incur leverage in connection with the investment by the private fund; (iii) uses the capital provided by the fund for operating or business expansion purposes rather than to buy out other investors; and (iv) is not itself a fund (*i.e.,* is an operating company).[275]

We also propose to grandfather existing funds by including in the definition of "venture capital fund" any private fund that: (i) Represented to investors and potential investors at the time the fund offered its securities that it is a venture capital fund; (ii) prior to December 31, 2010, has sold securities to one or more investors that are not related persons of any investment adviser of the venture capital fund; and (iii) does not sell any securities to, including accepting any additional capital commitments from, any person after July 21, 2011 (the "grandfathering provision").[276] An adviser seeking to rely on the exemption under section 203(l) of the Advisers Act would be eligible for the venture capital exemption only if it exclusively advised venture capital funds that met all of the elements of the proposed definition or grandfathering provision.

1. Benefits

Based on the testimony presented to Congress and our research, we believe that venture capital funds today would meet most, if not all, of the elements of our proposed definition of venture capital fund. Our proposed definition includes one specific element, however, that may not be characteristic of some existing venture capital funds. The proposed rule defines a venture capital fund as one that does not issue debt or provide guarantees except on a short-term basis (and correspondingly defines a qualifying portfolio company as one that does not borrow or otherwise incur leverage in connection with the venture capital fund investment). We propose this element of the qualifying portfolio company definition because of the focus on leverage in the Dodd-Frank Act as a potential contributor to systemic risk as discussed by the Senate Committee report,[277] and the testimony before Congress that stressed the lack of leverage in venture capital investing.[278] Our research suggests that on occasion, however, some venture capital funds may provide financing on a short-term basis to portfolio companies as a "bridge" between funding rounds.[279] It is possible that certain types of bridge financing currently used by venture capital funds may not satisfy the definition of equity security under our proposed rule.

Although the limitation on acquiring debt securities from portfolio companies may not be characteristic of some existing venture capital funds, the failure of existing venture capital funds to meet the proposed definition would not preclude advisers to those funds from relying on the exemption in section 203(l) of the Advisers Act under our proposed rule. An adviser of existing venture capital funds could avail itself of the exemption under the proposed grandfathering provision provided that each fund (i) Has represented to investors that it is a venture capital fund, (ii) has initially sold interests by December 31, 2010, and (iii) does not sell any additional interests after July 21, 2011.[280] We expect that all advisers to existing venture capital funds that currently rely on the private adviser exemption would be exempt from registration in reliance on the proposed grandfathering provision. As a result of this provision, we expect that advisers to existing venture capital funds that do not meet our proposed definition would benefit because those advisers could continue to manage existing funds without having to (i) Weigh the relative costs and benefits of registration and modification of fund operations to conform existing funds with our proposed definition and (ii) incur the costs associated with registration with the Commission or modification of existing funds. Advisers to venture capital funds that are in formation that would be able to launch by December 31, 2010 and meet the July 21, 2011 deadline for sales of all securities also would benefit from the grandfathering provision because they would not have to incur these costs.

Going forward, we recognize that some advisers to existing venture capital funds that seek to rely on the exemption in section 203(l) of the Advisers Act might have to structure new funds

[273] *See supra* notes 38–43 and accompanying and following text.

[274] Proposed rule 203(l)–1(a).

[275] Proposed rule 203(l)–1(c)(4).

[276] Proposed rule 203(l)–1(b).

[277] *See supra* note 99. *See also* S. Rep. No. 111–176, *supra* note 7, at 73–74 (stating that advisers of venture capital funds are not required to register with the SEC because they do not present the same risks as advisers to other private funds that are required to register, and specifying that the Commission shall require advisers of private funds to report systemic risk data including, among other things, information on the "use of leverage, counterparty credit risk exposure, trading and investment positions"). *See also supra* notes 136–137 and accompanying text.

[278] *See supra* note 100.

[279] *See, e.g., supra* note 83 and accompanying text.

[280] Proposed rule 203(l)–1(b).

differently to meet the proposed limitation on qualified portfolio company leverage. To the extent that advisers choose not to change how they structure or manage new funds they launch, those advisers would have to register with the Commission,[281] which offers many benefits to the investing public and facilitates our mandate to protect investors. Registered investment advisers are subject to periodic examinations by our staff and are also subject to our rules including rules on recordkeeping, custody of client funds and compliance programs. We believe that in general Congress considered registration to be beneficial to investors because of, among other things, the added protections offered by registration. Accordingly, Congress limited the section 203(l) exemption to advisers to venture capital funds. As noted above, we proposed certain elements in the portfolio company definition because of the focus on leverage in the Dodd-Frank Act as a potential contributor to systemic risk as discussed by the Senate Committee report,[282] and the testimony before Congress that stressed the lack of leverage in venture capital investing.[283] We expect that distinguishing between venture capital funds and other private funds that pursue investment strategies involving financial leverage that Congress highlighted for concern would benefit financial regulators mandated by the Dodd-Frank Act (such as the Financial Stability Oversight Council) with monitoring and assessing potential systemic risks. Because advisers that manage funds with these characteristics would be required to register, we expect that financial regulators could more easily obtain information and data regarding these financial market participants, which should benefit those regulators to the extent it helps to reduce the overall cost of systemic risk monitoring and assessment.[284]

In addition to the benefits discussed above, we expect that investment advisers that seek to rely on the exemption would benefit from the flexibility in the proposed definition of venture capital fund than a more rigid or narrow definition, which should allow them more easily to structure and operate funds that meet the definition. This flexibility should facilitate compliance with the proposed rule and transition to the new exemption. For example, we propose to define equity securities broadly to cover many types of equity securities in which venture capital funds typically invest, rather than limit the definition solely to common stock.[285] To meet the proposed definition, at least 80 percent (not 100 percent) of the equity securities of a portfolio company in which a venture capital fund invests must be acquired directly from the issuing portfolio company (including securities that have been converted into equity securities), but there is no limit as to how the remaining 20 percent could be acquired.[286] Furthermore, under the proposed definition, the venture capital fund may offer or provide managerial assistance to or alternatively control the qualified portfolio company directly, or may do so through its advisers. As noted above, we have modeled this element of the definition in part on existing provisions under the Advisers Act and Investment Company Act dealing with BDCs.[287] Our proposed definition also is designed to be a simplified version of the definition of "making available significant managerial assistance" under the BDC provisions, which we expect would reduce confusion and facilitate understanding of the proposed rule.[288] This approach would preserve flexibility for venture capital funds that invest as a group to determine which members of the group are best qualified, or best able, to control the portfolio company or alternatively to offer (and/or provide) managerial assistance to the portfolio company.

Our proposed definition of qualifying portfolio company is similarly broad because the definition does not restrict qualifying companies to "small or start-up" companies. As we have noted above, we believe that such definitions would be too restrictive and provide venture capital fund advisers with too little flexibility and limited options with respect to potential portfolio company investments.[289] In addition, we propose to define a "qualifying portfolio company" as a company that does not borrow from, or issue debt in connection with the investment from, venture capital funds. Thus, a qualifying portfolio company could borrow for working capital or other operating needs from other lenders, such as banks, without jeopardizing the venture capital fund adviser's eligibility for the exemption. These proposed broad definitions and criteria should benefit advisers that intend to rely on the exemption because they give the adviser flexibility to structure transactions and investments in underlying portfolio companies in a manner that meets their business objectives without unduly creating systemic or other risks of the kind that Congress suggested should require registration of the fund's adviser. For commenters recommending more narrow elements for our definition, we request comment on the costs to advisers of having to change their business practices to comply with such narrower elements.

We believe that the grandfathering provision would promote efficiency because it will allow advisers to existing venture capital funds to continue to rely on the exemption without having to restructure funds that may not meet the proposed definition. It also would allow advisers to funds that are currently in formation and can meet the requirements of the grandfathering provision to rely on the exemption without the potential costs of having to renegotiate with potential investors and restructure those funds within the limited period before the rule must be adopted. Advisers that seek to form new funds should have sufficient time and notice to structure those funds to meet the proposed definition should they seek to rely on the exemption in section 203(l) of the Advisers Act.

Finally, we believe that our proposed definition would include an additional benefit for investors and regulators. Section 203(l) of the Advisers Act provides an exemption specifically for

[281] *See infra* text following note 294; notes 299–303 and accompanying text for a discussion of potential costs for advisers that would have to choose between registering or restructuring venture capital funds formed in the future.

[282] *See supra* note 99.

[283] *See supra* note 100.

[284] *See* S. Rep. No. 111–176, *supra* note 7, at 39 (explaining the requirement that private funds disclose information regarding their investment positions and strategies, including information on fund size, use of leverage, counterparty credit risk exposure, trading and investment positions and any other information that the Commission in consultation with the Financial Stability Oversight Council determines is necessary and appropriate to protect investors or assess systemic risk).

[285] *See supra* notes 85–87 and accompanying text.

[286] *See supra* section II.A.1.d of this Release.

[287] *See supra* notes 123–128 and accompanying text.

[288] *See supra* note 128 and accompanying and following text. For example, unlike the BDC provision, the proposed definition does not specifically define managerial assistance by referring to a fund's directors, officers, employees or general partners. In addition, like the BDC provision, the proposed definition would require the venture capital fund to control the qualifying portfolio company (if it does not offer or provide significant managerial assistance), but without reference to exercising a controlling influence because the ability to exercise a controlling influence is inherent in the control relationship. *See* section 202(a)(12) of the Advisers Act (defining control to mean the power to exercise a controlling influence over the management or policies of a company unless such power is solely the result of an official position with such company). *See supra* note 129 for the definition of "making available significant managerial assistance" by a BDC.

[289] *See supra* discussion in section II.A.1.a of this Release.

advisers that "solely" advise venture capital funds. Currently none of our rules requires that an adviser exempt from registration specify the basis for the exemption. We are proposing, however, to require exempt reporting advisers to identify the exemption(s) on which they are relying.[290] Requiring that venture capital funds represent themselves as such to investors should allow the Commission and the investing public (particularly potential investors in venture capital funds) to determine, and confirm, an adviser's rationale for remaining unregistered with the Commission. This element is designed to deter advisers to private funds other than venture capital funds from claiming to rely on an exemption from registration for which they are not eligible.

We request comment on the potential benefits we have identified above. Are there benefits of the proposed definition that we have not identified?

2. Costs

*Costs for advisers to existing venture capital funds.* As discussed above, we do not expect that the proposed rule would result in any significant costs for unregistered advisers to venture capital funds currently in existence and operating. We estimate that currently there are 800 advisers to venture capital funds.[291] We expect that all these advisers, which we assume currently are not registered in reliance on the private adviser exemption, would continue to be exempt after the repeal of that exemption on July 21, 2011 in reliance on the proposed grandfathering provision.[292] We anticipate that such advisers to grandfathered funds would incur minimal costs, at most, to confirm that existing venture capital funds managed by the adviser meet the conditions of the grandfathering provision. We estimate that these costs would be no more than $800 to hire outside counsel to assist in this determination.[293]

We recognize, however, that advisers to funds that are currently in the process of being formed and negotiated with investors may incur costs to determine whether they qualify for the grandfathering provision. For example, these advisers may need to assess the impact on the fund of selling interests to initial third party investors by December 31, 2010 and selling interests to all investors no later than July 21, 2011. We do not expect that the cost of evaluating the grandfathering provision would be significant, however, because we believe that most funds in formation represent themselves as being venture capital funds or funds that pursue a venture capital investing strategy to their potential investors and the typical fundraising period for a venture capital fund is approximately 12 months.[294] Thus, we do not anticipate that venture capital fund advisers would have to alter typical business practice to structure or raise capital for venture capital funds being formed. Nevertheless, we recognize that after the final rule goes into effect, exempt advisers of such funds in formation may forgo the opportunity to accept investments from investors that may seek to invest after July 21, 2011 in order to comply with the grandfathering provision.

We request comment on the potential costs of this aspect of our proposed rule. Are there advisers to existing venture capital funds or venture capital funds in formation that would not be covered by the grandfathering provision? We request commenters to quantify the number of these advisers and provide us with specific examples of why such advisers would not be able to rely on the grandfathering provision.

*Costs for new advisers and advisers to new venture capital funds.* We expect that existing advisers that seek to form new venture capital funds and investment advisory firms that seek to enter the venture capital industry would incur one-time "learning costs" to determine how to structure new funds they may manage to meet the elements of our proposed definition. We estimate that on average, there are 24 new advisers to venture capital funds each year.[295] We expect that the one-time learning costs would be no more than between $2,800 and $4,800 on average for an adviser if it hires an outside consulting or law firm to assist in determining how the elements of our proposed definition may affect intended business practices.[296] Thus, we estimate the aggregate cost to existing advisers of determining how the proposed definition would affect funds they plan to launch would be from $67,200 to $115,200.[297] We request comment on whether these estimates accurately reflect the fees an adviser would be likely to pay to consulting and law firms it hires. As they launch new funds and negotiate with potential investors, these advisers would have to determine whether it is more cost effective to register or to structure the venture capital funds they manage to meet the proposed definition. Such considerations of legal or other requirements, however, comprise a typical business and operating expense of conducting new business. New advisers that enter into the business of managing venture capital funds also would incur such ordinary costs of doing business in a regulated industry.[298]

We believe that existing advisers to venture capital funds meet most, if not all, of the elements of the proposed

[290] *See* Implementing Release, *supra* note 25, at n.130 and accompanying text.

[291] *See* NVCA Yearbook 2010, *supra* note 41, at figure 1.04 (providing number of "active" venture capital advisers who have raised a venture capital partnership within the past eight years).

[292] We estimate that these advisers (and any other adviser that seeks to remain unregistered in reliance on the exemption under section 203(l) of the Advisers Act) would incur, on average, $2,041 per year to complete and update related reports on Form ADV, including Schedule D information relating to private funds. *See* Implementing Release, *supra* note 25, at section IV.B.2. This estimate includes internal costs to the adviser of $1,764 to prepare and submit an initial report on Form ADV and $277 to prepare and submit annual amendments to the report. These estimates are based on the following calculations: $1,764 = ($3,528,000 aggregate costs ÷ 2,000 advisers); $277 = ($554,400 aggregate costs ÷ 2,000 advisers). *Id.,* at nn.337, 339 and accompanying text. We estimate that one exempt reporting adviser would file Form ADV–H per year at a cost of $204 per filing. *Id.,* at n.344 and accompanying text. We further estimate that three exempt reporting advisers would file Form ADV–NR per year at a cost of $57 per filing. *Id.,* at nn.347, 349 and accompanying text. We anticipate that filing fees for exempt reporting advisers would be the same as those for registered investment advisers. *See infra* note 300. These reporting costs are attributable to the Dodd-Frank Act, which directs the Commission to require advisers to venture capital funds to provide such annual and other reports as we determine necessary or in the public interest or for the protection of investors. *See* section 203(l) of the Advisers Act.

[293] We expect that a venture capital adviser would need no more than 2 hours of legal advice to learn the differences between its current business practices and the conditions for reliance on the proposed grandfathering provision. We estimate that this advice would cost $400 per hour per firm based on our understanding of the rates typically charged by outside consulting or law firms.

[294] *See* BRESLOW & SCHWARTZ, *supra* note 144, at 2–22 ("Once the first closing [of a private equity fund] has occurred, subsequent closings are typically held over a defined period of time [the marketing period] of approximately six to twelve months."). *See also* Dow Jones Report, *supra* note 145, at 22.

[295] This is the average annual increase in the number of venture capital advisers between 1980 and 2009. *See* NVCA Yearbook 2010, *supra* note 41, at figure 1.04.

[296] We expect that a venture capital adviser would need between 7 and 12 hours of consulting or legal advice to learn the differences between its current business practices and the proposed definition, depending on the experience of the firm and its familiarity with the elements of the proposed rule. We estimate that this advice would cost $400 per hour per firm based on our understanding of the rates typically charged by outside consulting or law firms.

[297] This estimate is based on the following calculations: $2,800 x 24 = $67,200; 24 x $4,800 = $115,200.

[298] For estimates of the costs of registration for those advisers that would choose to register, *see infra* notes 299–304.

definition because it is modeled on current business practices of venture capital funds. We thus do not anticipate that many venture capital fund advisers would have to change significantly the structure of new funds they launch. Under our proposed definition, an adviser would not be able to rely on the exemption if a venture capital fund invested in securities that were not equity securities issued by qualifying portfolio companies. Although we believe this practice is not common in the industry, this element of our proposed rule may result in some venture capital funds incurring costs to structure and acquire equity investments that possess terms and protections typically found in debt instruments. To the extent that venture capital funds might not be able to structure equity investments in this way, and portfolio companies would have to forgo debt issuance, the proposal could have an adverse effect on capital formation.

We also recognize that some existing venture capital funds may have characteristics that differ from the elements of the proposed definition other than the limitation on investments in debt securities issued by portfolio companies. To the extent that investment advisers seek to form new venture capital funds with these characteristics, those advisers would have to choose whether to structure new venture capital funds to conform to the proposed definition, forgo forming new funds, or register with the Commission. In any case, each investment adviser would assess the costs associated with registering with the Commission relative to the costs of remaining unregistered (and hence structuring funds to meet our proposed definition in order to be eligible for the exemption). We expect that this assessment would take into account many factors, including the size, scope and nature of its business and investor base. Such factors will vary from adviser to adviser, but each adviser would determine whether registration, relative to other choices, is the most cost-effective or strategic business option for itself.

To the extent that advisers choose to structure new venture capital funds to conform to the proposed definition, or choose not to form new funds in order to avoid registration, these choices could result in fewer investment choices for investors, less competition and less capital formation. To the extent that advisers choose to register in order to structure new venture capital funds without regard to the proposed definitional elements or in order to expand their business (*e.g.,* pursue additional investment strategies beyond venture capital investing or expand the potential investor base to include investors that are required to invest with registered advisers), these choices may result in greater investment choices for investors, greater competition and greater capital formation.

Investment advisers to new venture capital funds that would not meet the proposed definition would have to register and incur the costs associated with registration (assuming the adviser could not rely on the private fund adviser exemption). We estimate that the internal cost to register with the Commission would be $11,526 on average for a private fund adviser,[299] excluding the initial filing fees and annual filing fees to the Investment Adviser Registration Depository ("IARD") system operator.[300] These registration costs include the costs attributable to completing and periodically amending Form ADV, preparing brochure supplements, and delivering codes of ethics to clients.[301] In addition to the internal costs described above, we estimate that for an adviser choosing to use outside legal services to complete its brochure, such costs would be $3,000 to $5,000.[302]

New registrants would also face costs to bring their business operations into compliance with the Advisers Act and the rules thereunder. These costs would vary depending on the size, scope and nature of the adviser's business, but in any case would be an ordinary business and operating expense of entering into any business that is regulated. We estimate that the one-time costs to new registrants to establish a compliance infrastructure would range from $10,000 to $45,000, while ongoing annual costs of compliance and examination would range from $10,000 to $50,000.[303]

We do not believe that the proposed definition of venture capital fund is likely to affect whether advisers to venture capital funds would choose to launch new funds or whether persons would choose to enter into the business of advising venture capital funds because, as noted above, we believe the proposed definition reflects the way most venture capital funds currently operate. For this reason, we expect that the proposed definition is not likely to significantly affect the way in which investment advisers to these funds do business and thus compete. For the same reason, we do not believe that our proposed rule is likely to have a significant effect on overall capital formation.

We request comment on the costs we have discussed above. Are there costs of the proposed definition that we have not identified? How many advisers to venture capital funds are likely to choose to register or structure new venture capital funds differently from their existing funds in order to meet the proposed definition? How costly would it be for advisers to structure new venture capital funds to conform to the proposed definition in order to qualify

[299] This estimate is based upon the following calculations: $11,526 = ($7,699,860 aggregate costs to complete Form ADV ÷ 750 advisers) + ($1,197,000 aggregate costs to complete private fund reporting requirements ÷ 950 advisers). *See* Implementing Release, *supra* note 25, at nn.355–361. This also assumes that an adviser's registration process would be conducted by a senior compliance examiner and a compliance manager at an estimated cost of $210 and $294 per hour, respectively. *See* Implementing Release, *supra* note 25, at nn.354 and accompanying text.

[300] The initial filing fee and annual filing fee for advisers with $25 million to $100 million of assets under management is $150 and for advisers with $100 million or more of assets under management is $200. *See* Electronic Filing for Investment Advisers on IARD: IARD Filing Fees, *available at http://www.sec.gov/divisions/investment/iard/iardfee.shtml.*

[301] Part 1 of Form ADV requires advisers to answer basic identifying information about their business, their affiliates and their owners, information that is readily available to advisers, and thus should not result in significant costs to complete. Registered advisers must also complete Part 2 of Form ADV and file it electronically with us. Part 2 requires disclosure of certain conflicts of interest and could be prepared based on information already contained in materials provided to investors, which could reduce the costs of compliance even further.

[302] *See* Implementing Release, *supra* note 25, at n.363, 421 (noting the cost estimate for compliance consulting services related to initial preparation of the amended Form ADV ranges from $3,000 for smaller advisers to $5,000 for medium-sized advisers).

[303] We expect that most advisers that might choose to register have already built compliance infrastructures as a matter of good business practice. Nevertheless, we expect advisers will incur costs for outside legal counsel to evaluate their compliance procedures initially and on an ongoing basis. We estimate that the costs to advisers to establish the required compliance infrastructure will be, on average, $20,000 in professional fees and $25,000 in internal costs including staff time. These estimates were prepared in consultation with attorneys who, as part of their private practice, have counseled private fund advisers establishing their registrations with the Commission. We have included a range because we believe there are a number of unregistered private funds whose compliance operations are already substantially in compliance with the Advisers Act and that would therefore experience only minimal incremental ongoing costs as a result of registration. In connection with previous estimates we have made regarding compliance costs for registered advisers, we received comments from small advisers estimating that their annual compliance costs would be $25,000 and could be as high as $50,000. *See, e.g.,* Comment Letter of Joseph L. Vidich (Aug. 7, 2004). *Cf.* Comment Letter of Venkat Swarna (Sept. 14, 2004) (estimating costs of $20,000 to $25,000). These comment letters were submitted in connection with Hedge Fund Adviser Registration Release, *supra* note 17, and are available on the Commission's Internet Web site at *http://www.sec.gov/rules/proposed/s73004.shtml.*

for an exemption from registration? Would advisers choose not to launch new funds or not enter the venture capital industry in order to avoid the costs associated with structuring venture capital funds to conform to the definition or registration? [304]

*B. Exemption for Investment Advisers Solely to Private Funds With Less Than $150 Million in Assets Under Management*

As discussed in Section II.B., proposed rule 203(m)–1 would exempt any investment adviser solely to private funds that has less than $150 million in assets under management in the United States. Our proposed rule is designed to implement the private fund adviser exemption, as directed by Congress, in section 203(m) of the Advisers Act and includes provisions for determining the amount of an adviser's private fund assets for purposes of the exemption and when those assets are deemed managed in the United States.[305]

1. Benefits

As discussed above and in the Implementing Release, we are proposing a uniform method of calculating assets under management in the instructions to Form ADV, which would be used to determine whether an adviser qualifies to register with the Commission rather than the states, and to determine eligibility for the private fund adviser exemption under section 203(m) of the Advisers Act and the foreign private adviser exemption under section 203(b)(3) of the Advisers Act.[306] We anticipate that this uniform approach would benefit regulators (both state and federal) as well as advisers, because only a single determination of assets under management would be required for purposes of registration and exemption from federal registration.

The instructions to Form ADV currently permit, but do not require, advisers to exclude certain types of managed assets.[307] As a result, it is not possible to conclude that two advisers reporting the same amount of assets under management are necessarily comparable because either adviser may elect to exclude all or some portion of certain specified assets that it manages. By specifying that assets under management must be calculated according to the instructions to Form ADV, our proposed approach should benefit advisers by increasing administrative efficiencies because advisers would have to calculate assets under management only once for multiple purposes.[308] We expect this would minimize costs relating to software modifications, recordkeeping, and training required to determine assets under management for regulatory purposes. We also anticipate that the consistent calculation and reporting of assets under management would benefit investors and regulators because it would provide enhanced transparency and comparability of data, and allow investors and regulators to analyze on a more cost effective basis whether any particular adviser may be required to register with the Commission or is eligible for an exemption.

We anticipate that the valuation of private fund assets under proposed rule 203(m)–1 would benefit private fund advisers that seek to rely on the exemption.[309] Under proposed rule 203(m)–1, each adviser would determine the amount of its private fund assets based on the fair value of the assets at the end of each quarter. We propose that advisers use fair value of private fund assets in order to ensure that, for purposes of this exemption, advisers value private fund assets on a meaningful and consistent basis. We understand that many, but not all, advisers to private funds value assets based on their fair value in accordance with GAAP or other international accounting standards.[310] We acknowledge that some advisers to private funds may not use fair value methodologies, which may be more difficult to apply when the fund holds illiquid or other types of assets that are not traded on organized markets.

Proposed rule 203(m)–1(c) specifies that an adviser relying on the exemption would determine the amount of its private fund assets quarterly, which we believe would benefit advisers. We understand that a quarterly calculation of assets under management is consistent with business practice— many types of private funds calculate fees payable to advisers and other service providers on at least a quarterly basis.[311] The quarterly calculation also would allow advisers that rely on the exemption to maintain the exemption despite short-term market value fluctuations that might result in the loss of the exemption if, for example, the rule required daily valuation. We expect that quarterly valuation would also benefit these advisers by allowing them to avoid the cost of more frequent valuations, including costs (such as third party quotes) associated with valuing illiquid assets, which may be particularly difficult to value more often because of the lack of frequency with which such assets are traded.

Under proposed rule 203(m)–1(a), all of the private fund assets of an adviser with a principal office and place of business in the United States would be considered to be "assets under management in the United States," even if the adviser has offices outside of the United States.[312] A non-U.S. adviser would need only count private fund assets it manages from a place of business in the U.S. toward the $150 million limit under the exemption. As discussed below, we believe that this interpretation of "assets under management in the United States" would offer greater flexibility to advisers and reduce many costs associated with compliance. These costs could include difficult attribution determinations that would be required if assets are managed by teams located in multiple jurisdictions or if portfolio managers located in one jurisdiction rely heavily on research or other

[304] Commission staff estimates that the one-time costs of registration for a venture capital fund adviser with $150 million in assets under management in the United States (*i.e.*, an adviser that would not qualify for the exemption under section 203(m) of the Advisers Act), would be approximately 0.01% of assets, and annual costs of compliance and examination would range from 0.007% to 0.03% of assets under management. These figures are based on the following calculations: ($11,526 (registration costs) + $3,000 (lower estimate of external costs to prepare brochure)) ÷ $150,000,000 = 0.000097; ($11,526 (registration costs) + $5,000 (higher estimate of external costs to prepare brochure)) ÷ $150,000,000 = 0.0001); $10,000 (lower estimate of ongoing costs) ÷ $150,000,000 = 0.000067; $50,000 (higher estimate of ongoing costs) ÷ $150,000,000 = 0.000333).

[305] *See supra* sections II.B.2–3 of this Release.

[306] *See supra* note 190 and accompanying text; Implementing Release, *supra* note 25, at nn.58–59 and accompanying text. Thus, under proposed rule 203(m)–1, to determine its assets under management for purposes of the proposed private fund adviser exemption, an adviser would calculate its "regulatory assets under management" attributable to private funds according to the instructions to Form ADV. Proposed rule 203(m)–1(a)(2), (b)(2) (conditioning the exemption on an adviser managing private fund assets of less than $150 million); proposed rule 203(m)–1(e)(1) (defining "assets under management" for purposes of the proposed rule's exemption); proposed rule 203(m)–1(e)(4) (defining "private fund assets" as the investment adviser's assets under management attributable to a qualifying private fund).

[307] *See* proposed Form ADV: Instructions to Part 1A, instr. 5.b(1).

[308] *See* Shearman & Sterling Letter, *supra* note 268.

[309] *See* proposed rule 203(m)–1(c); Implementing Release, *supra* note 25, proposed Form ADV: Instructions to Part 1A, instr. 5.b(4).

[310] *See supra* note 196.

[311] *See supra* section II.B.2 of this Release; *see, e.g.*, Breslow & Schwartz, *supra* note 144, at § 2.8.2[C].

[312] As discussed above, the proposed rule looks to an adviser's principal office and place of business as the location where it directs, controls and coordinates its global advisory activities. Proposed rule 203(m)–1(e)(3). *See supra* notes 202–203 and accompanying text.

advisory services performed by employees located in another jurisdiction.

To the extent that this interpretation may increase the number of advisers subject to registration under the Advisers Act, we anticipate that our proposal also would benefit investors by providing more information about those advisers (*e.g.*, information that would become available through Form ADV, Part I). We further anticipate that this would enhance investor protection by increasing the number of advisers registering pursuant to the Advisers Act and by improving the Commission's ability to exercise its investor protection and enforcement mandates over those newly registered advisers. As discussed above, registration offers benefits to the investing public, including periodic examination of the adviser and compliance with rules requiring recordkeeping, custody of client funds and compliance programs.[313]

Under proposed rule 203(m)–1(b), a non-U.S. adviser with no U.S. place of business could avail itself of the exemption under section 203(m) even if it advised non-U.S. clients that are not private funds, provided that it did not advise any U.S. clients other than private funds.[314] We anticipate that the proposed approach to the exemption under section 203(m) of the Advisers Act, which would look primarily to the principal office and place of business of an adviser to determine eligibility for the exemption, would increase the number of non-U.S. advisers that may be eligible for the exemption. As with other Commission rules that adopt a territorial approach, the private fund adviser exemption would be available to a non-U.S. adviser (regardless of its non-U.S. advisory activities) in recognition that non-U.S. activities of non-U.S. advisers are less likely to implicate U.S. regulatory interests and in consideration of general principles of international comity. This approach to the exemption is designed to encourage the participation of non-U.S. advisers in the U.S. market by applying the U.S. securities laws in a manner that does not impose U.S. regulatory and operational requirements on an adviser's non-U.S. advisory business.[315] We anticipate that our proposed interpretation of the availability of the private fund adviser exemption for non-U.S. advisers may benefit those advisers by facilitating their continued participation in the U.S. market with limited disruption to their non-U.S. advisory business practices.[316] This approach also might benefit U.S. investors and facilitate competition in the market for advisory services to the extent that it would maintain or increase U.S. investors' access to potential advisers. Furthermore, because non-U.S. advisers that elect to avail themselves of the exemption would be subject to certain reporting requirements,[317] our proposed approach would increase the availability of information publicly available to U.S. investors who invest in the private funds advised by such exempt but reporting non-U.S. advisers.

We request comment on the potential benefits we have identified above. Are there benefits of the proposed rule that we have not identified?

2. Costs

As noted above, under proposed rule 203(m)–1, we would look to an adviser's principal office and place of business as the location where the adviser directs, controls or has responsibility for, the management of private fund assets and therefore as the place where all the adviser's assets are managed. Thus, a U.S. adviser would include all its private fund assets under management in determining whether it exceeds the $150 million limit under the exemption. We also look to where day-to-day management of private fund assets may occur for purposes of a non-U.S. adviser, whose principal office and place of business is outside the United States.[318] A non-U.S. adviser therefore would count only the private fund assets it manages from a place of business in the United States in determining the availability of the exemption. This approach is similar to the way we have defined the location of the adviser for regulatory purposes under our current rules,[319] and thus we believe it is the way in which most advisers would interpret the exemption without our proposed rule.[320] We anticipate that our proposed approach would promote efficiency because advisers are familiar with it, and we do not anticipate that U.S. investment advisers to private funds would likely change their business models, the location of their private funds, or the location where they manage assets as a result of the proposed rule. We anticipate, however that non-U.S. advisers may incur minimal costs to determine whether they have assets under management in the U.S. We estimate that these costs would be no greater than $6,940 to hire U.S. counsel and perform an internal review to assist in this determination, in particular to assess whether a non-U.S. affiliate manages a discretionary account for the benefit of a United States person under the proposed rule.[321]

As noted above, because our rule is designed to encourage the participation of non-U.S. advisers in the U.S. market, we anticipate that it would have minimal regulatory and operational burdens on foreign advisers and their U.S. clients. Non-U.S advisers would be able to rely on proposed rule 203(m)–1 if they manage U.S. private funds with more than $150 million in assets from a non-U.S. location as long as the private fund assets managed from a U.S. place of business are less than $150 million. This could affect competition with U.S. advisers, which must register when they have $150 million in private fund assets under management regardless of where the assets are managed.

To avail themselves of proposed rule 203(m)–1, some advisers might choose to move their principal office and place of business outside the United States and manage private funds from that location. This might result in costs to U.S. investors in private funds that are managed by these advisers because they would not have the investor protection and other benefits that result from an adviser's registration under the Advisers Act. We do not expect that many advisers would be likely to relocate for

[313] *See supra* text following note 281 and preceding and accompanying text.

[314] By contrast, a U.S. adviser could "solely advise private funds" as specified in the statute. *Compare* proposed rule 203(m)–1(a)(1) *with* proposed rule 203(m)–1(b)(1).

[315] *See supra* note 208 and accompanying text.

[316] *See supra* section II.B.3 of this Release.

[317] *See* Implementing Release, *supra* note 25, at section II.B.

[318] *See supra* paragraph accompanying note 205.

[319] *See supra* note 202 and accompanying text.

[320] We do not believe that the statutory text refers to where the assets themselves may be located or traded or the location of the account where the assets are held. In today's market, using the location of assets would raise numerous questions of where a security with no physical existence is "located." Although physical stock certificates were once sent to investors as proof of ownership, stock certificates are now centrally held by securities depositories, which perform electronic "book-entry" changes in their records to document ownership of securities. This arrangement reduces transmittal costs and increases efficiencies for securities settlements. *See generally* Bank for International Settlements, The Depository Trust Company: Response to the Disclosure Framework for Securities Settlement Systems (2002), *http://www.bis.org/publ/cpss20r3.pdf*. An account also has no physical location even if the prime broker, custodian or other service that holds assets on behalf of the customer does. Each of these approaches would be confusing and extremely difficult to apply on a consistent basis.

[321] We expect that a non-U.S. adviser would need no more than 10 hours of external legal advice (at $400 per hour) and 10 hours of internal review by a senior compliance officer (at $294 per hour) to evaluate whether the adviser would qualify for the exemption under section 203(l).

purposes of avoiding registration, however, because we understand that the primary reasons for advisers to locate in a particular jurisdiction involve tax and other business considerations. We also note that if an adviser did relocate, it would incur the costs of regulation under the laws of most of the foreign jurisdictions in which it may be likely to relocate. We do not believe, in any case, that the adviser would relocate if relocation would result in a material decrease in the amount of assets managed because that loss would likely not justify the benefits of avoiding registration, and thus we do not believe our proposed rule would have an adverse effect on capital formation.

Our proposed rule incorporates the valuation methodology in the instructions to Form ADV. More specifically, proposed instruction 5.b(4) to Form ADV would require advisers to use fair value of private fund assets for determining regulatory assets under management. We acknowledge that there may be some private fund advisers that may not use fair value methodologies.[322] The costs incurred by these advisers to use fair valuation methodology would vary based on factors such as the nature of the asset, the number of positions that do not have a market value, and whether the adviser has the ability to value such assets internally or would rely on a third party for valuation services.[323] Nevertheless, we do not believe that the requirement to use fair value methodologies would result in significant costs for these advisers. We understand that private fund advisers, including those that may not use fair value methodologies for reporting purposes, perform administrative services, including valuing assets, internally as a matter of business practice.[324] Commission staff estimates that such an adviser would incur $1,224 in internal costs to conform its internal valuations to a fair value standard.[325] In the event a fund does not have an internal capability for valuing specific illiquid assets, we expect that it could obtain pricing or valuation services from an outside administrator or other service provider. In the event a fund does not have an internal capability for valuing specific illiquid assets, we expect that it could obtain pricing or valuation services from an outside administrator or other service provider. Staff estimates that the cost of such a service would range from $1,000 to $120,000 annually, which could be borne by several funds that invest in similar assets or have similar investment strategies.[326] We request comment on these estimates. Do advisers that do not use fair value methodologies for reporting purposes have the ability to fair value private fund assets internally? If not, what would be the costs to retain a third party valuation service? Are there certain types of advisers (*e.g.*, advisers to real estate private funds) that would experience special difficulties in performing fair value analyses? If so, why?

Our earlier discussion of the proposed rule also seeks comment on an alternative interpretation of "assets under management in the United States," which would reference the source of the assets (*i.e.,* U.S. private fund investors).[327] Under this approach, a non-U.S. adviser would count the assets of private funds attributable to U.S. investors towards the $150 million threshold, regardless of the location where it manages private funds, and a U.S. adviser would exclude assets that are not attributable to U.S. investors. As a result, under this alternative more U.S. advisers might be able to rely on rule 203(m)–1 than under our proposed approach. To the extent that non-U.S. advisers have U.S. investors in funds that they manage from a non-U.S. location, fewer non-U.S. advisers would be eligible for the exemption under this approach than under our proposal. Thus, this alternative could increase costs for those non-U.S. advisers who would have to register but reduce costs for those U.S. advisers who would not have to register. We seek comment on the number of U.S. advisers that would be able to avail themselves of the private fund adviser exemption under this alternative approach, but would not be able to rely on proposed rule 203(m)–1.

This alternative approach could discourage U.S. advisers that may want to avoid registration from managing U.S. investor assets, which could affect competition for the management of those assets. We believe this is unlikely however, because to the extent the adviser would manage fewer assets we do not believe the loss of managed assets would justify the savings from avoiding registration.

Under either the proposed approach or the alternative, each adviser may incur costs to evaluate whether it would be able to avail itself of the exemption. We estimate that each adviser may incur between $800 to $4,800 in legal advice to learn whether it may rely on the exemption.[328] Each adviser that registers would incur registration costs, which we estimate would be $11,526.[329] They also would incur estimated initial compliance costs ranging from $10,000 to $45,000 and ongoing annual compliance costs from $10,000 to $50,000.[330] Nevertheless, to the extent there would be an increase in registered advisers, as we have noted above, there

[322] *See supra* note 310 and accompanying and following text.

[323] *See supra* note 197.

[324] For example, a hedge fund adviser may value fund assets for purposes of allowing new investments in the fund or redemptions by existing investors, which may be permitted on a regular basis after an initial lock-up period. An adviser to private equity funds may obtain valuation of portfolio companies in which the fund invests in connection with financing obtained by those companies. Advisers to private funds also may value portfolio companies each time the fund makes (or considers making) a follow-on investment in the company. Private fund advisers could use these valuations as a basis for complying with the fair valuation requirement we propose with respect to private fund assets.

[325] This estimate is based upon the following calculation: 8 hours × $153/hour = $1,224. The hourly wage is based on data for a fund senior accountant from SIFMA's *Management and Earnings in the Securities Industry 2009,* modified by Commission staff to account for an 1,800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead.

[326] These estimates are based on conversations with valuation service providers. We understand that the cost of valuation for illiquid fixed income securities generally ranges from $1.00 to $5.00 per security, depending on the difficulty of valuation, and is performed for clients on weekly or monthly basis. We understand that appraisals of privately placed equity securities may cost from $3,000 to $5,000 with updates to such values at much lower prices. For purposes of this cost benefit analysis, we are estimating the range of costs for (i) a private fund that holds 50 fixed income securities at a cost of $5.00 to price and (ii) a private fund that holds privately placed securities of 15 issuers that each cost $5,000 to value initially and $1,000 thereafter. We believe that costs for funds that hold both fixed-income and privately placed equity securities would fall within the maximum of our estimated range. We note that funds that have significant positions in illiquid securities are likely to have the in-house capacity to value those securities or already subscribe to a third party service to value them. We note that many private funds are likely to have many fewer fixed income illiquid securities in their portfolios, some or all of which may cost less than $5.00 per security to value. Finally, we note that obtaining valuation services for a small number of fixed income positions on an annual basis may result in a higher cost for each security or require a subscription to the valuation service for those that do not already purchase such services. The staff's estimate is based on the following calculations: (50 × $5.00 × 4 = $1,000; (15 × $5,000) + (15 × $1,000 × 3) = $120,000).

[327] *See supra* paragraph following note 210.

[328] We expect that a private fund adviser would obtain between 2 and 12 hours of external legal advice (at a cost of $400 per hour) to determine whether it would be eligible for the private fund adviser exemption.

[329] This range is attributable to the amount of assets under management, which affects the magnitude of filing fees associated with registration, and whether the adviser chooses to retain outside legal services to prepare its brochure. *See supra* notes 300–302 and accompanying text.

[330] *See supra* note 303 and accompanying text.

are benefits to registration for both investors and the Commission.[331]

We seek comment on our analysis of the costs associated with the approach we have proposed and the costs of the alternative on which we seek comment. Are there costs of the proposed rule or the alternative approach that we have not identified?

*C. Foreign Private Adviser Exemption*

Section 403 of the Dodd-Frank Act replaces the current private adviser exemption from registration under the Advisers Act with a new exemption for a "foreign private adviser," as defined in new section 202(a)(30) of the Advisers Act.[332] We are proposing new rule 202(a)(30)–1, which would define certain terms in section 202(a)(30) for use by advisers seeking to avail themselves of the foreign private adviser exemption.[333] Because eligibility for the new foreign private adviser exemption, like the current private adviser exemption, is determined, in part, by the number of clients an adviser has, we propose to include in rule 202(a)(30)–1 the safe harbor and many of the client counting rules that appear in rule 203(b)(3)–1, as currently in effect.[334] In addition, we propose to define other terms used in the definition of "foreign private adviser" under section 202(a)(30) including: (i) "Investor;" (ii) "in the United States;" (iii) "place of business;" and (iv) "assets under management." [335]

Proposed rule 202(a)(30)–1 clarifies several provisions used in the statutory definition of "foreign private adviser." First, the proposed rule would include the safe harbor for counting clients currently in rule 203(b)(3)–1, as modified to account for its use in the foreign private adviser context. Under the safe harbor, an adviser would count certain natural persons as a single client under certain circumstances.[336] Proposed rule 202(a)(30)–1 would also retain another provision of rule 203(b)(3)–1 that permits an adviser to treat as a single "client" an entity that receives investment advice based on the entity's investment objectives and two or more entities that have identical owners.[337] As mentioned above, we would not include the "special rule" that allows advisers not to count as a client any person for whom the adviser provides investment advisory services without compensation.[338] Finally, we propose to add a provision that would permit advisers to avoid double-counting private funds and their investors.[339]

Second, section 202(a)(30) provides that a "foreign private adviser" eligible for the new registration exemption cannot have more than 14 clients "or investors." We propose to define "investor" in a private fund in rule 202(a)(30)–1 as any person that would be included in determining the number of beneficial owners of the outstanding securities of a private fund under section 3(c)(1) of the Investment Company Act, or whether the outstanding securities of a private fund are owned exclusively by qualified purchasers under section 3(c)(7) of that Act.[340] We are also proposing to treat as investors beneficial owners (i) who are "knowledgeable employees" with respect to the private fund; [341] and (ii) of "short-term paper" [342] issued by the private fund, even though these persons are not counted as beneficial owners for purposes of section 3(c)(1), and knowledgeable employees are not required to be qualified purchasers under section 3(c)(7).[343]

Third, proposed rule 202(a)(30)–1 defines "in the United States" generally by incorporating the definition of a "U.S. person" and "United States" under Regulation S.[344] In particular, we would define "in the United States" in proposed rule 202(a)(30)–1 to mean: (i) With respect to any place of business located in the "United States," as that term is defined in Regulation S; [345] (ii) with respect to any client or private fund investor in the United States, any person that is a "U.S. person" as defined in Regulation S,[346] except that under the proposed rule, any discretionary account or similar account that is held for the benefit of a person "in the United States" by a non-U.S. dealer or other professional fiduciary is a person "in the United States" if the dealer or professional fiduciary is a related person of the investment adviser relying on the exemption; and (iii) with respect to the public in the "United States," as that term is defined in Regulation S.[347] Fourth, proposed rule 202(a)(30)–1 defines "place of business" to have the same meaning as in Advisers Act rule 222–1(a).[348] Finally, for purposes of rule 202(a)(30)–1 we propose to define "assets under management" by reference to "regulatory assets under management" as determined under Item 5 of Form ADV.[349]

1. Benefits

We are proposing to define certain terms included in the statutory definition of "foreign private adviser" in order to clarify the meaning of these terms and reduce the potential administrative and regulatory burdens for advisers that seek to rely on the

[331] *See supra* text following note 281.

[332] *See supra* note 224 and accompanying text. The new exemption is codified as amended section 203(b)(3).

[333] *See supra* section II.C of this Release.

[334] *See supra* section II.C.1 of this Release. Rule 203(b)(3)–1, as currently in effect, provides a safe harbor for determining who may be deemed a single client for purposes of the private adviser exemption. We would not, however, carry over rules 203(b)(3)–1(b)(4), (5), or (7). *See supra* notes 228 and 233 and accompanying text.

[335] Proposed rule 202(a)(30)–1(c). *See supra* section II.C.2–4 of this Release.

[336] Proposed rule 202(a)(30)–1(a)(1).

[337] Proposed rule 202(a)(30)–1(a)(2)(i)–(ii). In addition, proposed rule 202(a)(30)–1(b)(1) through (3) would retain the following related "special rules": (1) An adviser must count a shareholder, partner, limited partner, member, or beneficiary (each, an "owner") of a corporation, general partnership, limited partnership, limited liability company, trust, or other legal organization, as a client if the adviser provides investment advisory services to the owner separate and apart from the legal organization; (2) an adviser is not required to count an owner as a client solely because the adviser, on behalf of the legal organization, offers, promotes, or sells interests in the legal organization to the owner, or reports periodically to the owners as a group solely with respect to the performance of or plans for the legal organization's assets or similar matters; and (3) any general partner, managing member or other person acting as an investment adviser to a limited partnership or limited liability company must treat the partnership or limited liability company as a client.

[338] *See* rule 203(b)(3)–1(b)(4); *supra* notes 233–235 and accompanying text.

[339] *See* proposed rule 202(a)(30)–1(b)(4) (specifying that an adviser would not be required to count a private fund as a client if it counted any investor, as defined in the proposed rule, in that private fund as an investor in the United States in that private fund).

[340] *See* proposed rule 202(a)(30)–1(c)(1); *supra* section II.C.2 of this Release. In order to avoid double-counting, we would allow an adviser to treat as a single investor any person that is an investor in two or more private funds advised by the investment adviser. *See* proposed rule 202(a)(30)–1(c)(1), at note to paragraph (c)(1).

[341] *See* proposed rule 202(a)(30)–1(c)(1)(A); *supra* note 246 and accompanying text.

[342] *See* proposed rule 202(a)(30)–1(c)(1)(B); *supra* notes 247–248 and accompanying text.

[343] *See* rule 3c–5(b) under the Investment Company Act; section 3(c)(1) of the Investment Company Act. *See also supra* note 249 and accompanying text.

[344] Proposed rule 202(a)(30)–1(c)(2). *See supra* notes 253–261 and accompanying paragraphs.

[345] *See* 17 CFR 230.902(l).

[346] *See* 17 CFR 230.902(k). We would allow foreign advisers to determine whether a client or investor is "in the United States" by reference to the time the person became a client or an investor. *See* proposed rule 202(a)(30)–1's note to paragraph (c)(2)(i).

[347] *See* 17 CFR 230.902(l).

[348] *See* proposed rule 202(a)(30)–1(c)(3); proposed rule 222–1(a) (defining "place of business" of an investment adviser as: "(i) An office at which the investment adviser regularly provides investment advisory services, solicits, meets with, or otherwise communicates with clients; and (ii) Any other location that is held out to the general public as a location at which the investment adviser provides investment advisory services, solicit, meets with, or otherwise communicates with clients."). *See supra* section II.C.4 of this Release.

[349] *See* proposed rule 202(a)(30)–1(c)(4); proposed Form ADV: Instructions to Part 1A, instr. 5.b(4). *See also supra* section II.C.5 of this Release.

foreign private adviser exemption. As discussed above, our proposed rule references definitions set forth in other Commission rules under the Advisers Act, the Investment Company Act and the Securities Act, all of which are likely to be familiar to foreign advisers active in the U.S. capital markets. We anticipate that by defining these terms, we would benefit foreign advisers by providing clarity with respect to the proposed terms that advisers would otherwise be required to interpret (and which they would likely interpret with reference to the rules we reference).[350] The proposal would provide consistency among these other rules and the new exemption. This would limit foreign advisers' need to undertake additional analysis with respect to these terms for purposes of determining the availability of the foreign private adviser exemption.[351] We believe that the consistency and clarity that would result from the proposed rule would promote efficiency for foreign advisers and the Commission.

For example, for purposes of determining eligibility for the foreign private adviser exemption, advisers would count clients substantially in the same manner they count clients under the current private adviser exemption.[352] In identifying "investors," advisers could rely on the determination made to assess whether the private fund meets the counting or qualification requirements under sections 3(c)(1) and 3(c)(7) of the Investment Company Act.[353] In determining whether a client, an investor, or a place of business is "in the United States," or whether it holds itself out as an investment adviser to the public "in the United States," an adviser would apply the same analysis it would otherwise apply under Regulation S.[354] In identifying whether it has a place of business in the United States, an adviser would use the definition of "place of business" under section 222 of the Advisers Act, which is used to determine whether a state may assert regulatory jurisdiction over the adviser.[355]

As noted above, the proposed definitions of "investor" and "United States" under our proposed rule would rely on existing definitions, with slight modifications.[356] Our proposed rule also would incorporate the current safe harbor in rule 203(b)(3)–1 for counting clients, except that it would no longer allow an adviser to disregard clients for whom the adviser provides services without compensation.[357] We propose these modifications in order to preclude some advisers from excluding certain assets or clients from their calculation so as to avoid registration with the Commission and the regulatory requirements associated with registration.[358] We believe that without a definition of these terms, advisers would likely rely on the same definitions we propose to cross reference in rule 202(a)(30)–1, but without the proposed modifications. Our proposal, therefore, would likely have the practical effect of narrowing the scope of the exemption, and thus would result in more advisers registering.

We believe that any increase in registration as compared to the number of foreign advisers that might register if we did not propose rule 202(a)(30)–1 would benefit investors. Investors whose assets are, directly or indirectly, managed by the foreign advisers that would be required to register would benefit from the increased protection afforded by federal registration of the adviser and application to the adviser of all of the requirements of the Advisers Act. As noted above, registration offers benefits to the investing public, including periodic examination of the adviser and compliance with rules requiring recordkeeping, custody of client funds and compliance programs.[359]

We request comment on the potential benefits we have identified above. Are there benefits of the proposed rule that we have not identified?

2. Costs

We do not believe that the proposed definitions would result in significant costs for foreign advisers. We anticipate that each foreign adviser that seeks to avail itself of the foreign private adviser exemption may incur costs to determine whether it is eligible for the exemption. We expect that these advisers would consult with outside U.S. counsel and perform an internal review of the extent to which an advisory affiliate manages discretionary accounts owned by a U.S. person that would be counted toward the limitation on clients and investors in the United States. We estimate these costs would be $6,940.[360]

Without the proposed rule, we expect that most advisers would interpret the new statutory provision by reference to the same rules we propose to cross reference in rule 202(a)(30)–1. Without our proposal, some advisers would likely incur additional costs because they would seek guidance in interpreting the terms used in the statutory exemption. By defining the statutory terms in a rule, we believe that we can provide certainty for foreign advisers and limit the time, compliance costs and legal expenses foreign advisers might incur in seeking an interpretation, all of which costs could inhibit capital formation or reduce efficiency. We expect that advisers also would be less likely to seek additional assistance from us because they could rely on relevant guidance we have previously provided with respect to the definitions we propose to cross reference. We also believe that foreign advisers' ability to rely on the definitions that we have referenced in the proposed rule and the guidance provided with respect to the referenced rules may reduce Commission resources that would be otherwise applied to administering the private foreign adviser exemption, which resources could be allocated to other matters.

We anticipate that our proposed instruction allowing foreign advisers to determine whether a client or investor is "in the United States" by reference to the time the person became a client or an investor, would also reduce advisers' costs.[361] Advisers would make the determination only once and would not be required to monitor changes in the

[350] *See* Paul Hastings Letter, *supra* note 258 (in response to our request for public views, urging us to provide guidance on the interpretation of the terms of the statutory definition of "foreign private adviser"). *See generally supra* note 24.

[351] This is true for all of the proposed definitions except for "assets under management." An adviser that relies on the foreign private adviser exemption would need to calculate its assets under management according to the proposed instructions to Item 5 of Form ADV only for purposes of the availability of the exemption. As discussed, above, proposed rule 202(a)(30)–1 includes a reference to Item 5 of Form ADV in order to ensure consistency in the calculation of assets under management for various purposes under the Advisers Act. *See supra* note 266 and accompanying text.

[352] *See supra* section II.C.1 of this Release.

[353] *See supra* paragraph accompanying note 240.

[354] *See supra* notes 258–259 and accompanying paragraph.

[355] *See supra* section II.C.3 of this Release. Under section 222 of the Advisers Act a state may not require an adviser to register if the adviser does not have a "place of business" within, and has fewer than 6 client residents of, the state.

[356] *See supra* notes 238, 246–251, 253–257 and accompanying text.

[357] *See supra* notes 336–339 and accompanying text.

[358] *See supra* notes 246–251, 253–257 and accompanying text. *See also infra* notes 362–363 and accompanying text for an estimate of the costs associated with registration.

[359] *See supra* text accompanying and following note 281.

[360] This estimate is based on consultation with outside counsel (at a cost of $400 per hour) of 10 hours and an internal review of discretionary accounts owned by U.S. persons performed by a senior compliance officer (at a cost of $294 per hour) of 10 hours. The calculation is as follows: (10 hours × $400) + (10 hours × $294) = $6,940.

[361] *See* proposed rule 202(a)(30)–1, at note to paragraph (c)(2)(i); *supra* notes 267–268 and accompanying text.

status of each client and private fund investor. Moreover, if a client or an investor moved to the United States, under our approach the adviser would not be forced to choose among registering with us, terminating the relationship with the client, or forcing the investor out of the the private fund.

The proposed modifications may result in some costs for foreign advisers who might change their business practices in order to rely on the exemption. Some foreign advisers may have to choose to limit the scope of their contacts with the United States in order to rely on the statutory exemption for foreign private advisers or to register with us. As noted above, we have estimated the costs of registration to be $11,526.[362] In addition, registered advisers would incur initial costs to establish a compliance infrastructure, which we estimate would range from $10,000 to $45,000 and ongoing annual costs of compliance and examination, which we estimate would range from $10,000 to $50,000.[363] In either case, foreign advisers would assess the costs of registering with the Commission relative to relying on the exemption. This assessment, however, would take into account many factors, which would vary from one adviser to another, to determine whether registration, relative to other options, is the most cost-effective business option for the adviser to pursue. If a foreign adviser limited its activities within the United States in order to rely on the exemption, the modifications might have the effect of reducing competition in the market for advisory services. Were the foreign adviser to register, competition among registered advisers would increase. Furthermore, to the extent that the modifications included in the definition of "investor" (in particular the one concerning knowledgeable employees) would limit a foreign adviser's ability to attract certain private fund investors, those modifications may have an adverse effect on capital formation.

By referencing the method of calculating assets under management under Form ADV, certain foreign private advisers would use the valuation method provided in the instructions to Form ADV to verify compliance with the $25 million asset threshold included in the foreign private adviser exemption.[364] More specifically, proposed instruction 5.b(4) to Form ADV would require advisers to use fair value of private fund assets for determining regulatory assets under management. Some foreign advisers to private funds may value assets based on their fair value in accordance with GAAP or other international accounting standards, while other advisers to private funds may not use fair value methodologies.[365] As discussed above, the costs associated with fair valuation would vary based on factors such as the nature of the asset, the number of positions that do not have a market value, and whether the adviser has the ability to value such assets internally or would rely on a third party for valuation services.[366] Nevertheless, we do not believe that the requirement to use fair value methodologies would result in significant costs for these advisers to these funds.[367] Commission staff estimates that such advisers would each incur $1,224 in internal costs to conform its internal valuations to a fair value standard.[368] In the event a fund does not have an internal capability for valuing illiquid assets, we expect that it could obtain pricing or valuation services from an outside administrator or other service provider. Staff estimates that the annual cost of such a service would range from $1,000 to $120,000 annually which could be borne by several funds that invest in similar assets or have similar investment strategies.[369] We request comment on these estimates. Do foreign advisers that do not use fair value methodologies for reporting purposes have the ability to fair value private fund assets internally? If not, what would be the costs to retain a third party valuation service? Are there certain types of foreign advisers (*e.g.,* advisers to real estate private funds) that would experience special difficulties in performing fair value analyses? If so, why?

We request comment on the potential costs we have identified above. Are there costs of the proposed rule that we have not identified?

### *D. Request for Comment*

The Commission requests comments on all aspects of the cost-benefit analysis, including the accuracy of the potential costs and benefits identified and assessed in this Release, as well as any other costs or benefits that may result from the proposals. We encourage commenters to identify, discuss, analyze, and supply relevant data regarding these or additional costs and benefits. For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996,[370] the Commission also requests information regarding the potential annual effect of the proposals on the U.S. economy. Commenters are requested to provide empirical data to support their views.

## VI. Regulatory Flexibility Act Certification

Pursuant to section 605(b) of the Regulatory Flexibility Act,[371] the Commission hereby certifies that proposed rules 203(l)–1 and 203(m)–1 under the Advisers Act would not, if adopted, have a significant economic impact on a substantial number of small entities. Under Commission rules, for the purposes of the Advisers Act and the Regulatory Flexibility Act, an investment adviser generally is a small entity if it: (i) Has assets under management having a total value of less than $25 million; (ii) did not have total assets of $5 million or more on the last day of its most recent fiscal year; and (iii) does not control, is not controlled by, and is not under common control with another investment adviser that has assets under management of $25 million or more, or any person (other than a natural person) that had $5 million or more on the last day of its most recent fiscal year ("small adviser").[372]

Investment advisers solely to venture capital funds and advisers solely to private funds in each case with assets under management of less than $25 million would remain generally ineligible for registration with the Commission under section 203A of the Advisers Act.[373] We expect that any small adviser solely to existing venture capital funds that would not be ineligible to register with the Commission would be able to avail itself of the exemption from registration under the grandfathering provision. If an adviser solely to a new venture capital fund could not avail itself of the exemption because, for example, the fund it advises did not meet the proposed definition of "venture capital fund," we anticipate that the adviser could avail itself of the exemption in section 203(m) of the Advisers Act as

[362] *See supra* note 299 and accompanying text.

[363] *See supra* note 303 and accompanying text.

[364] *See supra* section II.C.5 of this Release.

[365] *See supra* note 310 and accompanying and following text.

[366] *See supra* notes 322–325 and accompanying paragraph.

[367] *See supra* note 324 and accompanying text.

[368] *See supra* note 325.

[369] *See supra* note 326 and accompanying text.

[370] Public Law 104–121, Title II, 110 Stat. 857 (1996) (codified in various sections of 5 U.S.C., 15 U.S.C. and as a note to 5 U.S.C. 601).

[371] 5 U.S.C. 605(b).

[372] Rule 0–7(a) (17 CFR 275.0–7(a)).

[373] Section 203A of the Advisers Act (prohibiting an investment adviser that is regulated or required to be regulated as an investment adviser in the State in which it maintains its principal office and place of business from registering with the Commission unless the adviser has $25 million or more in assets under management or is an adviser to a registered investment company).

implemented by proposed rule 203(m)–1. Similarly, we expect that any small adviser solely to private funds would be able to rely on the exemption in section 203(m) of the Advisers Act as implemented by proposed rule 203(m)–1. We further believe that these advisers would be able to avail themselves of the exemption for private fund advisers regardless of whether our implementing rules required them to calculate assets under management as proposed approach or under the alternative method on which we request comment.[374]

Thus, we believe that small advisers solely to venture capital funds and small advisers to other private funds would generally be ineligible to register with the Commission. Those small advisers that may not be ineligible to register with the Commission, we believe, would be able to rely on the venture fund exemption under section 203(l) of the Advisers Act or the private fund adviser exemption under section 203(m) of that Act as implemented by our proposed rules. For these reasons, we are certifying that proposed rules 203(l)–1 and 203(m)–1 under the Advisers Act would not, if adopted, have a significant economic impact on a substantial number of small entities.

The Commission requests written comments regarding this certification. The Commission requests that commenters describe the nature of any impact on small businesses and provide empirical data to support the extent of the impact.

## VII. Statutory Authority

The Commission is proposing rule 202(a)(30)–1 under the authority set forth in sections 403 and 406 of the Dodd-Frank Act, to be codified at sections 203(b) and 211(a) of the Advisers Act, respectively (15 U.S.C. 80b–3(b), 80b–11(a)). The Commission is proposing rule 203(l)–1 under the authority set forth in sections 406 and 407 of the Dodd-Frank Act, to be codified at sections 211(a) and 203(l) of the Advisers Act, respectively (15 U.S.C. 80b–11(a), 80b–3(l)). The Commission is proposing rule 203(m)–1 under the authority set forth in sections 406 and 408 of the Dodd-Frank Act, to be codified at sections 211(a) and 203(m) of the Advisers Act, respectively (15 U.S.C. 80b–11(a), 80b–3(m)).

## List of Subjects in 17 CFR Part 275

Reporting and recordkeeping requirements; Securities.

[374] *See supra* section II.B.2 of this Release.

## Text of Proposed Rules

For reasons set out in the preamble, the Commission proposes to amend Title 17, Chapter II of the Code of Federal Regulations as follows:

## PART 275—RULES AND REGULATIONS, INVESTMENT ADVISERS ACT OF 1940

1 . The general authority citation for Part 275 is revised to read as follows:

**Authority:** 15 U.S.C. 80b–2(a)(11)(G), 80b–2(a)(11)(H), 80b–2(a)(17), 80b–3, 80b–4, 80b–6(4), 80b–6(a), and 80b–11, unless otherwise noted.

* * * * *

2. Section 275.202(a)(30)–1 is added to read as follows:

### § 275.202(a)(30)–1 Foreign private advisers.

(a) *Client.* You may deem the following to be a single client for purposes of section 202(a)(30) of the Act (15 U.S.C. 80b–2(a)(30)):

(1) A natural person, and:

(i) Any minor child of the natural person;

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

(iii) All accounts of which the natural person and/or the persons referred to in this paragraph (a)(1) are the only primary beneficiaries; and

(iv) All trusts of which the natural person and/or the persons referred to in this paragraph (a)(1) are the only primary beneficiaries;

(2)(i) A corporation, general partnership, limited partnership, limited liability company, trust (other than a trust referred to in paragraph (a)(1)(iv) of this section), or other legal organization (any of which are referred to hereinafter as a "legal organization") to which you provide investment advice based on its investment objectives rather than the individual investment objectives of its shareholders, partners, limited partners, members, or beneficiaries (any of which are referred to hereinafter as an "owner"); and

(ii) Two or more legal organizations referred to in paragraph (a)(2)(i) of this section that have identical owners.

(b) *Special rules regarding clients.* For purposes of this section:

(1) You must count an owner as a client if you provide investment advisory services to the owner separate and apart from the investment advisory services you provide to the legal organization, provided, however, that the determination that an owner is a client will not affect the applicability of this section with regard to any other owner;

(2) You are not required to count an owner as a client solely because you, on behalf of the legal organization, offer, promote, or sell interests in the legal organization to the owner, or report periodically to the owners as a group solely with respect to the performance of or plans for the legal organization's assets or similar matters;

(3) A limited partnership or limited liability company is a client of any general partner, managing member or other person acting as investment adviser to the partnership or limited liability company; and

(4) You are not required to count a private fund as a client if you count any investor, as that term is defined in paragraph (c)(1) of this section, in that private fund as an investor in the United States in that private fund.

**Note to paragraphs (a) and (b):** These paragraphs are a safe harbor and are not intended to specify the exclusive method for determining who may be deemed a single client for purposes of section 202(a)(30) of the Act (15 U.S.C. 80b–2(a)(30)).

(c) *Definitions.* For purposes of section 202(a)(30) of the Act (15 U.S.C. 80b–2(a)(30)),

(1) *Investor* means any person that would be included in determining the number of beneficial owners of the outstanding securities of a private fund under section 3(c)(1) of the Investment Company Act of 1940 (15 U.S.C. 80a–3(c)(1)), or whether the outstanding securities of a private fund are owned exclusively by qualified purchasers under section 3(c)(7) of that Act (15 U.S.C. 80a–3(c)(7)), except that any of the following persons is also an investor:

(i) Any beneficial owner of the private fund that pursuant to § 270.3c–5 of this title would not be included in the above determinations under section 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940 (15 U.S.C. 80a–3(c)(1), (7)); and

(ii) Any beneficial owner of any outstanding *short-term paper,* as defined in section 2(a)(38) of the Investment Company Act of 1940 (15 U.S.C. 80a–2(a)(38)), issued by the private fund.

**Note to paragraph (c)(1):** You may treat as a single investor any person that is an investor in two or more private funds you advise.

(2) *In the United States* means with respect to:

(i) Any client or investor, any person that is a "U.S. person" as defined in § 230.902(k) of this title, except that any discretionary account or similar account that is held for the benefit of a person in the United States by a dealer or other professional fiduciary is in the United States if the dealer or professional fiduciary is a related person of the investment adviser relying on this section and is not organized, incorporated, or (if an individual) resident in the United States.

**Note to paragraph (c)(2)(i):** A person that is in the United States 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, in the case of an investor in a private fund, at the time the investor acquires the securities issued by the fund.

(ii) Any place of business, *in the United States,* as that term is defined in § 230.902(l) of this chapter; and

(iii) The public, *in the United States,* as that term is defined in § 230.902(l) of this chapter.

(3) *Place of business* has the same meaning as in § 275.222–1(a).

(4) *Assets under management* means the regulatory assets under management as determined under Item 5.F of Form ADV (§ 279.1 of this chapter).

(d) *Holding out.* If you are relying on this section, you shall not be deemed to be holding yourself out generally to the public in the United States as an investment adviser, within the meaning of section 202(a)(30) of the Act (15 U.S.C. 80b–2(a)(30)), solely because you participate in a non-public offering in the United States of securities issued by a private fund under the Securities Act of 1933 (15 U.S.C. 77a).

3. Section 275.203(l)–1 is added to read as follows:

**§ 275.203(l)–1 Venture capital fund defined.**

(a) *Venture capital fund defined.* For purposes of section 203(l) of the Act (15 U.S.C. 80b–3(l)), a venture capital fund is any private fund that:

(1) Represents to investors and potential investors that it is a venture capital fund;

(2) Owns solely:

(i) Equity securities issued by one or more qualifying portfolio companies, and at least 80 percent of the equity securities of each qualifying portfolio company owned by the fund was acquired directly from the qualifying portfolio company; and

(ii) Cash and cash equivalents, as defined in § 270.2a51–1(b)(7)(i), and U.S. Treasuries with a remaining maturity of 60 days or less;

(3) With respect to each qualifying portfolio company, either directly or indirectly through each investment adviser not registered under the Act in reliance on section 203(l) thereof:

(i) Has an arrangement whereby the fund or the investment adviser offers to provide, and if accepted, does so provide, significant guidance and counsel concerning the management, operations or business objectives and policies of the qualifying portfolio company; or

(ii) Controls the qualifying portfolio company;

(4) Does not borrow, issue debt obligations, provide guarantees or otherwise incur leverage, in excess of 15 percent of the private fund's aggregate capital contributions and uncalled committed capital, and any such borrowing, indebtedness, guarantee or leverage is for a non-renewable term of no longer than 120 calendar days;

(5) Only issues securities the terms of which do not provide a holder with any right, except in extraordinary circumstances, to withdraw, redeem or require the repurchase of such securities but may entitle holders to receive distributions made to all holders pro rata; and

(6) Is not registered under section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a–8), and has not elected to be treated as a business development company pursuant to section 54 of that Act (15 U.S.C. 80a–53).

(b) *Certain pre-existing venture capital funds.* For purposes of section 203(l) of the Act (15 U.S.C. 80b–3(l)) and in addition to any venture capital fund as set forth in paragraph (a) of this section, a venture capital fund also includes any private fund that:

(1) Has represented to investors and potential investors at the time of the offering of the private fund's securities that it is a venture capital fund;

(2) Prior to December 31, 2010, has sold securities to one or more investors that are not related persons, as defined in § 275.204–2(d)(7), of any investment adviser of the private fund; and

(3) Does not sell any securities to (including accepting any committed capital from) any person after July 21, 2011.

(c) *Definitions.* For purposes of this section:

(1) *Committed capital* means any commitment pursuant to which a person is obligated to acquire an interest in, or make capital contributions to, the private fund.

(2) *Equity securities* has the same meaning as in section 3(a)(11) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(11)) and § 240.3a11–1 of this chapter.

(3) *Publicly traded* means, with respect to a company, being subject to the reporting requirements under section 13 or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o(d)), or having a security listed or traded on any exchange or organized market operating in a foreign jurisdiction.

(4) *Qualifying portfolio company* means any company that:

(i) At the time of any investment by the private fund, is not publicly traded and does not control, is not controlled by or under common control with another company, directly or indirectly, that is publicly traded;

(ii) Does not borrow or issue debt obligations, directly or indirectly, in connection with the private fund's investment in such company;

(iii) Does not redeem, exchange or repurchase any securities of the company, or distribute to pre-existing security holders cash or other company assets, directly or indirectly, in connection with the private fund's investment in such company; and

(iv) Is not an investment company, a private fund, an issuer that would be an investment company but for the exemption provided by § 270.3a–7, or a commodity pool.

4. Section 275.203(m)–1 is added to read as follows:

**§ 275.203(m)–1 Private fund adviser exemption.**

(a) *United States investment advisers.* For purposes of section 203(m) of the Act (15 U.S.C. 80b–3(m)), an investment adviser with its principal office and place of business in the United States is exempt from the requirement to register under section 203 of the Act if the investment adviser:

(1) Acts solely as an investment adviser to one or more qualifying private funds; and

(2) Manages private fund assets of less than $150 million.

(b) *Non-United States investment advisers.* For purposes of section 203(m) of the Act (15 U.S.C. 80b–3(m)), an investment adviser with its principal office and place of business outside of the United States is exempt from the requirement to register under section 203 of the Act if:

(1) The investment adviser has no client that is a United States person except for one or more qualifying private funds; and

(2) All assets managed by the investment adviser from a place of business in the United States are solely attributable to private fund assets, the total value of which is less than $150 million.

(c) *Calculations.* For purposes of this section, private fund assets are calculated as the total value of such assets as of the end of each calendar quarter.

(d) *Transition rule.* With respect to the calendar quarter period immediately following the calendar quarter end date that the investment adviser ceases to be exempt from registration under section 203(m) of the Act (15 U.S.C. 80b–3(m)) due to having $150 million or more in private fund assets, the Commission will not assert a violation of the requirement to register under section 203 of the Act (15 U.S.C. 80b–3) by an investment adviser that was previously exempt in reliance on section 203(m) of the Act; provided that such investment adviser has complied with all applicable Commission reporting requirements.

(e) *Definitions.* For purposes of this section,

(1) *Assets under management* means the regulatory assets under management as determined under Item 5.F of Form ADV (§ 279.1 of this chapter).

(2) *Place of business* has the same meaning as in § 275.222–1(a).

(3) *Principal office and place of business* of an investment adviser means the executive office of the investment adviser from which the officers, partners, or managers of the investment adviser direct, control, and coordinate the activities of the investment adviser.

(4) *Private fund assets* means the investment adviser's assets under management attributable to a qualifying private fund.

(5) *Qualifying private fund* means any private fund that is not registered under section 8 of the Investment Company Act of 1940 (15 U.S.C 80a–8) and has not elected to be treated as a business development company pursuant to section 54 of that Act (15 U.S.C. 80a–53).

(6) *Related person* has the meaning set forth in § 275.204–2(d)(7).

(7) *United States* has the meaning set forth in § 230.902(l) of this chapter.

(8) *United States person* means any person that is a "U.S. person" as defined in § 230.902(k) of this chapter, except that any discretionary account or similar account that is held for the benefit of a United States person by a dealer or other professional fiduciary is a United States person if the dealer or professional fiduciary is a related person of the investment adviser relying on this section and is not organized, incorporated, or (if an individual) resident in the United States.

By the Commission.

Dated: November 19, 2010.

**Elizabeth M. Murphy,**

*Secretary.*

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