SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 275
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: Final rule.

SUMMARY: The Securities and Exchange Commission (the “Commission”) is adopting rules to implement new exemptions from the registration requirements of the Investment Advisers Act of 1940 for advisers to certain privately offered investment funds; these exemptions 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 define “venture capital fund” and provide an exemption from registration for advisers with less than $150 million in private fund assets under management in the United States. The new rules also clarify the meaning of certain terms included in a new exemption from registration for “foreign private advisers.”

DATES: Effective Date: July 21, 2011.

FOR FURTHER INFORMATION CONTACT: Brian McLaughlin Johnson, Tram N. Nguyen 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 adopting 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) (the “Advisers Act”).

I. Background

On July 21, 2010, President Obama signed into law the Dodd-Frank Act, which, among other things, repeals section 203(b)(3) of the Advisers Act. Section 203(b)(3) exempted any investment adviser from registration if the investment adviser (i) had fewer than 15 clients in the preceding 12 months, (ii) did not hold itself out to the public as an investment adviser and (iii) did not act as an investment adviser to a registered investment company or a company that has elected to be a business development company (the “private adviser exemption”). 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.

The primary purpose of Congress in repealing section 203(b)(3) was to require advisers to “private funds” to register under the Advisers Act. Private 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 (“Investment Company Act”) by reason of section 3(c)(1) or 3(c)(7) of such Act. Section 3(c)(1) is available to a fund that does not publicly offer the securities it issues and has 100 or fewer beneficial owners of its outstanding securities. A fund relying on section 3(c)(7) cannot publicly offer the securities it issues and generally must limit the owners of its outstanding securities to “qualified purchasers.”

The term “private fund” was defined by section 2 of the Advisers Act, which was added by section 102(a)(9) of the Dodd-Frank Act. Section 102(a)(9) of the Dodd-Frank 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.” Interests in a private fund may be offered pursuant to an exemption from registration under the Securities Act of 1933 (15 U.S.C. 77) (“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. 78(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. 78(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.524 ("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"). 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.").

II. Discussion

A. Definition of Venture Capital Fund

1. Qualifying Investments

2. Short-Term Holdings

3. Qualifying Portfolio Company

4. Management Involvement

5. Limitation on Leverage

6. No Redemption Rights

7. Represents Itself as Pursuing a Venture Capital Strategy

8. Is a Private Fund

9. Application to Non-U.S. Advisers

10. Grandfathering Provision

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

1. Advisers Solely Private Funds

2. Private Fund Assets

3. Assets Managed in the United States

4. United States Person

C. Foreign Private Advisers

1. Clients

2. Private Fund Investor

3. In the United States

4. Place of Business

5. Assets Under Management

D. Subsidiary Relationships and Advisory Affiliates

III. Certain Administrative Law Matters

I. Background

On July 21, 2010, President Obama signed into law the Dodd-Frank Act, which, among other things, repeals section 203(b)(3) of the Advisers Act. Section 203(b)(3) exempted any investment adviser from registration if the investment adviser (i) had fewer than 15 clients in the preceding 12 months, (ii) did not hold itself out to the public as an investment adviser and (iii) did not act as an investment adviser to a registered investment company or a company that has elected to be a business development company (the “private adviser exemption”). 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.

2. Private Fund Investor

3. United States Person

4. United States

5. Foreign Private Adviser

6. No Redemption Rights

7. Represents Itself as Pursuing a Venture Capital Strategy

8. Is a Private Fund

9. Application to Non-U.S. Advisers

10. Grandfathering Provision

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

1. Advisers Solely Private Funds

2. Private Fund Assets

3. Assets Managed in the United States

4. United States Person

C. Foreign Private Advisers

1. Clients

2. Private Fund Investor

3. In the United States

4. Place of Business

5. Assets Under Management

D. Subsidiary Relationships and Advisory Affiliates

III. Certain Administrative Law Matters

I. Background

On July 21, 2010, President Obama signed into law the Dodd-Frank Act, which, among other things, repeals section 203(b)(3) of the Advisers Act. Section 203(b)(3) exempted any investment adviser from registration if the investment adviser (i) had fewer than 15 clients in the preceding 12 months, (ii) did not hold itself out to the public as an investment adviser and (iii) did not act as an investment adviser to a registered investment company or a company that has elected to be a business development company (the “private adviser exemption”). 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.

2. Private Fund Investor

3. United States Person

4. United States

5. Foreign Private Adviser

6. No Redemption Rights

7. Represents Itself as Pursuing a Venture Capital Strategy

8. Is a Private Fund

9. Application to Non-U.S. Advisers

10. Grandfathering Provision

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

1. Advisers Solely Private Funds

2. Private Fund Assets

3. Assets Managed in the United States

4. United States Person

C. Foreign Private Advisers

1. Clients

2. Private Fund Investor

3. In the United States

4. Place of Business

5. Assets Under Management

D. Subsidiary Relationships and Advisory Affiliates

VI. Regulatory Flexibility Certification

VII. Statutory Authority

Text of Rules
Each private fund advised by an adviser has typically qualified as a single client for purposes of the private adviser exemption.\textsuperscript{13} As a result, investment advisers could advise up to 14 private funds, regardless of the total number of investors investing in the funds or the amount of assets of the funds, without the need to register with us.\textsuperscript{14}

In Title IV of the Dodd-Frank Act ("Title IV"), Congress generally extended Advisers Act registration to advisers to hedge funds and many other private funds by eliminating the private adviser exemption.\textsuperscript{15} In addition to removing the broad exemption provided by section 203(b)(3), Congress amended the Advisers Act to create three more limited exemptions from registration under the Advisers Act.\textsuperscript{16} These amendments became effective on July 21, 2011.\textsuperscript{17} 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 (the "venture capital exemption") and directs the Commission to define "venture capital fund" within one year of enactment.\textsuperscript{18} 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 under management in the United States of less than $150 million (the "private fund adviser exemption").\textsuperscript{19} In this Release, we will refer to advisers that rely on the venture capital and private fund adviser exemptions as "exempt reporting advisers" because sections 203(l) and 203(m) provide that the Commission shall require such advisers to maintain such records and to submit such reports "as the Commission determines necessary or appropriate in the public interest or for the protection of investors."\textsuperscript{20}

Section 203(b)(3) of the Advisers Act, as amended by the Dodd-Frank Act, provides an exemption for certain foreign private investment advisers (the "foreign private adviser exemption").\textsuperscript{21} The term "foreign private adviser" is defined in new section 202(a)(30) of the Advisers Act 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,\textsuperscript{22} and less than $25 million in aggregate assets under management from such clients and investors.\textsuperscript{23}

These new exemptions are not mandatory.\textsuperscript{24} 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 most advisers from registering with the Commission if they do not have at least $100 million in assets under management.\textsuperscript{25}

On November 19, 2010, the Commission proposed three rules that would implement these exemptions.\textsuperscript{26} From the application of any adviser registered under the Advisers Act to define the term "venture capital fund" for purposes of the venture capital exemption. Second, we proposed rule 203(m)–1 to implement the private fund adviser exemption. Third, in order to clarify the application of the foreign private adviser exemption, we proposed new rule 202(a)(30)–1 to define several terms included in the statutory definition of a foreign private adviser as defined in section 202(a)(30) of the Advisers Act.\textsuperscript{27} On the same day, we holds itself out generally to the public in the United States as an investment adviser. Section 202(a)(30)(D)(i).

An adviser choosing to avail itself of an exemption under section 203(l), 203(m) or 203(b)(3), however, may be required to register as an adviser with one or more state securities authorities. See section 203A(b)(1) of the Advisers Act (excluding from state registration any adviser registered with the Commission or that is not registered because such person is excepted from the definition of an investment adviser under section 202(a)(11)). See also infra note 488 (discussing the application of section 222 of the Advisers Act).

These new exemptions are not mandatory.\textsuperscript{24} 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 most advisers from registering with the Commission if they do not have at least $100 million in assets under management.\textsuperscript{25}
also proposed rules to implement other amendments made to the Advisers Act by the Dodd-Frank Act, which included reporting requirements for exempt reporting advisers. 28

We received over 115 comment letters in response to our proposals to implement the new exemptions. 29 Most of these letters were from venture capital advisers, other types of private fund advisers, and industry associations or law firms on behalf of private fund and foreign investment advisers. 30 We also received several letters from investors and trade groups. 31 Although commenters generally supported the various proposed rules, many suggested modifications designed to expand the breadth of the exemptions or to clarify the scope of one or more elements of the proposed rules. Commenters also sought interpretative guidance on certain aspects of the scope of each of the rule proposals and related issues.

II. Discussion

Today, the Commission is adopting rules to implement the three new exemptions from registration under the Advisers Act. In response to comments, we have made several modifications to the proposals. In a separate companion release (the “Implementing Adopting Release”) we are adopting rules to implement other amendments made to the Advisers Act by the Dodd-Frank

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.


29 The comment letters on the Proposing Release (File No. 57–37–10) are available at: http://www.sec.gov/comments/s7–37–10/s73710.shtml. We also considered comments submitted in response to the Implementing Proposing Release that were germane to the rules adopted in this Release.


Act, some of which also concern certain advisers that qualify for the exemptions discussed in this Release. 32

A. Definition of Venture Capital Fund

We are adopting new rule 203(l)–1 to define “venture capital fund” for purposes of the new exemption for investment advisers that advise solely venture capital funds. 33 In summary, the rule defines a venture capital fund as a private fund that: (i) Holds no more than 20 percent of the fund’s capital commitments in non-qualifying investments (other than short-term holdings) (“qualifying investments” generally consist of equity securities of “qualifying portfolio companies” that are directly acquired by the fund, which we discuss below); (ii) does not borrow or otherwise incur leverage, other than limited short-term borrowing (excluding certain guarantees of qualifying portfolio company obligations by the fund); (iii) does not offer its investors redemption or other similar liquidity rights except in extraordinary circumstances; (iv) represents itself as pursuing a venture capital strategy to its investors and prospective investors; and (v) is not registered under the Investment Company Act and has not elected to be treated as a business development company (“BDC”). 34 Consistent with the proposal, rule 203(l)–1 also “grandfathers” any pre-existing fund as a venture capital fund if it satisfies certain criteria under the grandfathering provision. 35 An adviser is eligible to rely on the venture capital exemption only if it solely advises venture capital funds that meet all of the elements of the definition or funds that have been grandfathered.

The proposed rule defined the term venture capital fund in accordance with what we believed Congress understood venture capital funds to be, as reflected in the legislative materials, including the testimony Congress received. 36 As we discussed in the Proposing Release, the proposed definition of venture capital fund was designed to distinguish venture capital funds from other types of private funds, such as hedge funds and private equity funds, and to address concerns expressed by Congress regarding the potential for systemic risk. 37

We received over 70 comment letters on the proposed venture capital fund definition, most of which were from venture capital advisers or related industry groups. 38 A number of commenters supported the Commission’s efforts to define a venture capital fund, 39 citing the “thoughtful” approach taken and the quality of the proposed rule. 40 Commenters representing investors and investor groups and others generally supported the rule as proposed. 41 One of which stated that the proposed definition “succeeds in clearly defining those private funds that will be exempt.” 42 Some of these commenters expressed support for a definition that is no broader than necessary in order to ensure that only advisers to “venture capital funds, and not other types of private funds, are able to avoid the new mandatory registration requirements.” 43

Generally, however, our proposal prompted vigorous debate among commenters on the scope of the definition. For example, a number of commenters wanted us to take a different approach from the proposal and supported two alternatives. Two commenters urged us to rely on the California definition of “venture capital

32 See, e.g., Proposing Release, supra note 26, discussion at section II.A. and text accompanying nn.43, 60, 61, 82, 99, 136.

33 The National Venture Capital Association submitted a comment letter, dated January 13, 2011 (“NVCA Letter”) on behalf of its members, and 27 other commenters expressed their support for the comments raised in the NVCA Letter.


37 AFL–CIO Letter.

38 Sen. Levin Letter. Although they did not object to the approach taken by the proposed rule, several commenters cautioned us against defining venture capital fund more broadly than necessary to preclude advisers to other types of private funds from qualifying under the venture capital exemption. See AFR Letter; CalPERS Letter; Sen. Levin Letter (“a variety of advisers or funds are likely to try to seek refuge from the registration requirement by urging an overbroad interpretation of the term ‘venture capital fund’”). It is important for the Commission to define the term narrowly to ensure that only venture capital funds, and not other types of private funds, are able to avoid the new mandatory registration requirement.”).
operating company.”44 These commenters did not, however, address our concern, discussed in the Proposing Release, that the California definition includes many types of private equity and other private funds, and thus incorporation of this definition would not appear consistent with our understanding of the intended scope of section 203(l).45 Our concern was acknowledged in a letter we received from the current Commissioner for the California Department of Corporations, stating that “we understand the [Commission] cannot adopt verbatim the California definition of [venture capital fund]. Congressional directives require the [Commission] to exclude private equity funds, or any fund that pivots its investment strategy on the use of debt or leverage, from the definition of [venture capital fund].”46 For these reasons and the other reasons cited in the Proposing Release, we are not modifying the proposal to rely on the California definition.47

Several other commenters favored defining a venture capital fund by reference to investments in “small” businesses or companies, although they disagreed on the factors that would deem a business or company to be “small.”48 As discussed in the Proposing Release, we considered defining a qualifying fund as a fund that invests in small companies, but noted the lack of consensus for defining such a term.49 We also expressed the concern in the Proposing Release that defining a “small” company in a manner that imposes a single 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. This could have the potential result that even a low threshold for a size metric could inadvertently restrict venture capital funds from funding otherwise promising young small companies.50 For these reasons, we are not persuaded that the tests for a “small” company suggested by commenters address these concerns. Unilaterally, we also suggested these alternative approaches, most commenters representing venture capital advisers and related groups accepted the approach of the proposed rule, and many of them acknowledged that the proposed definition would generally encompass most venture capital investing activity that typically occurs.51 Several, however, also expressed the concern that a venture capital fund may, on occasion, deviate from its typical investing pattern with the result that the fund could not satisfy all of the definitional criteria under the proposed rule with respect to each investment all of the time.52 Others explained that an investment fund that seeks to satisfy the definition of a venture capital fund (a “qualifying fund”) would desire flexibility to invest small amounts of fund capital in investments that would not meet the criteria under the proposed rule, such as shares of other venture capital funds,53 non-convertible debt,54 or publicly traded securities.55 Both groups of commenters urged us to accommodate them by broadening the definition and modifying the proposed criteria.

Commenters wanted advisers seeking to be eligible for the venture capital exemption to have greater flexibility to operate and invest in portfolio companies and to accommodate existing (and potentially evolving) business practices that may vary from what commenters characterized as typical venture capital fund practice.56 Some argued that a limited basket for such atypical investing activity could facilitate job creation and capital formation.57 They were also concerned that the multiple detailed criteria of the proposed rule could result in “inadvertent” violations of the criteria under the rule.58 Some expressed concern that a Commission rule defining a venture capital fund by reference to investing activity would have the result of reducing an adviser’s investment discretion.59

We are sensitive to commenters’ concerns that the definition not operate to foreclose investment opportunities that would benefit investors but would not change the character of a venture capital fund.60 On the other hand, we are troubled that the cumulative effect of revising the rule to reflect all of the modifications supported by commenters could permit reliance on the exemption by advisers to other types of private funds and thus avoid regulation.

45 See Proposing Release, supra note 26, at n.72 and accompanying text.
46 Comment Letter of Preston DuFauchard, Commissioner for the California Department of Corporations (Jan. 21, 2011) (“DuFauchard Letter”) (further stating that “while regulators might have an interesting discussion on whether private equity funds contributed to the recent financial crisis, in light of the Congressional directives such a dialogue would be academic.”).
47 See Proposing Release, supra note 26, at n.72 and accompanying and preceding text.
49 See Proposing Release, supra note 26, at section II.A.1.a and n.69 and accompanying and following text.
50 See Proposing Release, supra note 26, at n.69 and accompanying and preceding text.
56 See Proposing Release, supra note 26, at n.69.
57 See, e.g., NVCA Letter; Comment Letter of Bessemer Venture Partners (Jan. 24, 2011) (“Bessemer Letter”); Oak Investment Letter. See also supra note 51.
58 See, e.g., NVCA Letter (stating that a low level of 15% would “allow innovation and job creation to flourish within the venture capital industry”); Sevin Rosen Letter (a 20% limit would be “flexible enough not to severely impair the operations of bona fide [venture capital funds], a critically important resource for American innovation and job creation”).
59 See, e.g., NVCA Letter (“Because of the consequence (i.e., Federal registration) of having even one inadvertent, non-qualifying investment, allowance for unintended or insignificant deviations, or differences in interpretations, is appropriate.”); Comment Letter of SV Life Sciences (Jan. 21, 2011) (“SV Life Sciences Letter”) (the “lack of flexibility and ambiguity in certain definitions * * * could cause our firm or other venture firms to inadvertently hold non-qualifying investments”). See also ATV Letter.
60 DuFauchard Letter (“Only the VC Fund advisers/managers are in a position to determine what best form ‘down-round’ financing should take. Whether that should be new capital, project finance, a bridge loan, or some other form of equity or debt, is neither a question for the regulators nor should it be a question of strict regulatory control.”); ESP Letter (“There is no way a single regulation can determine what the appropriate level of leverage should be for every portfolio company.”); Merki Letter (“The Commission should not regulate from whom the [portfolio company] securities can be acquired or how the [company’s] capital can be used.”).
expand the exemption beyond what we believe was the intent of Congress.61 A number of commenters argued that defining a venture capital fund by reference to multiple detailed criteria could result in “inadvertent” violations of the definitional criteria by a qualifying fund.62 Another commenter acknowledged that providing de minimis carve-outs to the multiple criteria under the proposed rule could be “cumbersome,”63 which could lead to the result, asserted by some commenters, that an overly prescriptive rule could invite further unintentional violations of the registration provisions of the Advisers Act.64

To balance these competing considerations, we are adopting an approach suggested by several commenters that defines a venture capital fund to include a fund that invests a portion of its capital in investments that would not otherwise satisfy all of the elements of the rule (“non-qualifying basket”).65 Defining a venture capital fund to include funds engaged in a “small” amount of non-qualifying investment activity provides advisers to venture capital funds with greater investment flexibility, while precluding an adviser relying on the exemption from altering the character of the fund’s investments to such extent that the fund could no longer be viewed as a venture capital fund within the intended scope of the exemption. To the extent an adviser uses the basket to invest in some non-qualifying investments, it will have less room to invest in others, but the choice is left to the adviser. While the definition limits the amount of non-qualifying investments, it allows the adviser to choose how to allocate those investments. Thus, one venture capital fund may take advantage of some opportunities to invest in debt whereas others may seek limited opportunities in publicly offered securities. The definition of “business development company” under the Advisers Act contains a similar basket for non-qualifying investments.66

Commenters suggested non-qualifying baskets ranging from 15 to 30 percent of a fund’s capital commitments, although many of these same commenters wanted us to expand the other criteria of the proposed rule.67 Several commenters in favor of a non-qualifying basket asserted that setting the level for non-qualifying investments at a sufficiently low threshold would preclude advisers to other types of private funds from relying on the venture capital exemption while providing venture capital advisers the flexibility to take advantage of investment opportunities.68 These commenters properly framed the question before us. We did not, however, receive specific empirical analysis regarding the venture capital industry as a whole that would help us determine the appropriate size of the basket.69 Many of those supporting a 15 percent non-qualifying basket also supported expanding some of the other elements of the definition, and thus it is unclear whether a 15 percent non-qualifying basket alone would satisfy their needs.70 On the other hand, those supporting a much larger basket did not, in our view, adequately address our concern that an overly expansive definition would provide room for advisers to private equity funds to remain unregistered, a consequence several commenters urged us to avoid.71

On balance, and after giving due consideration to the approaches suggested by commenters, we are adopting a limit of 20 percent of a qualifying fund’s capital commitments for non-qualifying investments. We believe that a 20 percent limit will provide the flexibility sought by many venture capital fund advisers while appropriately limiting the scope of the exemption. We note that several commenters recommended a non-qualifying basket limit of 20 percent.72

We considered adopting a 40 percent basket for non-qualifying investments by analogy to the Advisers Act definition of BDC.73 That basket was established by Congress rather than the Commission, and it strikes us as too far in light of our task of implementing a statutory provision that does not specify a basket.74 We find a better analogy in a rule we adopted in 2001 under the Investment Company Act. Under rule 35d–1 of that Act, commonly referred to as the “names rule,” an investment company with a name suggesting that it invests in certain investments is limited to investing no more than 20 percent of its assets in other types of investments (i.e., than never— we invest in the form of a straight, non-convertible Demand Note.”)75

See supra note 43.

See supra note 67.

See supra note 67.

See supra note 67.

See supra note 67.

See supra note 67.

See supra note 67.

See supra note 67.

See supra note 67.

See supra note 67.

See supra note 67.

See supra note 67.

See supra note 67.

See supra note 67.

See supra note 67.
non-qualifying investments). In adopting that rule, we explained that “if an investment company elects to use a name that suggests its investment policy, it is important that the level of required investments be high enough that the name will accurately reflect the company’s investment policy.” We noted that having a registered investment company hold a significant amount of investments consistent with its name is an important tool for investor protection, but setting the limit at 20 percent gives the investment company management flexibility. While our policy goal today in defining a “venture capital fund” is somewhat different from our goal in prescribing limitations on investment company names, the tensions we sought to reconcile are similar.

1. Qualifying Investments

Under the rule, to meet the definition of venture capital fund, the fund must hold, immediately after the acquisition of any asset (other than qualifying investments or short-term holdings), no more than 20 percent of the fund’s capital commitments in non-qualifying investments (other than short-term holdings).

Thus, as discussed above, a qualifying fund could invest without restriction up to 20 percent of the fund’s capital commitments in non-qualifying investments and would still fall within the venture capital fund definition.

For purposes of the rule, a “qualifying investment,” which we discuss in greater detail below, generally consists of any equity security issued by a qualifying portfolio company that is directly acquired by a qualifying fund and certain equity securities exchanged for the directly acquired securities.

a. Equity Securities of Portfolio Companies

Rule 203(l)(1) defines a venture capital fund as a private fund that, excluding investments in short-term holdings and non-qualifying investments, generally holds equity securities of qualifying portfolio companies.

We proposed to define “equity security” by reference to the Exchange Act. Commenters did not generally object to our proposal to do so, although many urged that we expand the definition of venture capital fund to include investments in other types of securities. Commenters asserted that venture capital funds may invest in securities other than equity securities (including debt securities) for various business reasons, including to provide “bridge” financing to portfolio companies between equity financing rounds, for working capital needs, for tax or structuring reasons. Many of these commenters recommended that the rule also define a venture capital fund to include funds that invest in non-convertible bridge loans of a portfolio company.

In other (other than qualifying investments or short-term holdings) no more than 20% of the fund’s aggregate capital commitments and uncalled committed capital may be held in assets (other than short-term holdings) that are not qualifying investments. See infra Section I.A.1.c. for a discussion on the operation of the 20% limit.

The final rule incorporates the definition of equity security in section 3(a)(11) of the Exchange Act and rule 3a11–1 thereunder. Accordingly, (supported venture capital fund investments in non-convertible debt without a time limit); Cook Children’s Letter; Leland Fikes Letter (each of which expressed general support). One commenter indicated that the proposed condition limiting investments in portfolio companies to equity securities was too narrow. See Fine Brook Letter.

Commenters urged that we expand the definition of equity security in section 3(a)(11) of the Exchange Act and rule 3a11–1 thereunder. Accordingly, (supported venture capital fund investments in non-convertible debt without a time limit); Cook Children’s Letter; Leland Fikes Letter (each of which expressed general support). One commenter indicated that the proposed condition limiting investments in portfolio companies to equity securities was too narrow. See Fine Brook Letter.

Commenters urged that we expand the definition of equity security in section 3(a)(11) of the Exchange Act and rule 3a11–1 thereunder. Accordingly, (supported venture capital fund investments in non-convertible debt without a time limit); Cook Children’s Letter; Leland Fikes Letter (each of which expressed general support). One commenter indicated that the proposed condition limiting investments in portfolio companies to equity securities was too narrow. See Fine Brook Letter. Continued
equity security includes common stock as well as preferred stock, warrants and other securities convertible into common stock in addition to limited partnership interests. Our definition of equity security is broad. The definition includes various securities in which venture capital funds typically invest and provides venture capital funds with flexibility to determine which equity securities in the portfolio company capital structure are appropriate for the fund. Our 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 but 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 funds.

b. Capital Used for Operating and Business Purposes

Rule 203(l)–1 defines a venture capital fund as a private fund that holds no more than 20 percent of the fund’s capital commitments in non-qualifying investments (other than short-term holdings). Under the final rule, qualifying investments are generally equity securities that were acquired by the fund in one of three ways that suggest that the fund’s capital is being used to finance the operations of businesses rather than for trading in secondary markets. As discussed in greater detail below, rule 203(l)–1 defines a “qualifying investment” as:

(i) Any equity security issued by a qualifying portfolio company that is directly acquired by the fund from the company (directly acquired equity’’); (ii) any equity security issued by a qualifying portfolio company in exchange for directly acquired equity issued by the same qualifying portfolio company; and (iii) any equity security issued by a company of which a qualifying portfolio company is a majority-owned subsidiary, or a predecessor, and that is acquired by the fund in exchange for directly acquired equity.

In the Proposing Release we explained that one of the features of venture capital funds that distinguish them from hedge funds and private equity funds is that they invest capital directly in portfolio companies for the purpose of funding the expansion and development of the companies’ business rather than buying out existing security holders. Thus, we proposed that, to meet the definition, at least 80 percent of a fund’s investment in each portfolio company must be acquired directly from the company, in effect limiting a venture capital fund’s ability to acquire secondary market shares to 20 percent of the fund’s investment in each company.

A few commenters objected to any limitation on secondary market purchases of a qualifying portfolio company’s shares, but did not address the critical role this condition played in differentiating venture capital funds from other types of private funds, such as leveraged buyout funds, which acquire controlling equity interests in operating companies through the “buyout” of existing security holders. Nor did they offer an alternative method in lieu of the direct acquisition criterion to distinguish venture capital funds from the buyout funds that are considered private equity funds. We continue to believe that the limit on secondary purchases is an important element for distinguishing advisers to venture capital funds from advisers to the types of private equity funds for which Congress did not provide an exemption. Therefore, we are not modifying the definition of qualifying investment to broadly include equity securities acquired in secondary transactions.

We are, however, making two changes in this provision in response to commenters. First, we have eliminated the 20 percent limit for secondary market transactions that we included in this provision in our proposal in favor of the broader 20 percent limit for assets that are not qualifying investments. Most commenters addressing the limit on secondary market acquisitions supported changing the threshold from 80 percent of the fund’s investment in each portfolio company to either 50 percent in each portfolio company, or 80 percent of the fund’s total capital commitments. These commenters argued that secondary acquisitions provide liquidity to founders, angel investors and employees/former employees or align the interests of a fund with those of a portfolio company.

We believe that the limit on secondary purchases remains an important element for distinguishing advisers to venture capital funds from advisers to the types of private equity funds for which Congress did not provide an exemption. However, as discussed above, a venture capital fund may purchase shares in secondary markets to the extent it has room for such securities in its non-qualifying basket.

Second, the final rule defines qualifying investments as including equity securities issued by the qualifying portfolio company that are received in exchange for directly acquired equity issued by the same qualifying portfolio company. This revision was suggested by a number of commenters.

103 Cf. proposed rule 203(l)–1(a)(2) and rule 203(l)–1(a)(2).
104 See DLA Piper VC Letter; Davis Polk Letter; Sevin Rosen Letter (each supported lowering the direct purchase requirement from 80% to 50% of each qualifying portfolio company’s equity securities); Dechert General Letter (argued that the 20% allowance for secondary purchases should be increased to 45%); Davis Polk Letter; S&K Letter; NVCA Letter; Oak Investment Letter; Sevin Rosen Letter; S&K Letter; DLA Piper VC Letter; Davis Polk Letter; Sevin Rosen Letter (each supported lowering the direct purchase requirement from 80% to 50% of each qualifying portfolio company’s equity securities).
105 See also ABA Letter (supported lowering the threshold from 80% to 70%); NVCA Letter; Mesirov Letter; Oak Investments Letter. Several commenters disagreed with the proposed direct acquisition criterion and recommended that venture capital fund investments in portfolio company securities through secondary transactions should not be subject to any limit. See, e.g., ESP Letter; Merki Letter.
106 ATV Letter; Bessemer Letter; Charles River Letter; Davis Polk Letter; First Round Letter; Gunderson Dettmer Letter; InterWest Letter; Mesirov Letter; Norwest Letter; NVCA Letter; Oak Investment Letter; Sevin Rosen Letter; S&K Letter; Union Square Letter; Vedanta Letter. See also Comment Letter of Alta Partners (Jan. 24, 2011) (“Alta Partners Letter”); U.S. V.P. Letter.
107 See, e.g., Bessemer Letter; Norwest Letter; Sevin Rosen Letter.
108 See Proposing Release, supra note 26, at n.112 and accompanying text.
109 Rule 203(l)–1(c)(3). A security received as a dividend by virtue of the fund’s holding of a qualifying investment would also be a qualifying investment. See generally infra note 480.
110 See supra note 26, at text accompanying n.104.
111 See supra note 26, at text accompanying n.112 and accompanying text.
112 See, e.g., ESP Letter; Merki Letter.
113 See also Proposing Release, supra note 26, at section II.A.1.d.
114 See supra note 26, at note 112 and accompanying text.
company that became a majority-owned subsidiary of the reporting company.113

Under the rule, to meet the definition of venture capital fund, a qualifying fund must hold, immediately after the acquisition of any asset (other than qualifying investments or short-term holdings), no more than 20 percent of the fund’s capital commitments in non-qualifying investments (other than short-term holdings). 114 Under this approach, a fund need only calculate the 20 percent limit when the fund acquires a non-qualifying investment (other than short-term holdings); after the acquisition, the fund need not dispose of a non-qualifying investment simply because of a change in the value of that investment. A qualifying fund, however, could not purchase additional non-qualifying investments until the value of its then-existing non-qualifying investments fell below 20 percent of the fund’s committed capital.

As discussed above, most commenters supporting a basket for non-qualifying investments recommended a limit expressed as a percentage of fund capital commitments.115 One commenter further suggested that the value of investments included in the non-qualifying basket be calculated at the time each investment is made to include only those non-qualifying investments that are then held by the fund (thus excluding liquidated assets); the commenter argued that this approach would give funds certainty that a qualifying investment would not become “non-qualifying” and simplify the test for compliance.116

We are persuaded that the non-qualifying basket should be based on a qualifying fund’s total capital commitments, and the fund’s compliance with the 20 percent limit should be calculated at the time any non-qualifying investment is made, based on the non-qualifying investments then held in the fund’s portfolio.117 We understand that using a fund’s capital commitments for determining investment thresholds is generally consistent with existing venture capital fund practice,118 and nearly all of the commenters requesting a basket specified the basket as a percentage of the fund’s capital commitments.119 We expect that calculating the size of the non-qualifying basket as a percentage of a qualifying fund’s capital commitments, which will remain relatively constant during the fund’s term, will provide advisers with a degree of predictability when managing the fund’s portfolio and determining how much of the basket remains available for new investments.

We acknowledge that limiting non-qualifying investments to a percentage of fund capital commitments could result in a qualifying fund that invests its initial capital call in non-qualifying investments;120 but that ability would be constrained by the adviser’s need to reconcile that investment with the fund’s required representation that it pursues a venture capital strategy.121 An investment adviser that manages a fund in such a manner that renders the representation to investors and potential investors that the fund pursues a venture capital strategy an untrue statement of material fact would violate the antifraud provisions of the Advisers Act.122 We understand that a venture capital fund is not typically required to call or fully draw down all of its capital commitments. However, only bona fide capital commitments may be included in the calculation under rule 203(l)–

109 See, e.g., NVCA Letter. See also Sevin Rosen Letter. Although we understand that the securities received in an exchange are typically newly issued, the rule would also cover exchanges for outstanding securities. See also infra note 113.

110 Under rule 203(l)–1(c)(3)(ii), “qualifying investments” include any equity security issued by a company of which a qualifying portfolio company or its majority-owned subsidiary is a majority-owned subsidiary (as defined in section 2(a)(24) of the Investment Company Act), or a predecessor company, and that is acquired by the fund in exchange for directly acquired securities of a company subject to the rule.

A “majority-owned subsidiary” is defined by reference to section 2(a)(24) of the Investment Company Act, 15 U.S.C. 80a(2)(a)(24), which defines a “majority” of any person as “a company 50 per centum or more of the outstanding voting securities of which are owned by such person, or by a company which, within the meaning of this paragraph, is a majority-owned subsidiary of such person.”

111 See, e.g., Davis Polk Letter; Comment Letter of Institutional Venture Partners [Jan. 24, 2011] (“IVP Letter”); Mesiorow Letter; PTV Sciences Letter. A number of commenters argued that without this expanded definition, typical transactions enabling a venture capital fund to restructure its investment in a portfolio company, exit its investment or obtain liquidity for itself and its investors, as well as profits, would be precluded. See, e.g., NVCA Letter; PTV Sciences Letter.

112 See, e.g., Davis Polk Letter. See also Mesiorow Letter.

113 See supra note 67.


115 Under the rule, a qualifying fund could separately purchase additional securities pursuant to a public offering (or recapitalization) from a company after it ceases to be a “qualifying portfolio company” (because for example such company has become a majority-owned subsidiary of a company), subject to the non-qualifying basket.

116 Sevin Rosen Letter. See also BioVentures Letter (endorsing the NVCA Letter supporting a non-qualifying basket as a percentage of fund capital commitments, but also arguing in favor of determining the basket “at any point in time, rather than in the aggregate over the life of the fund”).
1. For example, commitments made for the purpose of increasing the non-qualifying basket and with an understanding with investors that they will not be called cannot be included.

Moreover, we believe that by applying the 20 percent limit as of the time of acquisition of each non-qualifying investment, a fund is able to determine prospectively how much it can invest in the non-qualifying basket. We believe that this simpler approach to determining the non-qualifying basket would better limit a qualifying fund’s non-qualifying investments and ease the burden of determining compliance with the criterion under the rule.

To determine compliance with the 20 percent limit, a venture capital fund would, immediately after the acquisition of any non-qualifying investment, excluding any short-term holdings, calculate the total value of all of the fund’s assets held at that time, excluding short-term holdings, that are invested in non-qualifying investments, as a percentage of the fund’s total capital commitments. For this purpose, the 20 percent test is determined based on the qualifying fund’s non-qualifying investments after taking into account the acquisition of any newly acquired non-qualifying investment.

To determine if a fund satisfies the 20 percent limit for non-qualifying investments, the fund may use either historical cost or fair value, as long as the same method is applied to all investments of a qualifying fund in a consistent manner during the term of the fund. Under the rule, a venture capital fund could use either historical cost or fair value, depending, for example, on the fund’s approach to valuing investments since the fund’s inception. Under the final rule, a qualifying fund using historical cost need not account for changes in the value of its portfolio due to, for example, market fluctuations in the value of a non-qualifying investment or the sale or other disposition of a qualifying investment (including the associated distribution of sale proceeds to fund investors). Requiring fair value in this particular instance could make investment planning difficult because the amount of dollars allocated to the non-qualifying basket would vary depending on changes in the value of investments already made. In addition, requiring fair value could complicate compliance for those qualifying funds that make investments frequently, because each investment would result in a requirement to value the fund’s assets. Because the rule specifies that the valuation method must be consistently applied, this approach is designed to prevent a qualifying fund, or its adviser, from alternating between valuation methodologies in order to circumvent the 20 percent limit.

Our rule’s approach to the valuation method, which allows the use of historical cost in determining compliance with the non-qualifying basket limit, is similar in this respect to rules under the Employee Retirement Income Security Act of 1974 (“ERISA”) for funds qualifying as “venture capital operating companies,” which generally specify that the value of a fund’s investments is determined on a cost basis.

129 Many commentators cited the ERISA rule in connection with comments on other proposed criteria, and hence we believe advisers’ familiarity with the ERISA rule will facilitate compliance with our approach to the 20 percent limit and reduce the burdens associated with compliance.

2. Short-Term Holdings

A qualifying fund may also invest in cash and cash equivalents, U.S. Treasuries with a remaining maturity of 60 days or less and shares of registered money market funds. A qualifying fund need not include its investments in these short-term holdings when determining whether it satisfies the 20 percent limit for non-qualifying investments.

Most commenters that addressed the cash element of the proposal did not disagree with our approach to the cash element but urged us to expand it to include money market funds, any U.S. Treasury without regard to maturity, debt issued by foreign governments, repurchase agreements, and certain highly rated corporate commercial paper. Many commenters did not provide a rationale, other than business practice, for expanding the cash element to include these other types of investments or discuss whether these changes would also permit other types of funds to meet the definition. One commenter did note, however, that short-term investments are typically held during the period between a capital call and funding by valued at cost, invested in venture capital investments. 29 CFR 2510.3–101(d). See also Proposing Release, supra note 26, at n.70.

For example, a number of commenters urged us to adopt the approach taken by ERISA that would determine whether or not a fund has satisfied the managerial assistance criterion. See infra note 225.

Rule 203(1)–1(c)(6).

Rule 203(1)–1(a)(2). As proposed, a venture capital fund would have been defined as a fund that invested solely in certain investments, including specified cash instruments. Proposed rule 203(1)–1(a)(3)(ii). In the final rule, a venture capital fund is defined as a fund that holds no more than 20% of its committed capital in assets that are not qualifying investments, excluding for this purpose short-term holdings (which is defined to include specified cash instruments). Rule 203(1)–1(a)(2).

The general focus of both the proposal and the final rule is on the types of investments in which a qualifying fund may invest. As a result of the modifications to the rule to incorporate a non-qualifying basket, we are excluding short-term holdings from the calculation of qualifying and non-qualifying investments.

Comment Letter of Federated Investors, Inc. (Jan. 18, 2011); IVP Letter; Merki Letter.

See, e.g., Dechert General Letter; IVP Letter. See also Shearman Letter; SVB Letter (also argued that Treasuries pose no systemic risk issues).


IVP Letter; NVCA Letter.

Sevin Rosen Letter.
investors and invested in instruments that may provide higher returns than the cash items identified in the proposed rule.\textsuperscript{138}

The Commission recognizes that a broader definition of short-term holdings could yield venture capital funds greater returns.\textsuperscript{139} The exclusion of short-term holdings from a qualifying fund’s assets for purposes of the 20 percent test, however, recognizes that such holdings are not ordinarily held as part of the fund’s investment portfolio but as a cash management tool.\textsuperscript{140} Advice to venture capital funds that wish to invest in longer-term or higher yielding debt may make use of the non-qualifying basket for such investments. We are, however, modifying the definition to include as short-term holdings shares of registered money market funds that are regulated under rule 2a–7 under the Investment Company Act,\textsuperscript{141} which we understand are commonly held for purposes of cash management.\textsuperscript{142}

The rule defines short-term holdings to include “cash and cash equivalents” by reference to rule 2a51–1(b)(7)(i) under the Investment Company Act.\textsuperscript{143} We did not receive any comments on this aspect of the proposal and are adopting it without modification. 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).\textsuperscript{144} We are not defining 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 includes short-term U.S. Treasuries with a remaining maturity of 60 days or less.\textsuperscript{145}

3. Qualifying Portfolio Company

Under the rule, qualifying investments generally consist of equity securities issued by a qualifying portfolio company. A “qualifying portfolio company” is defined as any company that (i) is not a reporting or foreign traded company and does not have a control relationship with a reporting or foreign traded company; (ii) does not incur leverage in connection with the investment by the private fund and distribute the proceeds of any such borrowing to the private fund in exchange for the private fund investment; and (iii) is not itself a fund (i.e., is an operating company).\textsuperscript{146} We are adopting the rule substantially as proposed, with modifications to the leverage criterion in order to address certain concerns raised by commenters. We describe each element of a qualifying portfolio company below. We understand each of the criteria to be characteristic of issuers of portfolio securities held by venture capital funds.\textsuperscript{147} Moreover, collectively, we believe these criteria would operate to exclude most private equity funds and hedge funds from the definition.

a. Not a Reporting Company

Under the rule, a qualifying portfolio company is defined as a company that, at the time of any investment by a qualifying fund, is not a “reporting or foreign traded” company (a “reporting company”) and does not control, is not controlled by or under common control with, a reporting company.\textsuperscript{148} Under the definition, a venture capital fund may continue to treat as a qualifying investment any previously directly acquired equity security of a portfolio company that subsequently becomes a reporting company.\textsuperscript{149} Moreover, after a company becomes a reporting company, a qualifying fund could acquire the company’s publicly traded (or foreign traded) securities in the secondary markets, subject to the availability of the fund’s non-qualifying basket.

As we discussed in the Proposing Release, 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.\textsuperscript{150} Unlike

\textsuperscript{138} NVCA Letter.

\textsuperscript{139} See, e.g., NVCA Letter.

\textsuperscript{140} We do not view investing in short-term holdings as being a venture capital strategy; however, for purposes of the exemption, a qualifying fund could invest in short-term holdings as part of implementing its investment strategy. See also infra Section III.A.7.

\textsuperscript{141} Rule 203(l)(1)(c)(i)(6).

\textsuperscript{142} See, e.g., NVCA Letter.

\textsuperscript{143} 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) [bank deposits, certificates of deposit, bankers acceptances and similar bank instruments held for investment purposes; and (ii) the net cash surrender value of an insurance policy.]” 17 CFR 270.2a51–1(b)(7).

\textsuperscript{144} See generally sections 2(a)(51) and 3(c)(7) of the Investment Company Act; 17 CFR 270.2a51–1(b) and (c).

\textsuperscript{145} 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 end-of-period investments 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.

\textsuperscript{146} Rule 203(l)(1)(c)(i)(4). In the Proposing Release, we used the defined term “publicly traded” company, but are modifying the rule to use the defined term “reporting or foreign traded” company to match more closely the defined term and to make clear that certain companies that have issued securities that are traded on a foreign exchange are covered by the definition. See proposed rule 203(l)(1)(c)(i)(3) and (4).

\textsuperscript{147} See Proposing Release, supra note 26, sections II.A.1.a–II.A.1.e.

\textsuperscript{148} Rule 203(l)(1)(c)(i)(4); rule 203(l)(1)(c)(5) (defining a “reporting or foreign 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). 17 CFR 270.2a51–1; 17 CFR 240.12g3–2. Under the rule, securities of a “reporting or foreign traded company” include securities of non-U.S. companies that are listed on a non-U.S. market or non-U.S. exchange; Rule 203(l)(1)(c)(5).

\textsuperscript{149} Rule 203(l)(1)(c)(i)(4) (defining a qualifying portfolio company as any company that at the time of any investment by a qualifying fund is not a reporting or foreign traded company).

\textsuperscript{150} See Testimony of James Chanos, Chairman, Coalition of Private Investment Companies, July 15, 2009, at 4 (“[V]enture capital is an important source of funding for start-up companies or turnaround ventures.”); National Venture Capital Association Yearbook 2010 (“NVCA 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.”); George W. Penn, 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 the investment business but stating that “the phrase ‘venture capital’ is sometimes used narrowly to refer only to financing the start-up of a new... Continued
other types of private funds, venture capital funds are characterized as not trading in the public markets, but may sell portfolio company securities into the public markets once the portfolio company has matured. As of year-end 2010, U.S. venture capital funds managed approximately $176.7 billion in assets. In comparison, as of year-end 2010, the U.S. publicly traded equity market had a market value of approximately $15.4 trillion, whereas global hedge funds had approximately $1.7 trillion in assets under management. The aggregate amount invested in venture capital funds is considerably smaller. Congressional testimony asserted that these funds may be less connected with the public markets and may involve less potential for systemic risk. This appears to be business.

See testimony of Trevor Loy, Flywheel Ventures, before the Senate Banking Subcommittee on Securities, Insurance and Investment Hearing, July 15, 2009 ("Loy Testimony"). See also Testimony of Terry McGuire, Polaris Venture Partners, and Chairman, National Venture Capital Association, before the U.S. House of Representatives Committee on Financial Services, October 6, 2009 ("McGuire Testimony") 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 150, 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).

National Venture Capital Association Yearbook 2011 ("NVCA Yearbook 2011") at 9, Fig. 1.0.

Bloomberg Terminal Database, WCAUUS <Index> Bloomberg United States Exchange Market Capitalization.


In 2010, investors investing in newly formed funds committed approximately $12.3 billion to venture capital funds compared to approximately $8.15 billion to private equity funds. NVCA Yearbook 2011, supra note 152, at 20 at Fig. 2.02. In comparison, hedge funds raised approximately $22.6 billion from investors in 2010. Credit Suisse Report, supra note 154, at 3.

See S. Rep. No. 111–176, supra note 6, at 74–5 (noting that venture capital funds "do not present the same risks as the large private funds whose advisors 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 the 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 of a key consideration by Congress that led to the enactment of the venture capital exemption.

As we discussed in the Proposing Release, the rule we proposed 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. The proposed rule would have required that a qualifying fund invest primarily in equity securities of companies that are not capitalized by the public markets. Several commenters asserted that the definition should not exclude securities of reporting companies. Most, however, did not object to the rule’s limitation on investments in non-reporting companies, but instead sought a more flexible definition that would include some level of investments in reporting companies under certain conditions. For example, certain commenters supported venture capital fund investments in reporting companies only if, at the time the transactions occurred in the financial system in the last year, nor does it pose a future systemic risk to our financial markets or retail investors."

See also Loy Testimony, supra note 151, at 7 (noting the factors by which the venture capital industry is exposed to "entrepreneurial and technological risk not systemic financial risk"); McGuire Testimony, supra note 151, 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).

See supra note 156. See Proposing Release, supra note 26, at n.43 and n.60 and following text.

Most commenters did not express any objection to our proposed definition of "publicly traded," although a few disagreed with the proposed definition’s approach to foreign traded securities. This commenter argued that the proposed rule should be modified to "cover securities that have been publicly offered to investors in a foreign jurisdiction and equity securities that are widely held and traded over-the-counter in a foreign jurisdiction."

Merkl Letter. We decline to adopt this approach because the definition would require us to define what constitutes a "public offering" notwithstanding the laws of foreign regulators and legislatures. See also Bertrand, supra note 160 (also suggested additional conditions); Merkl Letter. One commenter also suggested that the definition should not exclude investments in companies that may be deemed to be "controlled" by a public company (or its venture capital investment division).

See Comment Letter of Berkeley Center for Law, Business and the Economy (Feb. 1, 2011) ("CBLCE Letter") and General Letter (argued that restricting the application of the control element may be necessary because an advisor to a venture capital fund could be controlled itself by a majority itself be deemed to control a portfolio company as a result of its prior investments). Under our rule, a venture capital fund could invest in such companies under the non-qualifying basket.

The company becomes a reporting company, the fund continued to hold at least a majority of its original investment made when the company was a non-reporting company. Some of these commenters asserted that public offerings, which trigger reporting requirements under the Federal securities laws, were viewed as an additional financing round, with pre-existing venture investors expected to participate. Alternatively, several commenters recommended that a venture capital fund could limit its investment in reporting companies, such as 15 or 20 percent of the fund’s capital commitments.

We understand that venture capital funds seek flexibility to invest in promising portfolio companies, including companies deemed sufficiently profitable to become reporting companies or companies that may be owned directly or indirectly by a public company. Rather than modify the rule to impose additional criteria for investing in reporting companies, however, we have adopted a limit of 20 percent for non-qualifying investments, which may be used to hold securities of reporting companies. We believe that the 20 percent limit appropriately balances commenters’ expressed desire for greater flexibility to accommodate existing business practices while providing sufficient limits on the extent of investments that would implicate Congressional statements regarding the interconnectedness of venture capital funds with the public markets.
Under our rule, a qualifying portfolio company is defined to include a company that is not a reporting company (and does not have a control relationship with a reporting company) at the time of each fund investment. However, one commenter observed that an existing investment in a portfolio company that ultimately becomes a successful venture capital investment (such as when the company issues its securities in a public offering or becomes a reporting company) should not result in the investment becoming a non-qualifying investment. We agree. Under the rule, such an investment would not become a non-qualifying investment because the definition focuses on the time at which the venture capital fund acquires the particular equity interest issued by a portfolio company and does not limit the definition of qualifying portfolio company solely to companies that are and remain non-reporting companies. Under this approach, an adviser could continue to rely on the exemption even if the venture capital fund’s portfolio ultimately consisted entirely of securities that become securities of reporting companies. We believe that our 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—whether that occurs at a time when the company is or is not a reporting company. Moreover, under the Federal securities laws, a person, such as a venture capital fund, that is deemed to be an affiliate of a company may be limited in its ability to dispose of the company’s securities. Under the final rule, a qualifying fund would not be in the position of having to dispose of securities of a qualifying company, which generally imposes specific tests for net worth, net income or number of employees for each type of company, depending on its geographic location and industry classification. SeeProposing Release, supra note 26, at n.69 and accompanying and following text. We have considered the issues raised in the NASBIC/SBIA Letter and continue to believe that a qualifying portfolio company should not be defined by reference to whether a company is “small” for the reasons cited in the Proposing Release.


166 SeePTV Sciences Letter (stating that following a merger or public offering of a qualifying portfolio company’s securities, the shares held by the fund “are turned into profits to our investors”).

167 SeeProposing Release, supra note 26, at n.55 and following text.

168 See sections 2(a)(11) (defining “underwriter”) and 5 of the Securities Act. See also E.H. Hawkins, SEC Staff No-Action Letter (June 26, 1997) (staff explained how the term “underwriter” in the Securities Act restricts resales of securities by affiliates of issuing companies).


170 Leveraged buyout funds are private equity funds that will “borrow significant amounts from banks to finance their deals—increasing the debt-to-equity ratio of the acquiring entity,” id. at 16. Such funds are typically required to distribute to the fund the proceeds of a leveraged buyout of the company for purposes of the SEC’s leveraged buyout definition as one that does not borrow “in connection with” a leveraged buyout. We proposed to define a qualifying portfolio company as a company that does not participate in an indirect buyout involving a qualifying fund (as a corollary to our proposed limitation on venture capital fund acquisitions of portfolio company securities through secondary transactions, i.e., direct buyouts). We proposed these elements to distinguish 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 “buyout” of existing security holders or which finance such investments or buyouts with borrowed money. We proposed these elements 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, and the testimony before Congress that stressed the lack of leverage in venture capital investing.

171 Some commenters argued that defining a venture capital fund as a fund that does not participate in buyouts was too restrictive or too difficult to apply. Most of the commenters who addressed the issue opposed a definition that excluded any buyouts of portfolio company securities by venture capital funds. Some commenters argued that because a venture capital fund could, under the proposed rule, acquire up to 20 percent of portfolio company securities in secondary transactions, indirect buyouts achieved at the portfolio company level should not be precluded. Some commenters stated that buyouts are an important means of providing liquidity to portfolio company founders, employees, former employees and vendors/service providers, while others argued that venture-backed firms. Moreover, compared to 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.”).

172 See generallyProposing Release, supra note 26, at sections II.A.1.c. and d.

173 See S. Rep. No. 111–176, supra note 6, 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.").

174 id. at 75 (concluding that private equity funds that use limited or no leverage at the fund level engage in activities that do not pose risks to the wider markets through credit or counterparty relationships).

175 SeeProposing Release, supra note 26, at n.100.

176 See, e.g., McGuireWoods Letter; NVCA Letter; Pine Brook Letter.

177 One commenter sought interpretative guidance on which buyout transactions would be considered to be “in connection with” a venture capital fund investment. McGuireWoods Letter; NVCA Letter (discussing some interpretative issues with the “in connection with” language).

178 ATV Letter; NVCA Letter. See alsoABA Letter (also recommending that the buyout bucket be increased to 30%); Charles River Letter (supported a 20% buyout limit to accommodate the increasing industry use of buyouts); First Round Letter (supported 25% buyout limit for each deal and a 20% limit for all fund investments in order to facilitate liquidity to founders).

179 See, e.g., Davis Polk Letter; ESP Letter; SVB Letter.
buyouts occurring as a result of recapitalizations or conversions of permissible bridge loans should not preclude a fund from relying on the definition.

We have eliminated the proposed indirect buyout criterion in the final rule. Because the non-qualifying basket does not exclude secondary market transactions (or other buyouts of existing security holders), it would be inconsistent to define a venture capital fund as a fund that does not participate in a buyout.

We are retaining and clarifying, however, the leveraged buyout criterion as it relates to qualifying portfolio companies. We had proposed to define a qualifying portfolio company as a company that, among other things, does not borrow “in connection” with a venture capital fund investment. As noted above, we proposed this element to distinguish venture capital funds from leveraged buyout funds, and we continue to believe that this remains an important distinction. 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.

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, or otherwise purchasing securities from other shareholders, or leveraging the capital investment with debt financing. Testimony received by Congress and our research suggest that venture capital funds provide capital to many types of businesses at different stages of development, generally with the goal of financing the expansion of the company 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.

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, generally achieved through the buyout of existing shareholders or other security holders and financed with debt incurred by the portfolio company, and compared to venture capital funds, hold the investment for shorter periods of time. As a result of the use of the capital provided and the incidence of this debt, following the buyout fund investment, the operating company may carry debt several times its equity and may default significant levels of its cash flow and corporate earnings to repaying the debt financing, rather than investing in capital improvement or business operations.

Some commenters agreed that distinguishing between venture capital funds and leveraged buyout funds, in particular, is important. Many commenters, however, urged a more narrowly drawn restriction on a portfolio company’s ability to borrow (or issue debt) or to effect indirect buyouts. Some argued that the manner in which proceeds from indebtedness are used by a portfolio company (e.g., distributed by the company to the venture capital fund) better distinguishes venture capital funds from leveraged buyout private equity funds. Nevertheless, the majority of commenters who addressed this criterion supported a leverage criterion that would be more specific, or

182 See supra note 174 and accompanying text.
184 See, e.g., McGuire Testimony, supra note 151, at 1; NVCA Yearbook 2010, supra note 150; PricewaterhouseCoopers and Venture Capital Capital Association MoneyTree Report, Q4 2009/Full-year 2009 Report (providing data on venture capital investments in portfolio companies); James Schell, Private Equity Fund Structure and Operations (2010), at 8.1.03(1) (“Schell”), at § 1.03(1); Paul A. Gompers & Josh Lerner, The Venture Capital Cycle, at 459 (MFT Press 2004), at 178, 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).
185 See supra note 189, at 503; Loy Testimony, supra note 151, at 3 (“We 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.”).
186 See GAO Private Equity Report, supra note 170, 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.”).
187 See Annalisa Barrett et al., Prepared by the Corporate Leadership Council, BARR Institute, What is the Impact of Private Equity Buyout Fund Ownership on IPO Companies’ Corporate Governance?, at 7 (June 2006) (“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.”); leke van den Burg and Poul Nyrup Rasmussen, Hedge Funds and Private Equity: A Critical Analysis (2007), at 17 (“Van den Burg”); Sahliman, supra note 186, 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;
188 See, e.g., AIC-CLIO Letter; Sen. Levin Letter; Pine Brook Letter.
189 See, e.g., ATV Letter; Charles River Letter; NVCA Letter; Oak Investment Letter; Pine Brook Letter.
190 See, e.g., NVCA Letter; Pine Brook Letter; SV Life Sciences Letter; Vedanta Letter.
limited, in scope, focusing on the use of proceeds derived from portfolio company leverage. Commenters suggested that the rule define leverage as leverage incurred for the purpose of buying out shareholders at the demand of the venture capital fund or for returning capital to the fund, and not, for example, define leverage to include indebtedness incurred to pay for a qualifying portfolio company’s operating expenses.

Some commenters argued that the proposed “in connection with” element would be difficult to apply, arguing that the standard was too vague or raised too many interpretative issues. In response to our request for comment, many commenters sought confirmation that the limitation on portfolio company leverage would be triggered only in the instances of leverage provided to the portfolio company by the venture capital fund or if portfolio company borrowing were effected in satisfaction of a contractual obligation with the venture capital fund.

After careful consideration of the intended purpose of the leverage limitation of the proposed rule and the concerns raised by commenters, we are modifying the qualifying portfolio company leverage criterion to define a qualifying portfolio company as any company that does not both borrow (or issue debt) in connection with a venture capital fund investment and distribute the proceeds of such borrowing or issuance to the venture capital fund in exchange for the fund’s investment. In contrast to the proposed rule, the final rule more specifically delineates the types of leveraged transactions involving a qualifying fund (i.e., a company’s distribution of proceeds received in a debt offering to the qualifying fund) that would result in the company being excluded from the definition of a qualifying portfolio company. We believe that these modifications more closely achieve our goal of distinguishing advisers to venture capital funds from other types of private funds for which Congress did not provide an exemption because it looks to the substance, not just the form, of a transaction or series of transactions.

This definition of qualifying portfolio company would only exclude companies that borrow in connection with a venture capital fund’s investment and distribute such borrowing proceeds to the venture capital fund in exchange for the 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, meet payroll, etc.). Under the rule, a venture capital fund could provide financing or loans to a portfolio company, provided that the financing meets the definition of equity security or is made subject to the 20 percent limit for non-qualifying investments. Although we would generally view any financing 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 in the company as being a type of financing that is “in connection with” the fund’s investment, the definition’s limitation would only apply if the proceeds of such financing were distributed to the venture capital fund in exchange for its investment. Moreover, subsequent distributions to the venture capital fund solely because it is an existing investor would not be inconsistent with this criterion. We believe that this modification to the rule adequately distinguishes between portfolio capital funds and leveraged buyout funds and provides a simpler and clearer approach to determining whether or not a qualifying portfolio company satisfies the definition.

c. Operating Company

Rule 203(l)–1 defines the term qualifying portfolio company for the purposes of the exemption to exclude any private fund or other pooled investment vehicle. Under the rule, a qualifying portfolio company could not be another private fund, a commodity pool or other “investment companies.” We are adopting this criterion because Congress did not express an intent to include venture capital funds of funds within the definition.

In the Senate Report, Congress characterized venture capital as a subset of private equity “specializing in long-term equity investment in small or start-up businesses” and did not refer to funds investing in other funds. Moreover, testimony to Congress described venture capital investments in operating companies rather than other private funds.

Moreover, without this definitional criterion, a qualifying fund could circumvent the intended scope of the rule by investing in other pooled investment vehicles that are not themselves subject to the definitional criteria under our rule. For example, without this criterion, a venture capital fund could circumvent the intent of the rule by incurring off-balance sheet leverage or indirectly investing in reporting companies in excess of the 20 percent limit for non-qualifying...
investments. Our exclusion is similar to the approach of other definitions of “venture capital” discussed in the Proposing Release, which limit investments to operating companies and thus would exclude investments in other private funds or securitized asset vehicles.

Many commenters opposed the operating company criterion and recommended that the rule include fund of venture capital fund structures. Some commenters supported no limits on investments in other pooled investment vehicles, while others supported broadening the definition to include funds that invest in other funds if either (i) the underlying funds qualify as venture capital funds (i.e., comply with rule 203(l)–1) or (ii) investment in underlying funds does not exceed a specified threshold (such as a percentage of fund capital). Commenters argued that broadening the definition of qualifying portfolio company was necessary in order to accommodate current business practices, or was appropriate because funds of funds (including secondary funds) provide investors with liquidity or do not pose systemic risk. Other commenters advocated a definition that would permit investments in qualifying portfolio companies held through an intermediate holding company structure formed solely for tax, legal or regulatory reasons.

For purposes of the definition of a qualifying portfolio company, we agree that a fund may disregard a wholly owned intermediate holding company formed solely for tax, legal or regulatory reasons to hold the fund’s investment in a qualifying portfolio company. Such structures are used to address the particular needs of venture capital funds or their investors and are not intended to circumvent the rule’s general limitation on investing in other investment vehicles.

We do not agree, however, that Congress viewed funds of venture capital funds as being consistent with the exemption, and continue to believe that this criterion remains an important tool to prevent circumvention of the intended scope of the venture capital exemption. A fund strategy of selecting a venture capital or other private fund in which to invest is different from a strategy of selecting qualifying portfolio companies. Nevertheless, we are persuaded that a venture capital fund’s limited ability to invest a limited portion of its assets in other pooled investment vehicles would not be inconsistent with the intent of the rule if the fund primarily invests directly in qualifying portfolio companies. As a result, for purposes of the exemption, investments in other private funds or venture capital funds could be made using the non-qualifying basket.

4. Management Involvement

We are not adopting a managerial assistance element of the rule, as originally proposed. We proposed that advisers seeking to rely on the rule have a significant level of involvement in developing a fund’s portfolio companies. We modeled our proposed approach to managerial assistance in part on existing provisions under the Advisers Act and the Investment Company Act dealing with BDCs. These provisions were added over the years to ease the regulatory burden on venture capital and other private equity investments. Congress did not use the existing BDC definitions when determining the scope of the venture capital exemption, and the primary policy considerations that led to the adoption of the BDC exemptions differed from those under the Dodd-Frank Act.

Commentators presented several problems with the application of the managerial assistance criterion and its intended scope under the proposed rule. Some objected to the managerial assistance criterion as proposed, arguing that such assistance to (or control of) a portfolio company is not a key or distinguishing characteristic of venture capital investing; that relationships between qualifying funds and qualifying portfolio companies may be less formal and may not constitute management or control of a portfolio company under the proposed rule; or that the discretion to determine the extent of involvement with a portfolio company should not affect a qualifying fund’s ability to satisfy the definitional criterion.

Most commenters sought guidance on determining what activities would constitute managerial assistance or “control.” Other commenters specifically requested confirmation that a management rights letter for purposes of “venture capital operating company” status under ERISA would be sufficient. Finally, some commenters recommended that the rule address syndicated transactions, and provide that the managerial assistance criterion would be satisfied if one fund within the syndicate provided the requisite assistance or control.

208 Similarly, a qualifying fund could not, for example, invest in an investment management entity (e.g., a general partner entity) that in turn invests in another pooled vehicle, except as an investment under the non-qualifying basket.

210 See Proposing Release, supra note 26, at nn.70–72 (discussing the California venture capital exemption and the VCOC definition under ERISA).

212 Merkl Letter; SVB Letter (managerial assistance criterion is unnecessary because it does not distinguish venture capital funds from other types of funds providing managerial assistance).

224 BCLBE Letter; Gunderson Dettmer Letter; McGuireWoods Letter; Sheeraman Letter. Sheeraman sought confirmation on whether control included both direct and indirect control, and BCLBE sought confirmation that board representation would be sufficient for control purposes. Other commenters, however, acknowledged that “Cook only” element of the proposed rule would provide sufficient flexibility for a venture capital fund to alter its relationship with a portfolio company over time. See, e.g., First Round Letter; NVCA Letter. The NVCA and one other commenter did not support imposing specific requirements as to what constituted managerial assistance. See NVCA Letter (definitive requirements are not appropriate); Sevin Rosen Letter (opposed requiring board seat or observer rights).

226 ATV Letter; Charles River Letter; NVCA Letter; Oak Investment Letter; Sevin Ventures Letter; Sevin Rosen Letter; Village Ventures Letter.

228 ATV Letter; ESQ Letter; McGuireWoods Letter.
We appreciate the difficulties of applying the managerial assistance criterion under the proposed definition and in particular the issues associated with a qualifying fund proving compliance when it participates in a syndicated transaction involving multiple funds. We are persuaded that to modify the rule to specify which activities constitute “managerial assistance” would introduce additional complexity and require us to insert our judgment for that of a venture capital fund’s adviser regarding the minimum level of portfolio company involvement that would be appropriate for the fund, rather than enabling investors to select venture capital funds based in part on their level of involvement.228 We also appreciate that the offer of managerial assistance may not distinguish venture capital funds from other types of funds.

While many venture capital fund advisers do provide managerial assistance, we believe that the managerial assistance criterion, as proposed, does not distinguish these advisers from other advisers, would be difficult to apply and could be unnecessarily prescriptive without creating benefits for investors. As a consequence of our modification to the proposed rule, a qualifying fund is not required to offer (or provide) managerial assistance to, or control any, qualifying portfolio company in order to satisfy the definition.

5. Limitation on Leverage

Under rule 203(l)–1, a venture capital fund is 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.229 For purposes of this leverage criterion, any guarantee by the private fund of a qualifying portfolio company’s obligations up to the value of the private fund’s investment in the qualifying portfolio company is not subject to the 120 calendar day limit.230 The 15 percent threshold is determined based on the venture capital fund’s aggregate capital commitments. In practice, this means that a qualifying fund could leverage an investment transaction up to 100 percent when acquiring equity securities of a particular portfolio company as long as the leverage amount does not exceed 15 percent of the fund’s total capital commitments.

Although a minority of commentators generally supported the leverage criterion as proposed,231 many commentators sought to broaden it in several ways. Two commentators that generally supported the leveraged acquisition criterion also recommended that the criterion exclude uncalled capital commitments so that a qualifying fund could not incur excessive leverage.232 Although determining the leverage criterion as a percentage of total fund capital commitments may enable a qualifying fund to incur a degree of leverage that represents a disproportionate percentage of the fund’s assets early in the life of the fund, the leverage criterion is also constrained by the 120 calendar day limit. Therefore, we do not believe it is necessary to exclude uncalled capital commitments from the leverage criterion.

Other commentators proposed to exclude from the 15 percent leverage limitation capital call lines of credit (i.e., venture capital fund borrowings repaid with proceeds of capital calls from fund investors),233 or borrowings by a venture capital fund in order to meet fee and expense obligations.234 One commentator sought to increase the leverage threshold from 15 percent to 20 percent.235 One commentator, on behalf of many venture capital advisers, however, agreed with the proposed leverage

230 Id.

228 For example, one commentator indicated that although it may seek to offer assistance to portfolio companies, not all of the companies have accepted. Charles River Letter. Similarly, a number of venture capital advisers stated that their funds may invest in a significant but non-controlling stake in underlying portfolio companies. See, e.g., ATV Letter; First Round Letter.

229 Rule 203(l)–1(a)(3).

231 See Sen. Levin Letter; NVCA Letter. See also AFL–CIO Letter; AFR Letter (generally supported the leverage limit but also supported excluding uncalled capital commitments); Oak Investment Letter (generally supported the support the leverage limit, but did not agree that the 120-day limit should apply to guarantees of portfolio company obligations by venture capital funds).

232 AFR Letter; AFL–CIO Letter.

233 Cook Children’s Letter; Leland Fikes Letter; SVB Letter. We would view a line of credit used to advance anticipated committed capital that remains available for longer than 120 days to be consistent with the criterion, if each drawdown is repaid within 120 days and subsequent drawdowns relate to subsequent capital calls.

234 Dechert General Letter.

235 Charles River Letter (argued that a qualifying fund should be able to borrow, without limit on duration, up to 20% of capital commitments with the consent of its investors).
capital funds are subject to investment restrictions, and, during the initial years of a fund, 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 fully funded by an investor. 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. 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, venture capital fund advisers 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.

Thus, we are retaining the 15 percent leverage threshold, as proposed, so that a qualifying fund could only incur debt (or provide guarantees of portfolio company obligations) subject to this threshold. However, we are modifying the leverage criterion to exclude from the 120-calendar day limit any guarantee of qualifying portfolio company obligations by the qualifying fund, up to the value of the fund’s investment in the qualifying portfolio company. Commenters generally argued in favor of extending the period during which a qualifying fund’s leverage could remain outstanding. Some recommended extending the 120-day limit with respect to leverage to 180 days with one 180-day renewal in the case of non-convertible bridge loans extended by the venture capital fund to a portfolio company. Others seeking to accommodate business practices and provide maximum flexibility for venture capital fund debt investments in portfolio companies recommended extending guarantees of portfolio company debt by a venture capital fund from the 120-day limit to receive pro rata distributions. Unlike hedge funds, a venture capital fund does not typically permit investors to redeem their interests during the life of the fund, but rather distributes assets generally as investments mature.

6. No Redemption Rights

We are adopting as proposed the definitional element under which a venture capital fund is a private fund that issues securities that do not provide investors redemption rights except in "extraordinary circumstances" but that entitle investors generally to receive pro rata distributions. Unlike hedge funds, a venture capital fund does not permit investors to redeem their interests during the life of the fund, but instead distributes assets generally as investments mature.

Operation 2010 (“Breslow & Schwartz”), at § 2.56 (discussing the 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 to take any other action permitted at law or in equity”).

242 See, e.g., Breslow & Schwartz, supra note 241, at § 2.57 (noting that a cap of 10% to 25% of remaining capital commitments is a common limitation for investments). See also Schell, supra note 185, 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.


244 Rule 203(l)–1(4)(ii).
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 to be excluded from particular investments due to regulatory or other legal requirements. These events may be "foreseeable" because they are circumstances that are known to occur (e.g., changes in law, corporate events such as mergers, etc.) but are unexpected in their timing or scope. Thus, withdrawal, exclusion or similar "opt-out" rights would be deemed "extraordinary circumstances" if they are triggered by a material 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. The trigger events for these rights are typically beyond the control of the adviser and fund investor (e.g., tax and regulatory changes).

Most commenters addressing the redeemability criterion did not oppose it, but rather sought clarification or guidance on the scope of its application. For example, commenters specifically requested confirmation that the lack of redeemability criterion would not preclude a qualifying fund from (i) making distributions of carried interest to a general partner, (ii) specifying redemption rights for certain categories of investors under certain circumstances or (iii) specifying opt-out rights for investors. Several commenters, however, indicated that the term "extraordinary circumstances" is sufficiently clear, suggesting that the proposal did not require further clarification.

We believe that the term "extraordinary circumstances" is sufficiently clear. Whether or not specific redemption or "opt-out" rights for certain categories of investors under certain circumstances should be treated as "extraordinary" will depend on the particular facts and circumstances.

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. We believe, and several commenters confirmed, that the phrase "extraordinary circumstances" is sufficiently clear to distinguish the terms for investor liquidity of venture capital funds, as they operate today, from hedge funds. Congressional 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. Although a fund prohibiting redemptions would satisfy the redeemability criterion of the venture capital fund definition, the rule does not specify a minimum period of time for an investor to remain in the fund.

In the Proposing Release, we expressed the general concern that a venture capital fund might seek to circumvent the intended scope of this criterion by providing investors with nominally "extraordinary" rights to redeem that effectively result in de facto redemption rights in the ordinary course. One commenter expressly disagreed with this view, asserting that in the case of transfers effected with the consent of a general partner, such transactions are intended to accommodate an investor's internal corporate restructurings, bankruptcies or portfolio allocations rather than to provide investors with liquidity from the fund. While consents to transfer do not raise the same level of concern as de facto redemption rights, we do not believe that an adviser or its related persons could, while relying on the venture capital exemption, create de facto periodic redemption or transfer rights by, for example, regularly identifying potential investors on behalf of fund investors seeking to transfer or redeem fund interests.

We are not modifying the rule to include additional conditions for fund redemptions, such as specifying a minimum holding or investment period by investors or a maximum amount that may be redeemed at any time. Commenters generally did not support...
the imposition of such conditions, and we agree that imposing such conditions would not appear to be necessary to achieve the purposes of the rule.

7. Represents Itself as Pursuing a Venture Capital Strategy

Under the rule, a qualifying fund must represent itself as pursuing a venture capital strategy to its investors and potential investors. 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 rule (because for example it only invests in short-term holdings, does not borrow, does not offer investors redemption rights, and is not a registered investment company). We believe that only funds that do not significantly differ from the common understanding of what a venture capital fund is, and that are actually offered to investors as funds that pursue a venture capital strategy, should qualify for the exemption. Thus, for example, an adviser to a venture capital fund that is otherwise relying on the exemption could not (i) 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 (ii) include the fund in a hedge fund database or hedge fund index.

As proposed, rule 204(1)—1 defined a venture capital fund as a private fund that “represents itself as being a venture capital fund to its investors and potential investors.” Although several commenters generally supported the “holding out” criterion as proposed, many sought confirmation that the use of specific self-identifying terminology by a fund in its name (e.g., “private equity” fund, “multi-strategy” fund or “growth capital” fund) would not automatically disqualify the fund under the definition.

Several commenters argued that historically, some funds have avoided referring to themselves as “venture capital funds.” One commenter argued that the proposed condition was too restrictive because it focuses on the fund’s name rather than its investment strategy and suggested that the definition instead exclude any fund that markets itself as a hedge fund, multi-strategy fund, buyout fund or fund of funds.

We believe that the “holding out” criterion remains an important distinction between funds that are eligible to rely on the definition and funds that are not; because an investor’s understanding of the fund and its investment strategy must be consistent with an adviser’s reliance on the exemption. However, we also recognize that it is not necessary (nor indeed sufficient) for a qualifying fund to name itself as a “venture capital fund” in order for its adviser to rely on the venture capital exemption. Hence, we are modifying the proposed definition to refer to the way a qualifying fund describes its investment strategy to investors and prospective investors. A qualifying fund name that does not use the words “venture capital” and is not inconsistent with pursuing a venture capital strategy would not preclude a qualifying fund from satisfying the definition. Whether or not a fund represents itself as pursuing a venture capital strategy, however, will depend on the particular facts and circumstances. Statements made by a fund to its investors and prospective investors, not just what the fund calls itself, are important to an investor’s understanding of the fund and its investment strategy. The appropriate framework for analyzing whether a qualitative fund has satisfied the holding out criterion depends on all of the statements (and omissions) made by the fund to its investors and prospective investors. While this includes the fund name, it is only part of the analysis.

This approach is similar to our general approach to antifraud provisions under the Federal securities laws, including Advisers Act rule 206(4)—8 regarding pooled investment vehicles. The general antifraud rule under rule 206(4)—8 looks to the private fund’s statements and omissions in light of the circumstances under which such statements or omissions are made.

Similarly, the holding out criterion under our venture capital fund definition looks to all of the relevant statements made by the qualifying fund regarding its investment strategy.

8. Is a Private Fund

We define a venture capital fund for purposes of the exemption as a private fund, which is defined in the Advisers Act, and exclude from the definition funds that are registered investment companies (e.g., mutual funds) or have elected to be regulated as BDCs. We are adopting this provision as proposed.

There is no indication that Congress intended the venture capital exemption to apply to advisers to these publicly available funds, referring to venture capital funds as a “subset of private investment funds.” The comment letters that addressed this proposed criterion generally supported it.

9. Application to Non-U.S. Advisers

The final rule does not define a venture capital fund as a fund advised by a U.S. adviser (i.e., an adviser with a principal office and place of business in the United States).
the United States). Thus, a non-U.S. adviser, as well as a U.S. adviser, may rely on the venture capital exemption provided that such adviser solely advises venture capital funds that satisfy all of the elements of the rule or satisfy the grandfathering provision (discussed in greater detail below). 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.

Neither the statutory text of section 203(l) nor the legislative reports provide 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. 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. 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.

Commenters generally did not support defining venture capital fund or qualifying portfolio company by reference to the jurisdiction of formation of the fund or portfolio company. Several commenters, however, supported modifying the rule to apply the venture capital exemption in the same manner as the proposed private fund adviser exemption, with the result that a non-U.S. adviser could disregard its non-U.S. activities when assessing eligibility for the venture capital exemption. Under this approach, only U.S.-domiciled private funds would be required to satisfy our definition of a venture capital fund in order for the adviser to rely on the venture capital exemption. One commenter suggested that the same policy rationale underlying the private fund adviser exemption justified this approach to the venture capital exemption. Two other commenters supported this approach arguing that non-U.S. funds may operate in a manner that does not resemble venture capital fund investing in the United States or by U.S. venture capital fund advisers.

We do not agree that the private fund adviser exemption is the appropriate framework for the venture capital exemption in the case of non-U.S. advisers. Section 203(l) provides an exemption for an investment adviser based on the strategy of the funds that the adviser manages (i.e., venture capital funds). This exemption thus specifies the activities in which an adviser’s clients may engage, and does not refer to activities in the United States. By contrast, section 203(m) is based upon the location where the advisory activity is conducted. Accordingly, we do not believe it would be appropriate for an adviser relying on section 203(l) to disregard its non-U.S. activities. Moreover, a non-U.S. adviser could circumvent the intended scope of the exemption by merely sponsoring and advising solely non-U.S. domiciled funds that are not venture capital funds. Under our rule, only a private fund may qualify as a venture capital fund. As we noted in the Proposing Release, a non-U.S. fund that uses U.S. jurisdictional means in the offering of the securities it issues and that relies on section 3(c)(1) or 3(c)(7) of the Investment Company Act would be a venture capital fund under the proposed rule if the non-U.S. fund that is treated as a private fund under the proposed rule if the non-U.S. fund that is treated as a private fund upon these circumstances by an adviser relying on the venture capital 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 14, at n.226; Offer and Sale of Securities to Canadian Tax-Deferred Retirement Savings Accounts, supra note 705, 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, supra note 319, at n.41. See also Dechert LLP, SEC Staff No-Action Letter (Aug. 24, 2009) at n.8; Goodwin, Procter & Harlow LLP, SEC Staff No-Action Letter (Feb. 28, 1997) (“Goodwin Procter No-Action Letter”); Touche Remnant & Co., SEC Staff No-Action Letter (Aug. 27, 1984) (“Touche Remnant No-Action Letter”); Proposing Release, supra note 26, at n.175 and accompanying text.

Under the Advisers Act, an adviser relying on the venture capital exemption must “solely” advise venture capital funds and under our rule all of the funds advised by the adviser must be private funds. See Proposing Release, supra note 26, at section II.A.8 (“[A] non-U.S. fund that is a private fund under the private fund exemption in the United States 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)”).

As discussed below, this issue also is relevant to the exemption provided by rule 203(m)–1. See also infra note 319.

287 See Loy Testimony, supra note 151, at 4–5; McGuire Testimony, supra note 151, at 5–6.
288 See, e.g., Bessemmer Letter; EVCA Letter; McDonald Letter; Merki Letter; NVCA Letter; SV Life Sciences Letter.
289 See McGuireWoods Letter; Shearman Letter.
290 See also EFAMA Letter (certain conditions of the proposed rule, such as the limitation on cash investments to U.S. Treasuries, are inconsistent with practices outside the United States). We believe that these concerns are adequately addressed by the non-qualifying basket.
291 See Shearman Letter.
292 See EFAMA Letter; McGuireWoods Letter.
293 See also infra note 322 and accompanying and following text.
294 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 section 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 in the United States 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 conduct an offering would not be a private fund and therefore could not qualify as a venture capital fund, even if it operated as a venture capital fund in a manner that would otherwise meet the criteria under our definition. As a result, under the proposed rule, if a non-U.S. fund did not qualify as a venture capital fund, then the fund’s adviser would not be able to rely on the exemption.
295 In light of this result, we asked in the Proposing Release whether we should adopt a broader interpretation of the term “private fund.” In response, commenters supported making the venture capital exemption available to non-U.S. advisers even if they advise venture capital funds that are not offered through the use of U.S. jurisdictional means. We agree. Accordingly, as adopted, rule 203(l)–1 contains a note indicating that an adviser may treat as a “private fund”—and thus a venture capital fund, if it meets the rule’s other criteria—any non-U.S. fund that is not offered through the use of U.S. jurisdictional means but that would be a private fund if the issuer were to conduct a private offering in the United States. Moreover, a non-U.S. fund that is treated as a private fund under these circumstances by an adviser relying on the venture capital
exemption would also be treated as a private fund under the Advisers Act for all purposes. This element is designed to ensure that an adviser relying on the venture capital exemption by operation of the note is subject to the same Advisers Act requirements as other advisers relying on the venture capital exemption without use of the note.

10. Grandfathering Provision

Under the rule, the definition of “venture capital fund” includes any private fund that: (i) Represented to investors and potential investors at the time the fund offered its securities that it pursues a venture capital strategy; (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 capital commitments from, any person after July 21, 2011 (the "grandfathering provision"). A grandfathered fund would thus include any fund that has accepted all capital commitments by July 21, 2011 (including capital commitments from existing and new investors) even if none of the capital commitments has been called by such date. The calling of capital after July 21, 2011 would be consistent with the grandfathering provision, as long as the investor became obligated by July 21, 2011 to make a future capital contribution. As a result, any investment adviser that solely advises private funds that meet the definition in either rule 203(l)–1(a) or (b) would be exempt from registration.

Although several commenters expressed support for the proposed rule, two commenters indicated that the proposed grandfathering provision was too restrictive because of the holding out criterion. In contrast, the North American Securities Administrators Association, Inc. expressed its view that the proposed grandfathering provision was too expansive and urged that the rule impose additional substantive requirements similar to those included

among the definitional elements in rule 203(l)–1(a). As in the case of the holding out criterion discussed above, this element of the grandfathering provision elicited the most comments. Generally, commenters either (i) did not support a grandfathering provision that defined a venture capital fund as a fund that identified itself (or called itself) “venture capital,” or (ii) sought clarification or an expansive interpretation of the holding out element so that existing funds would not be excluded from the definition merely because they have identified themselves as “growth capital,” “multi-strategy” or “private equity,” which commenters asserted is typical of some older funds. No commenter addressed the dates proposed in the grandfathering provision.

As discussed above, we believe that the “holding out” requirement is an important prophylactic tool to prevent circumvention of the intended scope of the venture capital exemption. Thus, we are adopting the grandfathering provision as proposed, with the modifications to the holding out criterion discussed above. As noted above in the definition of a venture capital fund generally, the holding out criterion in the grandfathering provision has also been changed to refer to the strategy pursued by the private fund. A fund that seeks to qualify under our rule should examine all of the statements and representations made to investors and prospective investors to determine whether the fund has satisfied the “holding out” criterion as it is incorporated into the grandfathering provision.

Thus, under the rule, 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 fund). Accordingly, we believe that advisers have not had an incentive to mis-characterize the investment strategies pursued by existing venture capital funds that have already been marketed to investors. As we note above, a fund that “represents” itself to investors as pursuing a venture capital strategy is typically one that discloses it pursues a venture capital strategy and identifies itself as such. We do not expect existing funds identifying themselves as pursuing a “private equity” or “hedge” fund strategy would be able to rely on this element of the grandfathering provision.

We believe that most funds previously sold as venture capital funds likely would satisfy all or most of the conditions in the grandfathering provision. Nevertheless, we recognize that investment advisers that sponsored new funds before the adoption of rule 203(l)–1 faced uncertainty regarding the precise terms of the definition and hence uncertainty regarding their eligibility for the new exemption. Thus, as proposed, the grandfathering provision specifies that a qualifying fund must have commenced its offering (i.e., initially sold securities) by December 2010 and must have concluded its offering by the effective date of Title IV (i.e., July 21, 2011). This provision is designed to prevent circumvention of 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 definition of a venture capital fund would likely be impossible in many cases and yield unintended consequences for the funds and their investors.

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 under the Advisers Act any investment adviser solely to private funds that have less than $150 million in assets under management in the United States. We believe that most funds previously sold as venture capital funds likely would satisfy all or most of the conditions in the grandfathering provision.
adapting today, provides the exemption and, in addition, addresses several interpretive questions raised by section 203(m). As noted above, we refer to this exemption as the “private fund adviser exemption.”

1. Advises Solely Private Funds

Rule 203(m)—1, like section 203(m), limits an adviser relying on the exemption to those advising “private funds” as that term is defined in the Advisers Act.319 An adviser that has one or more clients that are not private funds is not eligible for the exemption and must register under the Advisers Act unless another exemption is available. An adviser may advise an unlimited number of private funds, provided the aggregate value of the assets of the private funds is less than $150 million.314

In the case of an adviser with a principal office and place of business outside of the United States (a “non-U.S. adviser”), the exemption is available as long as all of the adviser’s clients that are United States persons are qualifying private funds.315 As a consequence, a non-U.S. adviser may enter the U.S. market and take advantage of the exemption without regard to the type or number of its non-U.S. clients or the amount of assets it manages outside of the United States. Under the rule, a non-U.S. adviser would not lose the private fund adviser exemption as a result of the size or nature of its advisory or other business activities outside of the United States. The rule reflects our long-held view that non-U.S. activities of non-U.S. advisers are less likely to implicate U.S. regulatory interests and that this territorial approach is in keeping with general principles of international comity.316

Commenters supported the proposed rule’s treatment of non-U.S. advisers.317 Some commenters urged that the rule should also permit U.S. advisers relying on the exemption to advise other types of clients.318 Section 203(m) directs us to provide an exemption to advisers that act solely as advisers to private funds.319 Our treatment of non-U.S. advisers with respect to their non-U.S. clients, as we note above, establishes certain appropriate limits on the extraterritorial application of the Advisers Act.320 In contrast, permitting U.S. advisers with additional types of clients to rely on the exemption would appear to directly conflict with section 203(m), and we therefore are not revising the rule as the commenters proposed. Some commenters suggested that the rule permit advisers to combine other exemptions with rule 203(m)—1 so that, for example, an adviser could advise venture capital funds with assets under management in excess of $150 million in addition to other types of private funds with less than $150 million in assets under management.321 We believe that the commenters’ proposed interpretation runs contrary to the language of section 203(m), which limits advisers relying on the exemption to advising solely private funds with assets under management in the United States of less than $150 million or solely venture capital funds in the case of section 203(l).322

A few commenters also asked us to address whether a fund with a single investor could be a “private fund” for purposes of the exemption.323 Whether a single-investor fund could be a private fund for purposes of the exemption depends on the facts and circumstances. We are concerned that an adviser simply could convert client accounts to single-investor funds in order to avoid registering under the Advisers Act.

Some “funds” would be tantamount to separately managed accounts. Section 208(d) of the Advisers Act anticipates these and other artifices and thus prohibits a person from doing, indirectly or through or by another person, any act or thing which it would be unlawful for such person to do directly.324 We recognize, however, that

315 See rule 203(m)—1(a) and (b). Section 202(a)(20) 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.” A “private fund” includes a private fund that invests in other private funds. See also supra note 294; Proposing Release, supra note 26, at n.75 and accompanying text.

314 We note, however, that depending on the facts and circumstances, we may view two or more separately formed advisory entities that each has less than $150 million in private fund assets under management as a single adviser for purposes of assessing the availability of exemptions from registration. See infra note 506. See also section 208(d), which prohibits a person from doing, indirectly or through or by another person, any act or thing which it would be unlawful for such person to do directly.

316 These considerations have, for example, been incorporated in permitting a non-U.S. adviser relying on the private adviser exemption to count only clients that are U.S. persons when determining whether it has 14 or fewer clients. Rule 203(b)(3)—1(e)(1) (“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 392. The Dodd—Frank Act repeals the private adviser exemption as of July 21, 2011, for non-U.S. advisers relying on rule 203(b)(3)—1 in the Implementing Adapting Release. See Implementing Adapting Release, supra note 32, at section II.D.2.a.


318 See, e.g., Letter of Sadis & Goldberg (Jan. 11, 2011) (submitted in connection with the Implementing Proposing Release, avail. at http://www.sec.gov/comments/s7-36-10/s73610.shtml) (“Sadis & Goldberg Implementing Release Letter”) (exemption should be available to advisers who, in addition to advising private funds, also have five or fewer clients that are separately managed accounts); Comment Letter of Seward & Kissel LLP (Jan. 31, 2011) (“Seward Letter”) (advisers should be permitted to rely on multiple exemptions and advisers relying on the private fund adviser exemption should not be precluded from engaging in “some activities that do not involve advising clients and have no effect on assets under management,” such as providing research to institutional investors). One commenter argued that a U.S. adviser should be permitted to treat as a private fund for purposes of rule 203(m)—1 a non-U.S. fund that has not made an offering to U.S. persons. See Comment Letter of Fox Hollo & Mora, LLP (Dec. 22, 2010). See also supra notes 294 and 313.

319 In contrast to the foreign private adviser exemption discussed in Section II.C, a non-U.S. adviser relying on the foreign private adviser exemption may have a U.S. place of business, but a non-U.S. adviser need not have a U.S. place of business to rely on the private fund adviser exemption.

320 We would view a structure with no purpose other than circumvention of the Advisers Act as inconsistent with section 208(d). See, e.g., Custody Conti

321 NASIB/SIBA Letter, Seward Letter.

322 The same analysis also would apply to non-U.S. advisers, which may not for example combine the private fund adviser exemption and the foreign private adviser exemption (e.g., a non-U.S. adviser could not advise private funds that are United States persons with assets in excess of $25 million in reliance on the private fund adviser exemption and also advise other clients in the United States that are not private funds under the foreign private adviser exemption). We also note that depending on the facts and circumstances, we may view two or more separately formed advisory entities, each of which purports to rely on a separate exemption from registration, as a single adviser for purposes of assessing the availability of exemptions from registration. See infra note 506. See also section 208(d), which prohibits a person from doing, indirectly or through or by another person, any act or thing which it would be unlawful for such person to do directly.

323 See ABA Letter (single-investor funds formed at the request of institutional investors should be considered private funds if they are managed in a manner similar to the adviser’s related multi-investor private funds, have audited financial statements, and are treated as private funds for purposes of the custody rule); Comment Letter of Alternative Investment Management Association (Jan. 24, 2011) (“AIMA Letter”); Comment Letter of Dechert LLP (Dec. 20, 2010).
there are circumstances in which it may be appropriate for an adviser to treat a single-investor fund as a private fund for purposes of rule 203(m)–1.325

One commenter argued that advisers should be permitted to treat as a private fund for purposes of rule 203(m)–1 a fund that also qualifies for another exclusion from the definition of “investment company” in the Investment Company Act in addition to section 3(c)(1) or 3(c)(7), as section 3(c)(5)(C), which excludes certain real estate funds.326 These funds would not be private funds, because a “private fund” is a fund that would be an investment company as defined in section 3 of the Investment Company Act but for section 3(c)(1) or 3(c)(7) of that Act.327

The commenter argued, and we agree, that an adviser should nonetheless be permitted to advise such a fund and still rely on the exemption. Otherwise, for example, an adviser to a section 3(c)(1) or 3(c)(7) fund would lose the exemption if it also qualified for another exclusion, even though the adviser may be unaware of the fund so qualifying and the fund does not purport to rely on the other exclusion. We do not believe that Congress intended that an adviser would lose the exemption in these circumstances. Accordingly, the definition of a “qualifying private fund” in rule 203(m)–1 permits an adviser to treat as a private fund for purposes of the exemption a fund that qualifies for an exclusion from the definition of investment company as defined in section 3 of the Investment Company Act in addition to the exclusions provided by section 3(c)(1) or 3(c)(7).328

An adviser relying on this provision must treat the fund as a private fund under the Advisers Act and the rules thereunder for all purposes. This is to ensure that an adviser relying on the exemption as a result of our modification of the definition of a “qualifying private fund” is subject to the same Advisers Act requirements as other advisers relying on the exemption. Therefore, an adviser to a fund that also qualifies for another exclusion in addition to section 3(c)(1) or 3(c)(7) may treat the fund as a private fund and rely on rule 203(m)–1 if the adviser meets the rule’s other conditions, provided that the adviser treats the fund as a private fund under the Advisers Act and the rules thereunder for all purposes including, for example, reporting on Form ADV, which requires advisers to report certain information about the private funds they manage.330

2. Private Fund Assets
a. Method of Calculation
Under rule 203(m)–1, an adviser must aggregate the value of all assets of private funds it manages to determine if the adviser is below the $150 million threshold. Rule 203(m)–1 requires advisers to calculate the value of private fund assets pursuant to instructions in Form ADV, which provide a uniform method of calculating assets under management for regulatory purposes under the Advisers Act.332

In the Implementing Adopting Release, we are revising the instructions to Form ADV to provide a uniform method to calculate assets under management for regulatory purposes, including determining eligibility for Commission, rather than state, registration; reporting assets under management for regulatory purposes on Form ADV; and determining eligibility for two of the new exemptions from registration under the Advisers Act discussed in this Release.333 Under the revised Form ADV instructions, as relevant here, advisers must include in their calculations proprietary assets and assets managed without compensation as well as uncalled capital commitments.334 In addition, an adviser must determine the amount of its private fund assets based on the market value of those assets, or the fair value of those assets where market value is unavailable,335 and must calculate the assets on a gross basis, i.e., without deducing liabilities, such as accrued fees and expenses or the amount of any borrowing.336

Use of this uniform method will, we believe, 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 assessment of risk.337 In addition, the uniform method of calculation is designed to ensure that, to the extent possible, advisers with similar amounts of assets under management will be treated similarly for regulatory purposes, including their ability to rely

325 See Implementing Adopting Release, supra note 32, discussion at section II.A.3 (discussing the rationale underlying the new instructions for calculating assets under management for regulatory purposes).
326 See Form ADV: Instructions for Part 1A, instr. 5.b.(1), (4). Advisers also must include in their “regulatory assets under management” assets of non-U.S. clients. See Implementing Adopting Release, supra note 32, at n.76 (explaining that a domestic adviser dealing exclusively with non-U.S. clients must register with the Commission if it uses any U.S. jurisdictional means in connection with its advisory business unless the adviser qualifies for an exemption from registration or is prohibited from registering with the Commission). See also infra note 415.
327 This valuation requirement is described in terms similar to the definition of “value” in the Investment Company Act, which looks to market value when quotations are readily available and, if not, to fair value. See Investment Company Act section 2(a)(41). See also Implementing Adopting Release, supra note 32, at n.91 and accompanying text. Other standards also may be expressed as requiring that a determination of fair value be based on market quotations where they are readily available. Id.
328 Rule 203(m)–1(d)(5). This provision may also apply to non-U.S. funds that seek to comply with section 7(d) of the Investment Company Act and exclusions in addition to those provided by section 3(c)(1) or 3(c)(7) of that Act.
329 Rule 203(m)–1(d)(5).
330 See Item 7.B of Form ADV, Part 1A.
331 Rule 203(m)–1(d)(4).
332 See rules 203(m)–1(a)(2); 203(m)–1(b)(2); 203(m)–1(d)(1) defining “private fund assets” to mean the “assets under management” attributable to a “qualifying private fund.” In the case of a subadviser, an adviser must count only that portion of the private fund assets for which it has responsibility. See Form ADV: Instructions for Part 1A, instr. 5.b.(2) (explaining that, if an adviser provides continuous and regular supervisory or management services for only a portion of a security portfolio, it should include only that portion of the securities portfolio for which it provides such services, and that an adviser should exclude, for example, the portion of an account under management by another person).
on the private fund adviser exemption and the foreign private adviser exemption, both of which refer to an adviser’s assets under management.338

Many commenters expressed general support for a uniform method of calculating assets under management in order to maintain consistency for registration and risk assessment purposes.339 The proposals to use fair value of private fund assets and to include uncalled capital commitments in private fund assets also received support.340 As discussed below, however, a number of commenters disagreed with or sought changes to one or more of the elements of the proposed method of calculating assets under management for regulatory purposes set forth in Form ADV.341 None of the commenters, however, suggested alternative approaches that could accommodate the specific changes they sought and achieve our goals of consistent asset calculations and reporting discussed above, and we are not aware of such an alternative approach.

For example, some commenters sought to exclude from the calculation proprietary assets and assets managed without compensation because such a requirement would be inconsistent with the statutory definition of “investment adviser.”342 Although a person is not an “investment adviser” for purposes of the Advisers Act unless it receives compensation for providing advice to others, once a person meets that definition (by receiving compensation from any client to which it provides advice), the person is an adviser, and the Advisers Act applies to the relationship between the adviser and any of its clients (whether or not the adviser receives compensation from them).343 Both the private fund adviser exemption and the foreign private adviser exemption are conditioned upon an adviser not exceeding specified amounts of “assets under management.”344 Neither statutory exemption limits the types of assets that should be included in this term, and we do not believe that such limits would be appropriate.345 In our view, the source of the assets managed should not affect the availability of the exemptions.

We also do not expect that advisers’ principals (or other employees) generally will cease to invest alongside the advisers’ clients as a result of the inclusion of proprietary assets, as some commenters suggested.346 If private fund investors value their advisers’ co-investments as suggested by these commenters, we expect that the investors will demand them and their advisers will structure their businesses accordingly.347 Other commenters objected to calculating regulatory assets under management on the basis of gross, rather than net, assets.348 They argued, among other things, that gross asset measurements would be confusing,349 complex,350 and inconsistent with industry practice.351 However, nothing in the current instructions suggests that liabilities should be deducted from the calculation of an adviser’s assets under management. Indeed, since 1997, the instructions have stated that an adviser should not deduct securities purchased on margin when calculating its assets.

338 See Proposing Release, supra note 26, discussion at section V.B.1 (explaining that, because the instructions to Form ADV previously permitted advisers to exclude certain types of managed assets, “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”).

339 See, e.g., AFL-CIO Letter (“We support the SEC’s proposal to require funds to use a uniform standard to calculate their assets under management and agree that it is important that the calculation account for asset appreciation.”); AFR Letter (“AFR supports the SEC’s proposal to require funds to use a uniform standard to calculate their assets under management, and to account for asset appreciation in those calculations”); AIMA Letter (“We agree that a clear and unified approach for calculation of AUM is necessary and we believe that using as a standard the assets for which an adviser ‘has responsibility’ is appropriate.”).

340 See Dechert General Letter; Seward Letter. See also ABA Letter (suggested a 12-month exclusion for seed capital consistent with the Volcker rule); Dechert Foreign Adviser Letter; EFAMA Letter; Katten Foreign Advisers Letter; MFA Letter. Under section 202(a)(11) of the Advisers Act, the definition of “investment adviser” includes, among others, “any person who, for compensation, engages in the business of advising others * * * as to the value of securities or as to the advisability of investing in, purchasing, or selling securities * * *.” One commenter argued that including proprietary assets would deter non-U.S. advisers that manage large amounts of proprietary assets from establishing U.S. operations. Katten Foreign Advisers Letter. Such an adviser, however, would not be ineligible for the private fund adviser exemption merely because it established U.S. operations. As discussed below, a non-U.S. adviser may rely on the private fund adviser exemption while also having one or more U.S. offices if that adviser complies with the exemption’s conditions. See infra Section II.B.3.


Whether a control affiliate is deemed to be an investment adviser would depend on the particular facts and circumstances. The calculation of regulatory assets under management, including the mandatory or optional inclusion of specified assets in that calculation, is applicable after the entity is determined to be an investment adviser. See sections 203(m) and 202(a)(30) of the Advisers Act.

342 See also Implementing Adopting Release, supra note 32, at n.68 and accompanying text.

343 See ABA Letter (supported use of fair value); AIMA Letter (supported including uncalled capital commitments, provided that the adviser has full contractual rights to call such capital and would be given responsibility for management of those assets).

344 See also Implementing Adopting Release, supra note 32, discussion at section II.A.3.

345 See infra Section II.B.2.b. We believe these measures will substantially mitigate or eliminate any volatility that may be caused by using gross assets measurement, as well as potential volatility in currency exchange rates identified by some commenters. See CompliGlobe Letter; EVCA Letter; O’Melveny Letter.
under management.\textsuperscript{352} Whether a client has borrowed to purchase a portion of the assets managed does not seem to us a relevant consideration in determining the amount an adviser has to manage, the scope of the adviser’s business, or the availability of the exemptions.\textsuperscript{353}

Moreover, we are concerned that the use of net assets could permit advisers to highly leveraged funds to avoid registration under the Advisers Act even though the activities of such advisers may be significant and the funds they advise may be appropriate for systemic risk reporting. Moreover, because private funds are not subject to the leverage restrictions in section 18 of the Investment Company Act, a private fund with less than $150 million in net assets could hold assets far in excess of that amount as a result of its extensive use of leverage. In addition, under a net assets test such a fund would be treated similarly for regulatory purposes as a fundamentally different fund, such as one that did not make extensive use of leverage and had $140 million in net assets.

The use of gross assets also need not cause any investor confusion, as some commenters suggested.\textsuperscript{356} Although an adviser will be required to use gross (rather than net) assets for purposes of determining whether it is eligible for the private fund adviser or the foreign private adviser exemptions (among other purposes), we would not preclude an adviser from holding itself out to its clients as managing a net amount of assets as may be its custom.\textsuperscript{357}

One commenter opposed the requirement that advisers include in the calculation of private fund assets uncalled capital commitments, asserting that the uncalled capital remains under the management of the fund investor.\textsuperscript{358} As we noted in the Proposing Release, in the early years of a private fund’s life, its adviser typically earns fees based on the total amount of capital commitments, which we presume reflects compensation for efforts expended on behalf of the fund in preparation for the investments.\textsuperscript{359}

A number of commenters objected to the requirement to determine private fund assets based on fair value, generally arguing that the requirement would cause those advisers that did not use fair value methods to incur additional costs, especially if the private funds’ assets that they manage are illiquid and therefore difficult to fair value.\textsuperscript{360} We noted in the Proposing Release that we understood that many private funds already value assets in accordance with U.S. generally accepted accounting principles ("GAAP") or other international accounting standards that require the use of fair value, citing letters we had received in connection with other rulemaking initiatives.\textsuperscript{361} We are sensitive to the costs this new requirement will impose. We believe, however, that this approach is warranted in light of the unique regulatory purposes of the calculation under the Advisers Act. We estimated these costs in the Proposing Release\textsuperscript{362} and we have taken several steps to mitigate them.\textsuperscript{363}

While many advisers will calculate fair value in accordance with GAAP or another international accounting standard,\textsuperscript{364} other advisers acting consistently and in good faith may utilize another fair valuation standard.\textsuperscript{365} While these other standards may not provide the quality of information in financial reporting (for example, of private fund returns), we expect these calculations will provide sufficient consistency for the purposes that regulatory assets under management serve in our rules, including rule 203(m).\textsuperscript{366}

Commenters also suggested alternative approaches to valuation, including the use of local accounting principles;\textsuperscript{367} the methodology used to report to the private fund’s investors;\textsuperscript{368} the methodologies described in a client’s governing documents or offering materials;\textsuperscript{369} historical cost;\textsuperscript{370} and aggregate capital raised by a private fund.\textsuperscript{371}

\textsuperscript{352} See Form ADV: Instructions for Part 1A, instr. 5.b.(2), as in effect before it was amended by the Implementing Adopting Release ("Do not deduct securities purchased on margin."). Instruction 5.b.(2) as amended in the Implementing Adopting Release, provides "Do not deduct any outstanding indebtedness or other accrued but unpaid liabilities." See Implementing Adopting Release, supra note 32, discussion at section II.B.3.

\textsuperscript{353} See id.

\textsuperscript{354} See id., at n.82 and preceding and accompanying text.

\textsuperscript{355} See id.

\textsuperscript{356} See, e.g., Dechert General Letter. See also Implementing Adopting Release, supra note 32, at n.80 and accompanying text.

\textsuperscript{357} In addition, in response to commenters seeking clarification of the application of the gross

\textsuperscript{358} See Merki Letter.\textsuperscript{359} Proposing Release, supra note 26, discussion at section II.B.2. See also Implementing Adopting Release, supra note 32, at n.90 and accompanying text.

\textsuperscript{360} See, e.g., Cumberland Dettmer Letter; Merki Letter; O’Melveny Letter; Seward Letter; Wellington Letter.

\textsuperscript{361} See Proposing Release, supra note 26, at n.196 and accompanying text.

\textsuperscript{362} See id., at n.326 and accompanying text.

\textsuperscript{363} We recognize that although these steps will provide advisers greater flexibility in calculating the value of their private fund assets, they also will result in valuations that are not as comparable as they could be if we specified a fair value standard (e.g., as specified in GAAP).

\textsuperscript{364} Several commenters asked that we not require advisers to fair value private fund assets in accordance with GAAP for purposes of calculating regulatory assets under management because many funds, particularly offshore ones, do not use GAAP and such a requirement would be unduly burdensome. See, e.g., EFAMA Letter; Katten Foreign Advisers Letter. We did not propose such a requirement, nor are we adopting one. See Implementing Adopting Release, supra note 32, at n.98.

\textsuperscript{365} See id., at n.99 and accompanying text.

\textsuperscript{366} See id., at n.100 and accompanying text. In addition, the fair valuation process need not be the result of a particular mandated procedure and the procedure need not involve the use of a third-party pricing service, appraiser or similar outside expert. An adviser could rely on the procedure for calculating fair value that is specified in a private fund’s governing documents. The fund’s governing documents may provide, for example, that the fund’s general partner determines the fair value of the fund’s assets. Advisers acting for private funds would be required to fair value real estate assets only in those limited circumstances where real estate assets are not required to be fair valued for financial reporting purposes under accounting principles that otherwise require fair value for assets of private funds. For example, in those cases, an adviser may instead value the real estate assets as the private fund does for financial reporting purposes. We note that the Financial Accounting Standards Board ("FASB") has a current project related to investment property entities that may require real estate assets subject to that accounting standard to be measured by the adviser at fair value. See FASB Project on Investment Properties. We also note that certain international accounting standards currently permit, but do not require, fair valuation of certain real estate assets. See International Accounting Standard 40, Investment Property. To the extent that an adviser follows GAAP or another accounting standard that requires or in the future requires real estate assets to be fair valued, this limited exception to the use of fair value measurement for real estate assets would not be available.

\textsuperscript{367} Dechert Foreign Adviser Letter; EFAMA Letter.

\textsuperscript{368} Merki Letter; Wellington Letter.

\textsuperscript{369} AIMA Letter; MFA Letter; Seward Letter.

\textsuperscript{370} O’Melveny Letter.
of an adviser’s private fund assets between annual updating amendments will not affect the availability of the exemption.

We proposed to require advisers relying on the exemption to calculate their private fund assets each quarter to determine if they remain eligible for the exemption. Commenters persuaded us, however, that requiring advisers to calculate their private fund assets annually in connection with their annual updating amendments to Form ADV would be more appropriate because it would likely result in the same advisers becoming registered each year while reducing the costs and burdens associated with quarterly calculations. In addition, annual calculations provide a range of dates on which an adviser may calculate its private fund assets, addressing concerns raised by commenters about short-term fluctuations in assets under management. The rule as adopted also is consistent with the timeframes for valuing assets under management and registering with the Commission applicable to state-registered advisers switching to Commission registration.

As noted above, if an adviser reports in its annual updating amendment that it has $150 million or more of private fund assets under management, the adviser is no longer eligible for the exemption. An adviser that has complied with all Commission reporting requirements applicable to an exempt reporting adviser as such, however, may apply for registration with the Commission up to 90 days after filing the annual updating amendment, and may continue to act as a private fund adviser, consistent with the requirements of rule 203(m)–1, during this transition period. This 90-day transition period is not available to advisers that have failed to comply with all Commission reporting requirements applicable to an exempt reporting adviser as such or that have accepted a client that is not a private fund. These advisers therefore should plan to register before becoming ineligible for the exemption.

Commenters who addressed the issue generally supported the proposed transition period, but requested that we extend the transition period beyond one calendar quarter as proposed or otherwise make it more broadly available. Requiring annual calculations extends the transition period, as commenters recommended, and is consistent with the amount of time provided to state-registered advisers switching to Commission registration. Advisers to whom the transition period is available will have up to 180 days after the end of their fiscal years to register.

One commenter argued that the transition period should be available to all advisers relying on rule 203(m)–1, including those that had not complied with their reporting requirements. The transition period is a safe harbor that provides advisers flexibility in

...
complying with rule 203(m)–1, and we continue to believe that it would be inappropriate to extend this benefit to advisers that have not met their reporting requirements.382

3. Assets Managed in the United States Under 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 are considered to be “assets under management in the United States,” even if the adviser has offices or personnel in the United States.383 A non-U.S. adviser, however, need only count private fund assets it manages at a place of business in the United States toward the $150 million asset limit under the exemption.384

As discussed in the Proposing Release, the rule deems 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. This is the location where the adviser controls, or has ultimate responsibility for, the management of private fund assets, and therefore is the place where all the adviser’s assets are managed, although day-to-day management of certain assets may also take place at another location.385 For most advisers, this approach will 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.

Most commenters who addressed the issue supported our proposal to treat “assets under management in the United States” for non-U.S. advisers as those assets managed at a U.S. place of business.386 One commenter did, however, urge us to presume that a non-U.S. adviser’s assets are managed from its principal office and place of business to avoid the inherent difficulties in determining the location from which any particular assets of a private fund are managed if an adviser operates in multiple jurisdictions.387 As we stated in the Proposing Release, this commenter’s approach ignores situations in which day-to-day management of some assets of the private fund does in fact take place “in the United States.”388 It also 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 of the United States. This consequence is 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.389

In addition, some commenters supported an alternative approach under which we would interpret “assets under management in the United States” by reference to the source of the assets (i.e., U.S. private fund investors).390 One of the commenters argued that our interpretation would disadvantage U.S.-based advisers by permitting non-U.S. advisers to accept substantial amounts of money from U.S. investors without having to comply with certain U.S. regulatory requirements, and cause U.S. advisers to move offshore or close U.S. offices to avoid regulation.391

As we explained in the Proposing Release, we believe that our interpretation recognizes that non-U.S. activities of non-U.S. advisers are less likely to implicate U.S. regulatory interests and is in keeping with general principles of international comity.392 The rule also 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 a non-U.S. adviser’s non-U.S. advisory business.393 Non-U.S. advisers relying on rule 203(m)–1 will remain subject to the Advisers Act’s antifraud provisions and will become subject to the requirements applicable to exempt reporting advisers.

One commenter proposed an additional interpretation under which we would determine the “assets under management in the United States” for U.S. advisers only by reference to the amount of assets invested, or “in play,” in the United States.394 We decline to adopt this approach because it would be difficult for advisers to ascertain and monitor which assets are invested in the United States, and this approach thus could be confusing and difficult to apply on a consistent basis. For example, an adviser might invest in the American Depository Receipts of a company incorporated in Bermuda that: (i) Engages in mining operations in Canada, the principal trading market for its common stock; and (ii) derives the majority of its revenues from exports to the United States. It is not clear whether

382 See Proposing Release, supra note 26, discussion at n.223 and accompanying text.

383 Rule 203(m)–1(a). The rule defines 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.” Rule 203(m)–1(d)(7); 17 CFR 203.902(l).

384 Rule 203(m)–1(b). Any assets managed at a U.S. place of business for clients other than private funds would make the exemption unavailable. See also supra note 378. We revised this provision to refer to assets managed “at” a place of business in the United States, rather than “from” a place of business in the United States as proposed. The revised language is intended to reflect more clearly the rule’s territorial focus on the location at which the asset management takes place.

385 This approach is similar to the way we have identified the location of the adviser for regulatory purposes under our current rules, which define an adviser’s principal office and place of business as the location where it “directs, controls and coordinates” its advisory activities, regardless of the location where some of the advisory activities might occur. See rule 203A–3(c); rule 222–1.


387 Katten Foreign Advisers Letter.

388 See supra note 26, at nn.204–205 and accompanying text.

389 See infra Section II.C.

389 Comment Letter of Portfolio Manager [Jan. 24, 2011] (“Portfolio Manager Letter”); Merkl Letter (suggested that it “may be useful” to look both to assets managed from a U.S. place of business and assets contributed by U.S. private fund investors to address both investor protection and systemic risk concerns).

these investments should be considered “in play” in the United States.  

Another commenter urged us to exclude assets managed by a U.S. adviser at its non-U.S. offices.395 This, the commenter argued, would allow more U.S. advisers to rely on the exemption and allow us to focus our resources on larger advisers more likely to pose systemic risk. But the management of assets at these non-U.S. offices could have investor protection implications in the United States, such as by creating conflicts of interest for an adviser between assets managed abroad and those managed in the United States. 

In addition, we sought comment as to whether, under the approach we are adopting today, some or most U.S. advisers with non-U.S. branch offices would re-organize those offices as subsidiaries in order to avoid attributing assets managed to the non-U.S. office.396 We continue to believe that rule 203(m)–1 will have only a limited effect on multi-national firms, which for tax or business reasons keep their non-U.S. advisory activities organizationally separate from their U.S. advisory activities. For these reasons, and our substantial interest in regulating all of the activities of U.S. advisers, we decline to revise rule 203(m)–1 as this commenter suggested.  

Several commenters asked that we clarify whether certain U.S. activities or arrangements would result in an adviser having a “place of business” in the United States.397 Commenters also sought guidance as to whether limited-purpose U.S. offices of non-U.S. advisers would be considered U.S. places of business (e.g., offices conducting research or due diligence).398 Under rule 203(m)–1, if a non-U.S. adviser relying on the exemption has a place of business in the United States, all of the clients whose assets the adviser manages at that place of business must be private funds and the assets managed at that place of business must have a total value of less than $150 million. Rule 203(m)–1 defines a “place of business” by reference to rule 222–1(a) as any office where the adviser “regularly provides advisory services, solicits, meets with, or otherwise communicates with clients,” and “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.” Whether a non-U.S. adviser has a place of business in the United States depends on the facts and circumstances, as discussed below in connection with the foreign private adviser exemption.399 For purposes of rule 203(m)–1, however, the analysis frequently will turn not on whether a non-U.S. adviser has a U.S. place of business, but on whether the adviser manages assets, or has “assets under management,” at such a U.S. place of business. Under the Advisers Act, “assets under management” are the securities portfolios for which an adviser provides “continuous and regular supervisory or management services.”400 This is an inherently factual determination. We would not, however, view providing research or conducting due diligence to be “continuous and regular supervisory or management services” at a U.S. place of business if a person outside of the United States makes independent investment decisions and implements those decisions.401 

4. United States Person 

Under rule 203(m)–1(b), a non-U.S. adviser may not rely on the exemption if it has any client that is a United States person other than a private fund.402 Rule 203(m)–1 defines a “United States person” generally by incorporating the definition of a “U.S. person” in Regulation S under the Securities Act.403 Regulation S looks generally to the residence of an individual to determine whether the individual is a United States person,404 and also addresses the circumstances under which a legal person, such as a trust, partnership or a corporation, is a United States person.405 Regulation S generally treats legal partnerships and corporations as United States persons if they are organized or incorporated in the United States, and analyzes trusts by reference to the residence of the trustee.406 It treats discretionary accounts generally as United States persons if the fiduciary is a resident of the United States.407 Commenters generally supported defining “United States person” by reference to Regulation S because, among other reasons, the definition is well developed and understood by advisers.408 

Rule 203(m)–1 also contains a special rule that requires an adviser relying on the exemption to treat a discretionary or other fiduciary account as a United States person if the adviser holds for the benefit of a United States person by a non-U.S. fiduciary who is a related person of the adviser.409 

395 Comment Letter of T.A. McKay & Co., Inc. (Nov. 23, 2010). 

396 See Proposing Release, supra note 26, at discussion following n.208. 

397 See, e.g., EFAMA Letter. 

398 AIMA Letter; Dechert General Letter; EFAMA Letter. See also ABA Letter; Vedanta Letter. 

399 See infra Section II.C.4. 

400 Section 203A(a)(2) of the Advisers Act. The instructions to Item 5 of Form ADV provide guidance on the circumstances under which an adviser would be providing “continuous and regular supervisory or management services with respect to an account.” Form ADV: Instructions for Part 1A, instr. 5.b. The calculation of an adviser’s assets under management at a U.S. place of business turns on whether the adviser is providing those services with respect to a particular account or accounts at a U.S. place of business. 

401 See Form ADV: Instructions for Part 1A, instr. 5.b(3)(b) (an adviser provides continuous and regular supervisory or management services with respect to an account if it has “ongoing responsibility to select or make recommendations, based upon the needs of the client, as to specific securities or other investments the account may purchase or sell and, if such recommendations are accepted by the client, [it is] responsible for arranging or effecting the purchase or sale”). These research or due diligence services, while not “continuous and regular supervisory or management services,” do provide investment advisory services that, if performed at a U.S. location, would cause the adviser to have a place of business in the United States. See infra note 493 and accompanying text. 

402 In response to commenters seeking clarity on this point, we note that a non-U.S. adviser need not have one or more private fund clients that are United States persons in order to rely on the exemption. 


404 17 CFR 230.902(k)(1)(i) and (2). 

405 See supra Section II.C.4. 

406 17 CFR 230.902(k)(1)(ii) and (iv). 


408 AIMA Letter; CompliGlobe Letter; Debevoise Letter; Dechert General Letter; Gunderson Dettmer Letter; Katten Foreign Advisers Letter; O’Melveny Letter. As we explained in the Proposing Release, advisers 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. See Proposing Release, supra note 26, at n.217 and accompanying text. 

409 Rule 203(m)–1(d)(8). We are adding a note to rule 203(m)–1 that clarifies that a client will not be considered a United States person if the client was a non-U.S. person at the time of becoming a client of the adviser. This will permit a non-U.S. adviser to continue to rely on rule 203(m)–1 if a non-U.S. client that is not a private fund, such as a natural person client residing abroad, relocates to the United States or otherwise becomes a United States person. As one commenter recognized, this also will establish similar treatment in these circumstances for non-U.S. advisers relying on rule 203(m)–1 or the foreign private adviser exemption, which contains an analogous note. See EFAMA Letter. See also Comment Letter of Investment Funds Institute of Canada (Jan. 24, 2011) (“IFIC Letter”). The note applicable to the foreign private adviser exemption generally describes the time an adviser must determine if a client is “in the United States” for purposes of that exemption. See infra Section II.C.3. 

410 17 CFR 230.902(k)(1)(i) and (ii).
commenter expressed concern that the special rule is unnecessary while another who supported the special rule as proposed noted that the special rule should be “narrowly drawn” to avoid frustrating legitimate subsidiary relationships between non-U.S. advisers and their U.S. adviser affiliates.\textsuperscript{410} We believe that the special rule is narrowly drawn and necessary to prevent advisers from purporting to rely on the exemption and establishing 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.\textsuperscript{411}

Another commenter suggested the rule apply a different approach with respect to business entities than that under Regulation S, which as noted above generally treats legal partnerships as U.S. persons if they are organized or incorporated in the United States.\textsuperscript{412} The commenter suggested that advisers should instead look to a business entity’s principal office and place of business in certain instances because an entity organized under U.S. law should not necessarily be treated as a United States person if it was formed by a non-United States person to pursue the entity’s investment objectives.\textsuperscript{413} We decline to adopt this suggestion because we believe it is most appropriate to incorporate the definition of “U.S. person” in Regulation S with as few modifications as possible. As noted above, Regulation S provides a well-developed body of law with which advisers to private funds and their counsel must today be familiar in order to comply with other provisions of the Federal securities laws. Incorporating this definition in rule 203(m)–1, therefore, makes rule 203(m)–1 easier to apply and fosters consistency across the Federal securities laws. Deviations from the definition used in Regulation S, including an entirely different approach to defining a “United States person,” would detract from these benefits. Moreover, a test that looks to a business entity’s principal office and place of business, as suggested by the commenter, would be difficult for advisers to apply. It frequently is unclear where an investment fund maintains its “principal office and place of business” because investment funds typically have no physical presence or employees other than those of their advisers.

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).\textsuperscript{414} 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;\textsuperscript{415} (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;\textsuperscript{416} and (iv) does not hold itself out generally to the public in the United States as an investment adviser.\textsuperscript{417} Section 202(a)(30) authorizes the Commission to increase the $25 million threshold “in accordance with the purposes of this title.”\textsuperscript{418}

Today we are adopting, substantially as proposed, new rule 202(a)(30)–1, which defines certain terms in section 202(a)(30) for use by advisers seeking to avail themselves of the foreign private adviser exemption, including: (i) “investor;” (ii) “in the United States;” (iii) “place of business;” and (iv) “assets under management.”\textsuperscript{419} We are also including in rule 202(a)(30)–1 the safe harbor and many of the client counting rules that appeared in rule 203(b)(3)–1.

1. Clients

Rule 202(a)(30)–1 includes a safe harbor for advisers to count clients for purposes of the definition of “foreign private adviser” that is similar to the safe harbor that has been included in rule 203(b)(3)–1.\textsuperscript{420} The commenter that generally addressed this aspect of our proposed rule agreed with our approach,\textsuperscript{421} which was designed to apply a well-developed body of law to and investors in the United States in private funds” (emphasis added). As noted in the Proposing Release, we interpret these provisions consistently so that only clients in the United States and investors in the United States would be counted for purposes of subparagraph (B). See Proposing Release, supra note 26, at n.225.

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). As noted in the Proposing Release, we interpret subparagraph (II) to prohibit an adviser that advises a business development company from relying on the exemption. See Proposing Release, supra note 26, at n.226.

Section 202(a)(30)(C).

Rule 202(a)(30)–1(c).

Rule 203(b)(3)–1, which we are rescinding with the Implementing Adopting Release, provided a safe harbor for determining who may be deemed a single client for purposes of the private adviser exemption. We are not, however, carrying 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. See supra note 334. Under the definition of “foreign private adviser,” an adviser relying on the exemption may not have any place of business in the United States. See section 402 of the Dodd-Frank Act (defining “foreign private adviser”). We are also not including rule 203(b)(3)–1(b)(7), which specifies that a client who is an owner of a private fund is a resident of the United States at the time of the client’s investment in the fund. The provision was vacated by a Federal court in Goldstein, supra note 14. As discussed below, we are including a provision in rule 202(a)(30)–1 that addresses when an adviser may be treated as a “foreign private adviser.” If a client or investor is “in the United States” for purposes of the exemption. See infra note 476 and accompanying text.

419 Rule 202(a)(30)–1(c).

420 Section 202(a)(30)(C).

421 Rule 203(b)(3)–1, which we are rescinding with the Implementing Adopting Release, provided a safe harbor for determining who may be deemed a single client for purposes of the private adviser exemption. We are not, however, carrying 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. See supra note 334. Under the definition of “foreign private adviser,” an adviser relying on the exemption may not have any place of business in the United States. See section 402 of the Dodd-Frank Act (defining “foreign private adviser”). We are also not including rule 203(b)(3)–1(b)(7), which specifies that a client who is an owner of a private fund is a resident of the United States at the time of the client’s investment in the fund. The provision was vacated by a Federal court in Goldstein, supra note 14. As discussed below, we are including a provision in rule 202(a)(30)–1 that addresses when an adviser may be treated as a “foreign private adviser.” If a client or investor is “in the United States” for purposes of the exemption. See infra note 476 and accompanying text.

422 See Kalten Foreign Advisers Letter.
give effect to a statutory provision with a similar purpose.

New rule 202(a)(30)–1 allows 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, spousal equivalent, or relative of the spouse or of the spousal equivalent of the natural person who has the same principal residence; 422 (iii) all accounts of which the natural person and/or the person’s minor child or relative, spouse, spousal equivalent, or relative of the spouse or of the spousal equivalent 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, spousal equivalent, or relative of the spouse or of the spousal equivalent who has the same principal residence are the only primary beneficiaries and (v) any person for whom the adviser provides investment advisory services without compensation. Some commenters argued that an adviser should not have to count such persons, who may be employees and principals of the firm and their family members.426 But as we explained in the Proposing Release, allowing an adviser not to count as clients persons in the United States who do not compensate the adviser would allow certain advisers to avoid registration through reliance on the foreign private adviser exemption despite the fact that, as those commenters acknowledge, the adviser provides advisory services to those persons.427

The new rule includes two provisions that clarify that advisers need not double-count private funds and their investors under certain circumstances. One provision, as proposed, specifies 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 exemptions. The other provision, recommended by commenters,430 clarifies that an adviser is not required to count a person as an investor if the adviser counts such person as a client of the adviser. Thus, a client who is also an investor in a private fund advised by the adviser would only be counted once.

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. Rule 202(a)(30)–1 defines an “investor” in a private fund 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.431 In addition, a beneficial owner of short-term paper issued by the private fund also is an investor.432 We are adopting rule 202(a)(30)–1 substantially as proposed. In a modification to the proposal, however, we are not including knowledgeable employees in the definition of “investor.”

The term “investor” is not currently defined under the Advisers Act or the rules under the Advisers Act. We are adopting the new definition to provide for consistent application of the statutory provision and to prevent non-U.S. advisers from circumventing the limitations in section 203(b)(3). As discussed in the Proposing Release, we believe that defining the term “investor” by reference to sections 3(c)(1) and 3(c)(7) of the Investment Company Act will best achieve these purposes.

Commenters who addressed the issue agreed with our decision to define investor for purposes of this rule by reference to the well-developed understanding of ownership under

422 As suggested by a commenter, we incorporated in rule 202(a)(30)–1(a)(1) the concept of a “spousal equivalent,” which we define by reference to rule 203(a)(11)(G)–1(d)(9) as “a cohabitant occupying a relationship generally equivalent to that of a spouse.” See ABA Letter.

423 Rule 202(a)(30)–1(a). If a client relationship involving multiple persons does not fall within the rule, whether the relationship may appropriately be treated as a single “client” depends on the facts and circumstances.

424 Rule 202(a)(30)–1(b)(2). In addition, rule 202(a)(30)–1(b)(1) through (3) contain 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 partner in a general partnership, limited liability company, trust, or other legal organization to which the adviser provides investment advice based on the legal organization’s investment objectives, and (ii) two or more legal organizations that have identical shareholders, partners, limited partners, members, or beneficiaries.424

425 See rule 203(b)(3)–1(b)(4).

426 See Dechert General Letter (“In many instances, advisers manage the assets of employees and principals of their family members, and use such services as a legitimate compensation arrangement to retain talented employees.”). Katten Foreign Advisers Letter (“Such persons are likely to be in a special relationship with the adviser that allows them to benefit from the advisers’ investment advice without having to pay.”). See also ABA Letter.

427 Cf. Form ADV. The term “client” “includes clients from which [an adviser] receives no compensation * * * .” 42 We also are adopting in the Implementing Adopting Release a uniform method for calculating assets under management for regulatory purposes, including availability of the foreign private adviser exemption, that requires advisers to include in that calculation assets they manage without compensation. See Implementing Adopting Release, supra note 32, discussion at section II.A.3. Requiring foreign private advisers to treat as clients persons from whom they receive no compensation is consistent with the use of this new uniform method of calculating assets under management for regulatory purposes.

428 See rule 202(a)(30)–1(b)(4)–(5).

429 See rule 202(a)(30)–1(b)(4); 202(a)(30)–1(c)(2).

See also infra Section II.C.2 (discussing the definition of investor). This provision is applicable only for purposes of determining whether an adviser has fewer than 15 clients in the United States and investors in the United States in private funds it advises under section 202(a)(30) of the foreign private adviser exemption. It does not apply to the determination of the assets under management relevant for purposes of that exemption under section 202(a)(30)(C). As a result, an adviser must include the assets of a private fund that is a client in the United States even if the adviser may exclude that private fund when determining that an adviser has fewer than 15 clients or investors in the United States. See also infra note 499.

430 See ABA Letter; Katten Foreign Advisers Letter.


432 See rule 202(a)(30)–1(c)(2)(ii). supra notes 10 and 12 and accompanying text. We note that the definition of “investor” in rule 202(a)(30)–1 is for purposes of the foreign private adviser exemption and does not limit the scope of that term for purposes of rule 206(4)–8.

433 See rule 202(a)(30)–1(c)(2)(ii).

434 See rule 202(a)(30)–1(c)(2), at note to paragraph (c)(2).

435 See rule 202(a)(30)–1(c)(2). See also infra notes 448–452 and accompanying text.
sections 3(c)(1) and 3(c)(7). 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). More importantly, defining the term “investor” by reference to sections 3(c)(1) and 3(c)(7) places appropriate limits on the ability of a non-U.S. adviser to avoid application of the registration provisions of the Advisers Act by setting up intermediate accounts through which investors may access a private fund and not be counted for purposes of the exemption. Advisers must “look through” 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. Holders of both equity and debt securities must be counted as investors.

Under the new rule, an adviser will determine the number of investors in a private fund based on the 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. Depending upon the facts and circumstances, persons other than the nominal holder of a security issued by a private fund may be counted as the beneficial owner under section 3(c)(1), or be required to be a qualified purchaser under section 3(c)(7). An adviser relying on the exemption would have to count such a person as an investor.

For example, 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. In addition, an adviser would need to count as an investor an owner of a total return swap on the private fund because that arrangement effectively provides the risks and rewards of investing in the private fund to the swap counterparty. Whether an owner of another type of instrument referencing a private fund would be counted as the beneficial owner under section 3(c)(1), or be required to be a qualified purchaser under section 3(c)(7), would depend on the facts and circumstances.

Several commenters generally disagreed that advisers should be required to “look through” total return swaps or similar instruments or master-feeder arrangements in at least certain circumstances, arguing among other things that these instruments or arrangements serve legitimate business purposes. As we explain above, however, the requirement to count as investors persons other than the nominal holder of a security issued by a private fund is derived from provisions in both the Advisers Act and the Investment Company Act prohibiting a person from doing indirectly, or through or by any other person, what is unlawful to do directly, and from sections 3(c)(1) and 3(c)(7).

Some commenters also argued that “looking through” a total return swap or similar instrument would be impractical or unduly burdensome in certain circumstances, including situations in which the adviser did not participate in the swap’s creation or know of its existence. An issuer relying on section 3(c)(7) may treat as a qualified purchaser any person whom the issuer reasonably believes is a qualified purchaser, and the definition of investor that we are adopting today provides that an adviser counts as investors those persons who must be qualified purchasers under section 3(c)(7). Therefore, an adviser may treat as an investor a person the adviser reasonably believes is the actual investor. Similarly, if an adviser reasonably believes that an issuer is not “in the United States,” the adviser may treat the investor as not being “in the United States.”

The final rule, unlike the proposal, does not treat as investors beneficial owners who are “knowledgeable employees” with respect to the private fund, and certain other persons related to such employees (we refer to them, collectively, as “knowledgeable employees”). In formulating our

---

436 See ABA Letter; Dechert General Letter; Katten Foreign Advisers Letter.
437 See supra notes 10 and 12 and accompanying text. In the Proposing Release, we noted that 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.
438 Rule 202(a)(30)–1(c)(2).
439 See generally sections 3(c)(1) and 3(c)(7) of the Investment Company Act.
440 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 sections 2(a)(36) of that Act to include debt and equity).
441 See section 208(d) of the Advisers Act; section 48(a) of the Investment Company Act.
442 As noted above, we have recognized that in certain circumstances it is appropriate to “look through” an investor (i.e., attribution ownership of a private fund to another person who is the ultimate owner). See, e.g., Privately Offered Investment Company, Investment Company Act Release No. 22597 (Apr. 3, 1997) [62 FR 17512 (Apr. 9, 1997)] (“NSMIA Release”) (“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
443 One commenter argued that the swap counterparty is not required to hedge its exposure by investing the full notional amount in the private fund, see Dechert General Letter. We do not find this distinction persuasive in situations in which the adviser knows or should know of the existence of the swap. See infra discussion accompanying and following note 447.
444 See, e.g., ABA Letter; Dechert General Letter; EFAMA Letter.
445 See supra notes 440–443 and accompanying text.
446 See, e.g., Dechert General Letter; EFAMA Letter.
447 Rule 202(a)(30)–1(c)(2) defines the term “investor” generally to include persons that must be counted for purposes of section 3(c)(1) of the Investment Company Act or qualified purchasers for purposes of section 3(c)(7) of that Act. See supra notes 432–443 and accompanying text. Advisers to private funds relying on section 3(c)(7) may under Investment Company Act rule 2a51–3(a) treat as an investor a person the adviser reasonably believes is the actual investor. Similarly, if an adviser reasonably believes that an issuer is not “in the United States,” the adviser may treat the investor as not being “in the United States.”
448 In formulating our
proposal to include knowledgeable employees in the definition of investor, we were concerned that excluding knowledgeable employees from the definition of investor would allow certain advisers to avoid registration by relying on the foreign private adviser exemption. A number of commenters opposed our proposal. In particular, they argued that the proposed approach was inconsistent with Congressional and prior Commission determinations that such employees do not need the protections of the Investment Company Act.

Upon further consideration, we have determined that the same policy considerations that justify disregarding knowledgeable employees for purposes of other provisions provide a valid basis for excluding them from the definition of “investor” under the foreign private adviser exemption. Treating knowledgeable employees in the same manner for purposes of the definition of investor and sections 3(c)(1) and 3(c)(7) will also simplify compliance with regulatory requirements imposed by both the Advisers Act and the Investment Company Act.

The new rule requires advisers to treat as investors beneficial owners of “short-term paper” issued by the private fund. These persons are not counted as beneficial owners for purposes of section 3(c)(1) but must be qualified purchasers under section 3(c)(7).

Some commenters opposed this approach, arguing that holders of short-term paper do not make an investment decision but rather are creditors making a credit risk evaluation. We disagree. The acquisition of those instruments involves an investment decision, although the considerations involved in that decision might differ from the considerations involved in a decision to make an equity investment.

One commenter asserted that treating holders of short-term paper as investors could result in a U.S. commercial lender to a fund being treated as an investor, leading non-U.S. advisers to avoid U.S. lenders. Unless the extension of credit by a bank’s broker-dealer or custodian bank results in the issuance of a security by the fund to its creditor, the creditor would not be considered an investor for purposes of the foreign private adviser exemption. As we stated in the Proposing Release, there appears to be no valid reason to treat as investors all debt holders except holders of short-term paper. Certain issuers continually roll over short-term paper and effectively use it as a permanent source of capital, further supporting our view that there appears to be no reason to treat holders of short-term paper differently than other longer-term debt holders for purposes of the exemption. Moreover, a private fund’s losses directly affect the interests of holders of short-term paper in the fund just as they affect the interests of other debt holders in the fund. In contrast to the treatment of knowledgeable employees, holders of short-term paper must be qualified purchasers under section 3(c)(7), the more recent of the two exclusions under the Investment Company Act on which private funds rely. Thus, we are requiring advisers to count as investors all debt holders, including holders of short-term paper.

Some commenters expressed concern that the look-through requirement contained in the statutory definition of a “foreign private adviser” could impose significant burdens on advisers to non-U.S. funds, including non-U.S. retail funds publicly offered outside of the United States. Two of these commenters stated, for example, that in their view a non-U.S. fund could be considered a private fund as a result of independent actions of U.S. investors, such as if a non-U.S. shareholder of a non-U.S. fund moves to the United States and purchases additional shares. If these funds were “private 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; see also Marcin Kacperczyk And Philipp Schnabl, When Safe Proved Risky: Commercial Paper During the Financial Crisis Of 2007–2008 (Nov. 2009).

As discussed in the Proposing Release, 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 Proposing Release, supra note 26, at n. 251. See also Money Market Fund Reform Release, supra note 460, 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).

As we noted in the Proposing Release, because commercial paper issuers often refinance the repayment of maturing commercial paper with newly issued commercial paper, they may face roll-over risk, i.e., the risk that investors may not be willing to refinance maturing commercial paper. See Proposing Release, supra note 26, at n. 134. These risks became particularly apparent for issuers of asset-backed commercial paper beginning in 2007.
funds,” their advisers would, if seeking to rely on the foreign private adviser exemption, be required to determine the number of private fund investors in the United States and the assets under management attributable to them.

As we explain above, if an adviser reasonably believes that an investor is not “in the United States,” the adviser may treat the investor as not being “in the United States.” Moreover, we understand that non-U.S. private funds currently count or qualify their U.S. investors in order to avoid regulation under the Investment Company Act.465 A non-U.S. adviser would need to count the same U.S. investors (except for holders of short-term paper with respect to a fund relying on section 3(c)(1)) in order to rely on the foreign private adviser exemption. In this respect, therefore, the look-through requirement of the foreign private adviser exemption will generally not impose any new burden on advisers to non-U.S. funds.

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 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.466 Today, we are defining the term “in the United States” to clarify the term for all of the above purposes as well as to provide specific instructions as to the relevant time for making the related determination.

New rule 202(a)(30)–1 defines “in the United States,” as proposed, generally by incorporating the definition of a “U.S. person” and “United States” under Regulation S.467 In particular, we are defining “in the United States” to mean: (i) With respect to any place of business, any such place that is located in the “United States,” as defined in Regulation S;468 (ii) with respect to any client or private fund investor in the United States, any person who is a “U.S. person” as defined in Regulation S,469 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 defined in Regulation S.470

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.471 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.472 The references to Regulation S with respect to a place of business “in the United States” and the public in the “United States” also allows us to maintain consistency across our rules. Two commenters specifically supported our approach.473

465 Rule 202(a)(30)–1(c)(3). As discussed above, we are also referencing Regulation S’s definition of a “U.S. person” for purposes of the definition of “United States person” in rule 202(a)(30)–1. See supra Section II.B.4.

466 See 17 CFR 210.902(l).

467 Rule 202(a)(30)–1(c)(3). As we noted in the Proposing Release, many non-U.S. advisers identify whether a client is a “U.S. person” under Regulation S in order to determine whether the client may invest in certain private funds and certain private placement offerings exempt from registration under the Securities Act. See Proposing Release, supra note 26, at n. 259. 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 for purposes of a non-U.S. private fund meeting the section 3(c)(1) and 3(c)(7) counting or qualification requirements. See id., at n. 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.

471 See supra notes 404–407 and accompanying text.

472 As we noted in the Proposing Release, many non-U.S. advisers identify whether a client is a “U.S. person” under Regulation S in order to determine whether the client may invest in certain private funds and certain private placement offerings exempt from registration under the Securities Act. See Proposing Release, supra note 26, at n. 259. 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 for purposes of a non-U.S. private fund meeting the section 3(c)(1) and 3(c)(7) counting or qualification requirements. See id., at n. 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.

473 Dechert Foreign Adviser Letter; Dechert General Letter. Commenters generally addressed our proposal to rely on Regulation S to identify U.S.

Similar to our approach in new rule 203(m)–1(d)(8) and as we proposed,474 we are treating as persons “in the United States” for purposes of the foreign private adviser exemption certain persons that would not be considered “U.S. persons” under Regulation S. For example, we are treating as “in the United States” any discretionary account 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 advising assets of persons in the United States.475

We also are including the note to paragraph (c)(3)(i) specifying that for purposes of that definition, a person who is “in the United States” may be treated as not being “in the United States” if the 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, each time the investor acquires securities issued by the fund.476 As we explained in the Proposing Release, the note is designed to reduce the burden of having to monitor the location of clients and investors on an ongoing basis, and to avoid placing an adviser in a position whereby it might have to choose between registering with the Commission 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.477

Several commenters supported the inclusion of the note.478 Some commenters, however, advocated expanding the note to treat a private persons within the context of the private fund adviser exemption. See supra Section II.B.4.

474 See supra Section II.B.4 (discussing the definition of United States persons and the treatment of discretionary accounts).


476 Rule 202(a)(30)–1, at note to paragraph (c)(3)(i) (“A person who 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, each time the investor acquires securities issued by the fund.”). We revised the note to provide that it applies “each time” the investor acquires securities issued by the fund. Cf. proposed rule 202(a)(30)–1, at note to paragraph (c)(3)(i). This change to the note as proposed more clearly reflects the note’s intended operation.

477 See Proposing Release, supra note 26, at n.257 and accompanying and following text.

478 See, e.g., Dechert General Letter (“The note provides helpful relief at a time when advisory clients often move across international borders while keeping an existing relationship with a financial institution.”). See also ABA Letter; Dechert Foreign Adviser Letter.
fund investor in the same way as a client so that additional investments in a fund made after moving to the United States would not cause the investor to become a U.S. person. They argued that, as discussed above, advisers to non-U.S. funds should not be required to “look through” these funds to ensure that their investors who purchased shares while outside of the United States did not subsequently relocate to the United States and purchase additional shares.

As we explain above, if an adviser reasonably believes that an investor is not “in the United States,” the adviser may treat the investor as not being “in the United States.” In addition, we understand that, based on no-action positions taken by our staff, non-U.S. funds do not consider for purposes of section 3(c)(1) beneficial owners who were not U.S. persons at the time they invested in the fund, but do consider those beneficial owners if they make additional purchases in the same fund after relocating to the United States. The note is consistent with the funds’ current practices, and thus generally should not impose any new burdens on non-U.S. funds. The note also is consistent with section 3(c)(7), which requires an investor to be a qualified purchaser at the time the investor acquires the securities.

The Investment Funds Institute of Canada (IFIC) and the Investment Industry Association of Canada (IIAC) urged that, for purposes of the look-through provision, the Commission allow non-U.S. advisers not to count persons (and their assets) who invest in a foreign private fund through certain clients so that additional investments in the same fund made after moving to the United States. The commenters noted that this treatment would be consistent with rule 7d–2 under the Investment Company Act and certain related rules. We agree. A non-U.S. fund sold to Participants would be deemed a private fund if it conducted a private offering in the United States, but we have previously stated that Participants need not be counted toward the 100-investor limit for purposes of section 3(c)(1). As a result, and based on the same policy considerations embodied in rule 7d–2, we believe that a non-U.S. adviser should not be required to treat Participants as investors in the United States under rule 202(n)(30)–1 with respect to investments they make after moving to the United States if the fund is in compliance with rule 7d–2.

4. Place of Business

New rule 202(a)(30)–1, by reference to rule 222–1, 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 activity. We are adopting this provision as proposed because we believe the definition appropriately identifies a location where an adviser is doing business for purposes of section 202(n)(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. As discussed in the Proposing Release, 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, we believe it is logical as well as efficient to use the rule 222–1(a) definition of “place of business” for purposes of the foreign private adviser exemption. The two commenters that considered the proposed definition of “place of business” by reference to rule 222–1 agreed with this analysis.

Some commenters asked us to clarify that a “place of business” would not include an office in the United States where a non-U.S. adviser solely conducts research, communicates with non-U.S. clients, or performs administrative services and back-office books and recordkeeping activities. Under rule 202(a)(30)–1, as under rule 203(m)–1, an adviser must determine whether it has a place of business, as defined in rule 222–1, in the United States in light of the relevant facts and circumstances. For example, any office from which an adviser regularly communicates with its clients, whether U.S. or non-U.S., would be a place of business. In addition, an office or other location where an adviser regularly conducts research would be a place of business because research is intrinsic to the provision of investment advisory services. A place of business would not, however, include an office where an adviser solely performs administrative services and back-office activities if they are not activities intrinsic to providing investment advisory services and do not involve communicating with clients. A number of commenters sought guidance as to whether the activities of U.S. affiliates of non-U.S. advisers would be deemed to constitute places of business in the United States of the non-U.S. advisers. The presumption that a non-U.S. adviser has a place of business in the United States solely because it is affiliated with a U.S. adviser might be deemed to have a place of business in Canada.
the United States, however, if the non-U.S. adviser’s personnel regularly conduct activities at an affiliate’s place of business in the United States.496

5. Assets Under Management

For purposes of rule 202(a)(30)–1 we are defining “assets under management,” as proposed, by reference to the calculation of “regulatory assets under management” for Item 5 of Form ADV.497 As discussed above, in Item 5 of Form ADV we are implementing 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 and the private fund adviser exemption.498 Because the foreign private adviser exemption is also based on a uniform method for managing, 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.499

We believe that uniformity in the method for calculating assets under management will 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 assessment of risk.500 One commenter specifically agreed that the uniform method should be applied for purposes of the foreign private adviser exemption.501 Most commenters addressed the components of the new method of calculation in reference to the calculation of “regulatory assets under management” under Form ADV, or with respect to the calculation of private fund assets for purposes of the private fund adviser exemption.502 We address these comments in the Implementing Adopting Release and in Section II.B.2.a.

D. Subadvisory Relationships and Advisory Affiliates

We generally interpret advisers as including subadvisers,503 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 rule.504 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 rule 203(m)–1 if the subadviser’s services to the primary adviser relate solely to private funds and the other conditions of the rule 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 anticipated that an adviser with advisory affiliates could encounter interpretative issues as to whether it may rely on any of the exemptions discussed in this Rule, specifically 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 the adviser itself could not provide while relying on an exemption. In the Proposing Release, we requested 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, by having the rule, for example, specify that the exemption is not available to an affiliate of a registered investment adviser.

Commenters that responded to our request for comment generally supported treating each advisory entity separately without regard to the activities of, or relationships with, its affiliates.505 This approach, however, would for example permit an adviser managing $200 million in private fund assets simply to reorganize as two separate advisers, each of which could purport to rely on the private fund adviser exemption. While the exemption would in our view be inconsistent with the intent of Congress in establishing the exemption’s $150 million threshold and would violate section 208(d) of the Advisers Act, which prohibits any person from doing indirectly or through or by any other person any act or thing which would be unlawful for such person to do directly. Accordingly, we would treat as a single adviser two or more affiliated advisers that are separately organized but operationally integrated, which could result in a requirement for one or both advisers to register.506 Some commenters

\[\text{496 We have provided guidance as to whether certain activities would result in an investment adviser representative having a place of business as defined in rule 203A–3(b), which we believe also is applicable to an adviser's determination as to whether it has a U.S. place of business under rule 222–1(c) under rule 203(m)–1 or rule 203(a)(30)–1. We have explained that the definition in rule 203A–3(b) "encompasses permanent and temporary offices as well as other locations at which an adviser may provide advisory services, such as a hotel or auditorium." (Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Act Release No. 1633 [May 15, 1997] [62 FR 28112 (May 22, 1997)].) We further explained that whether a temporary office or location is a place of business "will turn on whether the adviser representative has let it generally be known that he or she will conduct advisory business at the location, rather than on the frequency with which the adviser representative conducts advisory business there."}

\[\text{497 See rule 202(a)(30)–1(c)(1); instructions to Item 5.F of Form ADV, Part 1A. As discussed above, we are taking the same approach under rule 203(m)–1. See supra Section II.B.2.a.}

\[\text{498 See supra Section II.B.2.a; Implementing Adopting Release, supra note 32, discussion at section II.A.3.}

\[\text{499 See Seward Letter.}

\[\text{500 See supra Section II.B.2.a; Implementing Adopting Release, supra note 32, discussion at section II.A.3. A few commenters raised the same arguments in favor of revising the method of calculation also with respect to the calculation under the foreign private adviser exemption. See, e.g., ABA Letter; EFAMA Letter; Katten Foreign Advisers Letter (arguing that the method should exclude proprietary and knowledgeable employee assets, and assets for which the adviser receives no compensation).}

\[\text{501 See Implementing Adopting Release, supra note 32, discussion at section II.A.3. In addition, several commenters requested that we exercise our authority to increase the $25 million asset threshold applicable to the foreign private adviser exemption. See, e.g., ABA Letter ($100 million); AFGE Letter ($150 million); AIMA Letter (at least $100 million); Comment Letter of Autorité des Marchés Financiers (Jan. 18, 2011) ($150 million); EVCA Letter ($100 or $150 million); DLA Piper VC Letter ($250 million); Fulbright Letter ($500 million). We acknowledged in the Proposing Release that Section 204 of the Advisers Act provides us with the authority to raise the threshold, but we did not propose to do so. Therefore, we have not considered raising the threshold in connection with this rulemaking, but we will evaluate whether doing so may be appropriate in the future, consistent with a comment we received Letter (asked that we "monitor this issue * * * undertake dialogue with foreign regulators with respect to their supervisory regimes over investment advisers, and * * consider proposing an increase in the exemption amount in the near future.")}

\[\text{502 See, e.g., Pay to Play Release, supra note 9, at nn.391–94 and accompanying and following text; Hedge Fund Adviser Registration Release, supra note 14, at n.243.}

\[\text{503 See, e.g., AFGE Letter (in determining exemption thresholds, each entity’s assets should be determined separately; does not support combining different entities with different business activities); Debevoise Letter (in context of rule 203(m)–1).}

\[\text{504 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}

\[\text{505 See, e.g., AFGE Letter (in determining exemption thresholds, each entity’s assets should be determined separately; does not support combining different entities with different business activities); Debevoise Letter (in context of rule 203(m)–1).}

\[\text{506 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}
accompanying text.

In the Unibanco letters, the staff provided assurances that it would not recommend enforcement action against the substantive provisions of the Advisers Act with respect to a non-U.S. adviser's relationships with its non-U.S. clients. In addition, and as relevant here, the staff agreed not to recommend enforcement action if a non-U.S. advisory affiliate of a registered adviser, often termed a "participating affiliate," shares personnel with, and provides certain services through, the registered adviser affiliate, without such advice registering under the Advisers Act. Many commenters asserted that affirming these positions would accommodate established business practices of global advisory firms without reducing the Commission's ability to protect U.S. markets and investors, because the Commission would continue to have access to records and personnel of unregistered non-U.S. advisory entities that are involved in the U.S. advisory business of an affiliated and registered adviser.

A number of commenters asserted that the staff positions in the Unibanco letters are consistent with our approach to the territorial application of the Advisers Act with respect to non-U.S. advisers. As we stated in 2004, we do not apply most of the substantive provisions of the Advisers Act to the non-U.S. clients of a non-U.S. adviser registered with the Commission.

III. Certain Administrative Law Matters

The effective date for rules 203(l)–1, 203(m)–1 and 202(a)(30)–1 is July 21, 2011. The Administrative Procedure Act generally requires that an agency publish a final rule in the Federal Register not less than 30 days before its effective date. This requirement does not apply, however, if the rule is a substantive rule which recognizes an exemption or relieves a restriction or is an interpretative rule.

As discussed above, effective July 21, 2011, the Dodd-Frank Act amends the Advisers Act to eliminate the private adviser exemption in pre-existing sections 203(b)(3), which will require advisers relying on that exemption to register with the Commission as of July 21, 2011 unless another exemption is available. Also effective July 21, 2011, are the Dodd-Frank Act amendments to the Advisers Act that are described immediately below. Sections 203(l) and 203(b)(3) of the Advisers Act provide exemptions from

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 14. The staff noted, 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.

Our staff has provided assurances that it would not recommend enforcement action in situations in which the unregistered non-U.S. adviser, often termed a "participating affiliate" in these letters, and its registered affiliate are separately organized; the registered firm has its own management staff located in the U.S. or abroad who are capable of providing investment advice and who are independent of the participating affiliate involved in U.S. advisory activities are deemed "associated persons" of the registered firm and the Commission's ability to protect U.S. markets and investors is not compromised.

Generally, the staff has provided assurances that it will not recommend enforcement action in situations in which the unregistered non-U.S. adviser, often termed a "participating affiliate" in these letters, and its registered affiliate are separately organized; the registered firm has its own management staff located in the U.S. or abroad who are capable of providing investment advice and who are independent of the participating affiliate involved in U.S. advisory activities are deemed "associated persons" of the registered firm and the Commission's ability to protect U.S. markets and investors is not compromised.
registration for advisers to venture capital funds and foreign private advisers, respectively. Rule 203(l)–1 defines venture capital fund, and rule 202(a)(30)–1 defines several terms in the definition of “foreign private adviser” in section 202(a)(30). Thus, these interpretative rules implement the new venture capital and foreign private adviser exemptions added to the Advisers Act by the Dodd-Frank Act.

Section 203(m) of the Advisers Act, as amended by the Dodd-Frank Act, directs the Commission to provide an exemption for advisers solely to private funds with assets under management in the United States of less than $150 million. Rule 203(m)–1, which implements section 203(m), grants an exemption and relieves a restriction and in part has interpretative aspects.

Accordingly, we are making the rules effective on July 21, 2011.

IV. Paperwork Reduction Analysis

The rules do not contain a “collection of information” requirement within the meaning of the Paperwork Reduction Act of 1995. Accordingly, the Paperwork Reduction Act is not applicable.

V. Cost-Benefit Analysis

As discussed above, we are adopting 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 they are eligible for a new exemption. Thus, the benefits and costs associated with registration for advisers that are not eligible for an exemption are attributable to the Dodd-Frank Act. Moreover, the Dodd-Frank Act provides that, unlike an adviser that is specifically exempt pursuant to section 203(b), an adviser relying on an exemption provided by section 203(l) of the Advisers Act or rule 203(m)–1 thereunder may be subject to reporting and recordkeeping requirements.

Hence, the benefits and costs associated with being an exempt reporting adviser, relative to being an adviser that is registered or specifically exempted by reason of section 203(b), 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 rules that we are adopting to implement the exemptions discussed in this Release.

We are sensitive to the costs and benefits imposed by our rules, and understand that there will be costs and benefits associated with complying with the rules we are adopting today. We recognize that certain aspects of these rules may place burdens on advisers that seek to qualify for the various exemptions discussed in this Release. We believe that these rules, as modified from the proposed version, provide clarity for advisers seeking to qualify for the exemptions. We have designed the rules to balance these concerns with respect to potential costs and burdens with what we understood was intended by Congress.

In the Proposing Release, we identified possible costs and benefits of the proposed rules and requested comment on the analysis, including identification and assessment of any costs and benefits not discussed in the analysis. We requested that commenters provide analysis and empirical data to support their views on the costs and benefits associated with the proposals. In addition, we requested confirmation of our understanding of how advisers that may seek to rely on the exemptions operate and manage private funds and how the proposals may affect them and their businesses.

A. Definition of Venture Capital Fund

We define a venture capital fund as a private fund that: (i) Holds no more than 20 percent of the fund’s capital commitments in non-qualifying investments (other than short-term holdings) (“qualifying investments” generally consist of equity securities of “qualifying portfolio companies” and are discussed below); (ii) does not borrow or otherwise incur leverage, other than limited short-term borrowing (excluding certain guarantees of qualifying portfolio company obligations by the fund); (iii) does not offer its investors redemption or other similar liquidity rights except in extraordinary circumstances; (iv) represents itself as pursuing a venture capital strategy to investors; and (v) is not registered under the Investment Company Act and has not elected to be treated as a BDC.

We define “qualifying investments” as: (i) Directly acquired equities; (ii) equity securities issued by a qualifying portfolio company in exchange for directly acquired equities issued by the same qualifying portfolio company; and (iii) equity securities issued by a company of which a qualifying portfolio company is a majority-owned subsidiary, or a predecessor, and is received in exchange for directly acquired equities of the qualifying portfolio company (or securities exchanged for such directly acquired equities). We define a “qualifying portfolio company” as any company that: (i) Is not a reporting company and does not have a control relationship with a reporting company; (ii) does not borrow or issue debt obligations in connection with the investment by the private fund and distribute proceeds of the borrowing or issuance to the private fund in exchange for the private fund investment; and (iii) is not itself a fund (i.e., is an operating company).

The final rule also grandfathers 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 pursues a venture capital strategy; (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”). 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 satisfy all of the elements of the definition of venture capital funds 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”).
We have identified certain costs and benefits, discussed below, that may result from our definition of venture capital fund, including modifications to the proposal. As we discussed in the Proposing Release, the proposed rule was 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 funds such as private equity funds and hedge funds; and (ii) facilitate the transition to the new exemption. As discussed above, we have modified the proposed rule to give qualifying funds greater flexibility with respect to their investments, partly in response to comments we received. The final rule defines the term venture capital fund consistently with what we believe Congress understood venture capital funds to be, and in light of other concerns expressed by Congress with respect to the intended scope of the venture capital exemption. Approximately 26 comment letters addressed the costs and benefits of the proposed rule defining venture capital fund. As discussed below, most of these commenters did not provide empirical data to support their views. However, a number of venture capital advisers commenting on the proposed rule offered observations based upon their experiences managing venture capital funds and presented views on the potential impact of the proposed rule on their businesses and business practices.

1. Benefits

In the Proposing Release, we stated that based on the testimony presented to Congress and our research, we believed that venture capital funds currently in existence would meet most, if not all, of the elements of our proposed definition of venture capital fund. Several commenters agreed that the proposed rule is consistent with Congressional intent. Many venture capital advisers acknowledged that the proposed definition would generally encompass most venture capital investing activity that typically occurs, but expressed the concern that a venture capital fund may, on occasion, deviate from its typical investing pattern with the result that the fund could not satisfy all of the definitional criteria under the proposed rule with respect to each investment all of the time. Several commenters also expressed the concern that the final rule should provide sufficient flexibility to accommodate future business practices that are not known or contemplated today.

For the reasons discussed above, we have modified the definition of venture capital fund. Our modifications include specifying a non-qualifying basket and excluding from the 120-day limit with respect to leverage certain guarantees of portfolio company obligations by a qualifying fund. For the reasons discussed in greater detail above, we are adopting a limit of 20 percent for non-qualifying investments. In summary, the non-qualifying basket is designed to address commenters’ concerns regarding occasional deviations from typical venture capital investing activity, inadvertent violations of the definitional criteria and flexibility to address evolving or future business practices. We considered these comments in light of our concerns that the exemption not be expanded beyond what we believe was the intent of Congress and that defined so as to prevent it from undermining the requirement all other fund managers register. We believe that the language in the proposed rule meets this goal. Sen. Levin Letter (“[T]he proposed definition captures the essence of venture capital firms whose mission is to encourage the development and expansion of new business.”). See also DuFauchard Letter (“Congressional directives require the SEC to exclude private equity funds, or any fund that pivots its investment strategy on the use of debt or leverage, from the definition of VC Fund.”). Cook Children’s Letter (“The Commission’s definition of a venture capital fund does a thorough job capturing many of the aspects that differentiate venture capital funds from other types of private investment funds.”). Leland Fikes Letter; NVCA Letter (“[T]he Proposed Rules are generally consistent with existing venture capital industry practice.”). See also CompliGlobe Letter; BLA Piper VC Letter. See, e.g., ATV Letter; BIO Letter; NVCA Letter; Sevin Rosen Letter.

33 The SEC has generally discussed at text immediately preceding text accompanying n.273. See supra notes 36–37 and accompanying and following text. See also infra note 535. See supra discussion at Section II.A. See, e.g., ATV Letter; NVCA Letter; NVCA Letter; Sevin Rosen Letter; SVB Letter; Trident Letter. See supra note 26, at section IV.A.1. AFL–CIO Letter (“[T]he SEC has generally provided appropriate definitions for each of the factors.”). AFR Letter (“[W]e believe that the exemption ultimately created in the [Dodd-Frank Act] for venture capital funds must be narrowly

532 See Proposing Release, supra note 26, discussion at text immediately preceding text accompanying n.273.

533 See generally Section II.A.1.

534 See supra notes 36–37 and accompanying and following text. See also infra note 535.

535 See supra discussion at Section II.A.

536 See, e.g., ATV Letter; NVCA Letter; OAK Investments Letter; Sevin Rosen Letter; SVB Letter; Trident Letter.

537 Proposing Release, supra note 26, at section IV.A.1.

538 AFL–CIO Letter (“[T]he SEC has generally provided appropriate definitions for each of the factors.”). AFR Letter (“[W]e believe that the exemption ultimately created in the [Dodd-Frank Act] for venture capital funds must be narrowly

539 Rule 203(l)–1(a)(2).

540 Rule 203(l)–1(a)(3).

541 See generally Section II.A.

542 See supra note 56.

543 See supra note 58.

544 See supra note 56.

545 See supra notes 45 and 61 and accompanying text.

546 See supra note 60.

547 See supra note 72 and following text.

548 For example, the final rule does not specify that a qualifying fund must provide managerial assistance or exercise sufficient control in order to satisfy this element of the proposed definition. See, e.g., ESP Letter; Merkl Letter. The final rule also allows a qualifying fund to exclude investments in market funds from the non-qualifying basket. A number of commenters indicated that market funds are typically used by venture capital funds for cash management purposes. See, e.g., NVCA Letter. We expect that these modifications to the rule would avoid the cost of altering an advisor’s existing business practices.

549 See, e.g., NVCA Letter; Oak Investments Letter; Quaker BioVentures Letter. See also supra discussion at Section II.A.1.

550 See, e.g., NVCA Letter; Quaker BioVentures Letter. See also supra note 856.

551 See, e.g., NVCA Letter (stating that a low level of 15% would “allow innovation and job creation to flourish within the venture capital industry”). See also supra note 856.

552 See, e.g., NVCA Letter; Quaker BioVentures Letter. See also supra note 856.

553 See, e.g., NVCA Letter; Oak Investments Letter; Quaker BioVentures Letter. See also supra note 856.

554 See, e.g., NVCA Letter; Oak Investments Letter; Quaker BioVentures Letter. See also supra note 856.

555 See, e.g., NVCA Letter (stating that a low level of 15% would “allow innovation and job creation to flourish within the venture capital industry”). See also supra note 856.

556 See, e.g., NVCA Letter; Quaker BioVentures Letter. See also supra note 856.
its typical business practices. Other commenters maintained that an approach providing advisers some flexibility on occasion to take advantage of promising investment opportunities that might not be typical of most venture capital activity would benefit those funds and their investors.

We anticipate that a number of benefits, described by commenters, may result from allowing qualifying funds limited investments in non-qualifying investments, including publicly traded securities, securities that are not equity securities (e.g., non-convertible debt instruments) and interests in other private funds. For example, increasing the potential pool of investors that could provide financing to publicly traded companies to include venture capital funds could facilitate access to capital for a portfolio company’s expansion and growth. Including investments that are not equity securities could offer funds seeking to qualify as venture capital funds the flexibility to structure an investment in a manner that is most appropriate for the fund (and its investors), including for example to obtain favorable tax treatment, manage risks (such as bankruptcy protection), maintain the value of the fund’s equity investment or satisfy the specific financing needs of a portfolio company. Including non-convertible bridge financing also would enable a portfolio company to seek such financing from venture capital funds if it is unable to obtain financing from traditional lending sources. In addition, permitting qualifying funds to invest in other underlying private funds could facilitate capital formation and enhance liquidity for the underlying private funds. Under the final rule, qualifying funds also would have increased flexibility to invest in portfolio companies through secondary market transactions. Commenters asserted that this would help align the interests of portfolio company founders with the interests of venture capital funds and prevent dilution of the venture capital fund’s investment in the portfolio company. Under the final rule, the non-qualifying basket is determined as a percentage of a qualifying fund’s capital commitments, and compliance with the 20 percent limit is determined each time a qualifying fund makes any non-qualifying investment (excluding short-term holdings). We expect that calculating the size of the non-qualifying basket as a percentage of a qualifying fund’s capital commitments, which will remain relatively constant during the fund’s term, will provide advisers with a degree of predictability when managing the fund’s portfolio and determining how much of the fund is available for new investments. Moreover, we believe that by applying the 20 percent limit only as of the time of acquisition of each non-qualifying investment, a fund is able to determine prospectively how much it can invest in the non-qualifying basket. We believe that this approach to determining the non-qualifying basket will appropriately limit a qualifying fund’s non-qualifying investments and ease the burden of determining compliance with the criterion under the rule.

As discussed above, a qualifying fund can only invest up to 20 percent of its capital commitments in non-qualifying investments, as measured immediately after it acquires any non-qualifying investment. The final rule treats as a qualifying investment any equity security of a qualifying portfolio company, or a company acquiring the qualifying portfolio company, that is exchanged for directly acquired equities issued by the qualifying portfolio company. This definition should benefit venture capital funds because it allows funds to participate in the reorganization of the capital structure of a portfolio company. It also provides qualifying funds with liquidity and an opportunity to take profits from their investments because they can acquire securities in connection with the acquisition (or merger) of a qualifying portfolio company by another company—typical means by which venture capital funds exit an investment.

The final rule excludes from the 120-day limit with respect to leverage any venture capital fund guarantees of portfolio company indebtedness, up to the value of the fund’s investment in the company. We agree with several commenters who stated that guarantees of portfolio company indebtedness under these circumstances will facilitate a portfolio company’s ability to obtain credit for working capital or business operations. Thus, we believe this provision, which is designed to accommodate existing business practices typical of funds. In addition, a portfolio company can obtain financing for working capital or expansion needs from typical lenders, effect shareholder buyouts and conclude a simultaneous debt and equity offering, without affecting the adviser’s eligibility for the venture capital exemption. For the foregoing reasons, commenters maintained, and we agree, that this approach would facilitate compliance with the rule without restricting a portfolio company’s access to financing or other capital. We believe that this provision of the final rule will benefit venture capital funds and their investors because it restricts a portfolio company’s ability to incur debt that may implicate Congressional concerns regarding the use of leverage and effectively distinguishes advisers to venture capital funds from advisers to leveraged buyout private equity funds for which Congress did not provide an exemption.
Our final rule clarifies that an adviser seeking to rely on the venture capital exemption may treat as a private fund any non-U.S. fund managed by the adviser that does not offer its securities in the United States or to U.S. persons. This treatment will enable an adviser to rely on the exemption when it manages only funds that satisfy the venture capital fund definition, regardless of the funds’ jurisdiction of formation and investor base. We believe that this treatment facilitates capital formation and competition because it would allow an adviser to sponsor and advise funds in different jurisdictions in order to meet the different tax or regulatory needs of the fund’s investors without risking the availability of the exemption.

The final rule includes several other characteristics that provide additional flexibility to venture capital advisers and their funds. For example, a qualifying fund cannot provide its investors with redemption or other liquidity rights except in extraordinary circumstances. Although venture capital funds typically do not permit investors to redeem their interests during the life of the fund, the approach of the final rule allows a venture capital fund to respond to extraordinary events, including redeeming investors from the fund, without resulting in a registration obligation for the fund’s adviser. Under the final rule, a venture capital fund must affirmatively represent itself as pursuing a venture capital strategy to its investors, a criterion designed to preclude advisers to create private funds from claiming an exemption from registration for which they are not eligible. We believe that this element will 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.

Because it takes into account existing business practices of venture capital funds and permits some flexibility for venture capital funds (and their managers) to adopt, or adapt to, new or evolving business practices, we believe that the final rule will facilitate advisers’ transition to the new exemption. The rule generally limits investments of a qualifying fund, but creates a basket that will allow these funds flexibility to make limited investments that may vary from typical venture capital fund investing practices. The final rule also provides an adviser flexibility and discretion to structure transactions in underlying portfolio companies to meet the business objectives of the fund without creating significant risks of the kind that Congress suggested should require registration of the fund’s adviser. We expect that this flexibility will permit investment advisers that seek to rely on the venture capital exemption because they will be more easily to structure and operate funds that meet the definition now and in the future, but will not permit reliance on the exemption by private fund advisers that Congress did not intend to exclude from registration.

Our final rule also should benefit advisers of existing venture capital funds that fail to meet the definition of venture capital fund. Our grandfathering provision permits an adviser to rely on the exemption provided that each fund that does not satisfy the definition (i) has represented to investors that it pursues a venture capital strategy, (ii) has initially sold interests by December 31, 2010, and (iii) does not sell any additional interests after July 21, 2011. We expect that most advisers to existing venture capital funds that currently rely on the private adviser exemption would be exempt from registration in reliance on the grandfathering provision. As a result of this provision, we expect that advisers to existing venture capital funds that do not meet our definition will benefit because they can 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 definition and (ii) incur the costs associated with registration with the Commission or modification of existing funds. Advisers to venture capital funds that were launched 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. We believe that the grandfathering provision will promote efficiency because it will allow advisers to existing venture capital funds to continue to rely on the exemption without having to restructure those funds within the limited period before the rule is effective. After the effective date, advisers that seek to form new funds will have sufficient time and notice to structure those funds to meet the definition should they seek to rely on the exemption in section 203(l) of the Advisers Act.

Finally, we believe that our definition would include an additional benefit for investors and regulators. Section 203(l) of the Advisers Act provides an exemption specifically for advisers that “solely” advise venture capital funds. Currently none of our rules requires that an adviser exempt from registration identify the exemption(s) on which they are relying. 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 believe that existing venture capital funds would meet most, if not all, of the elements of the final definition of venture capital fund. Nevertheless, 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 differently to satisfy the definitional criteria under the final rule. To the extent that advisers choose not to

---

568 See note accompanying rule 203(l)-1.
569 See supra notes 255–256 and accompanying text.
570 See Merkl Letter (stating that a description of the investment strategy is a key element of any private placement memorandum).
571 Rule 203(l)-1(b).
572 A number of commenters specifically inquired about the scope of the holding out criterion and noted that under existing business practice venture capital funds may refer to themselves as private equity funds. As we discuss in greater detail above, we do not believe that the name used by a fund is the sole dispositive factor, and that satisfying the holding out criterion will depend on all of the facts and circumstances. See supra Section II.A.7. This criterion is similar to our general approach to antifraud provisions under the Federal securities laws and our rules.
573 Many commenters supported the grandfathering provision, and one specifically cited the benefit of avoiding the need to alter fund terms to the potential detriment of fund investors. AV Letter.
574 See Implementing Adopting Release, supra note 32, at n.175 and accompanying text.
change how they structure or manage new funds they launch, those advisers would have to register with the Commission, 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 solely to venture capital funds.

As noted above, we proposed, and are retaining in the final rule, 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, and the testimony before Congress that stressed the lack of leverage in venture capital investing. 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.

We believe that investors will benefit from enhanced disclosure and oversight of the activities of private fund advisers by regulators, which in turn could contribute to a more efficient allocation of capital.

2. Costs

Costs for advisers to existing venture capital funds. As we discussed in the Proposing Release and above, we do not expect that the definition of venture capital fund would result in significant costs for unregistered advisers to venture capital funds currently in existence and operating. We estimate that currently there are 791 advisers to venture capital funds.575 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 grandfathering provision.576 We anticipate that such advisers to grandfathered funds will incur minimal costs, if any, 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.

We recognize, however, that advisers to funds that were launched by December 31, 2010 but have not concluded offerings to 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, 2011.577 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 funds that pursue a venture capital strategy to their potential investors and the typical fundraising period for a venture capital fund is approximately 12 months.578 Thus, we do not anticipate that venture capital fund advisers would have to alter typical business practices 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.

To the extent that an existing adviser could not rely on the grandfathering provision with respect to funds in formation, we also expect that the adviser would not be required to modify its business practices significantly in order to rely on the exemption. Our final rule includes many modifications requested by commenters, such as the non-qualifying basket, and as a result, we expect that these modifications would reduce some of the costs associated with modifying current business practices to satisfy the proposed definitional criteria that commenters addressed.579 As we discussed in the Proposing Release, supra note 26, at text immediately preceding text accompanying n.273. See supra note 152, at Fig. 1.04 (providing “active” venture capital advisers, as of December 2010, that have raised a venture capital fund within the past eight years; 456 of the total number of venture capital advisers manage less than $100 million in capital).

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 Investment Advisers Act or rule 203(m)–1 thereunder) would incur, on average, $2,311 per year to complete and update related reports on Form ADV, including Schedule D information relating to private funds. See Implementing Adopting Release, supra note 32, at section V.B.2. This estimate includes internal costs to the adviser of $2,032 to prepare and submit an initial report on Form ADV and $275 to prepare and submit annual amendments to the report. These estimates are based on the following calculations: $2,032 = ($4,064,000 aggregate costs for 262 advisers); $275 = ($558,800 aggregate costs for 2,000 advisers). Id. at nn.579–581 and accompanying text. We estimate that approximately two exempt reporting advisers would file Form ADV–H annually at a cost of $189 per filing. Id., at n.596 and accompanying text. We further estimate that three exempt reporting advisers would file Form ADV–NR per year at a cost of $186 per year. Id., at nn.598–602 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 598. These estimates, some of which differ from the estimates included in the Proposing Release, supra note 26, are discussed in more detail in the Implementing Adopting Release, supra note 32, at section V.B.2.576

As discussed in the Proposing Release, supra note 26, 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 those required by 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. See Proposing Release, supra note 26, at n.293. We did not receive any comments on these cost estimates.

581 We did not receive any comments on the dates specified in the grandfathering provision. See supra note 307.

582 See supra note 572.

583 See supra note 241, 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 242, at 22.

584 See, e.g., Charles River Letter; Gunderson Dettmer Letter; NVCA Letter (arguing that as proposed the rule would have required venture capital fund advisers to modify their business practices in order to be eligible for the exemption).

585 See also ABA Letter; David Duke Letter; SVB Investment Letter; Charles River Letter; Gunderson Dettmer Letter; NVCA Letter (arguing that as proposed the rule would have required venture capital fund advisers to modify their business practices in order to be eligible for the exemption).
discuss above, we believe that the final rule better reflects venture capital activity conducted by venture capital advisers that are likely to seek to rely on the exemption, and provides flexibility that will allow these funds to take advantage of new investment opportunities. To the extent that some commenters expressed concerns that they would have to divert personnel time from other functions to monitoring inadvertent failures to meet the definitional elements, we believe that the greater investment flexibility provided by the rule would offset most of these compliance costs.

Our rule does not provide separate definitional criteria for non-U.S. advisers seeking to rely on the exemption. These advisers might incur costs to the extent that cash management instruments they typically acquire may not be “short-term holdings” for purposes of the definition.587 We expect that these costs would be mitigated, however, to the extent that these advisers can continue to acquire these instruments using the non-qualifying basket.

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 will incur one-time “learning costs” to determine how to structure new funds they may manage to meet the elements of our definition. We estimate that on average, there are 23 new advisers to venture capital funds each year.588 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 definition may affect intended business practices.589 Thus, we estimate the aggregate cost to existing advisers of determining how the definition would affect funds they

587 See, e.g., EFAMA Letter (asserting that a non-U.S. fund could not invest in non-U.S. equivalent cash holdings under the proposed rule).
588 This is the average annual increase in the number of venture capital advisers between 1981 and 2010. See NVCA Yearbook 2010, supra note 150, at Fig. 1.04; NVCA Yearbook 2011, supra note 152, at Fig. 1.04.
589 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 definition, depending on the expertise of the firm and its familiarity with the elements of the 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.
590 This estimate is based on the following calculations: 23 × $2,800 = $64,400; 23 × $4,800 = $110,400. We did not receive any comments on these cost estimates.
591 For estimates of the costs of registration for those advisers that would choose to register, see infra notes 597–600.
592 Proposing Release, supra note 26, at Section V.A.1.
593 See supra note 51.
594 See supra note 52.
595 This is the average annual increase in the number of venture capital advisers between 1981 and 2010. See NVCA Yearbook 2010, supra note 150, at Fig. 1.04; NVCA Yearbook 2011, supra note 152, at Fig. 1.04.
596 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 definition, depending on the expertise of the firm and its familiarity with the elements of the 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.
597 See, e.g., Lowenstein Letter; NVCA Letter; Venrock Letter.
598 See, e.g., “Asia’s Cash-Poor Small Hedge Funds Vulnerable to U.S. Rules,” Bloomberg.com (Feb. 23, 2011) (identifying two fund of funds managers that either require or prefer to allocate client assets to advisers registered with the Commission).
incure the costs associated with registration (assuming the adviser could not rely on the private fund adviser exemption). We note that the costs of registration for advisers that do not qualify for the venture capital fund adviser exemption flow from the Dodd-Frank Act, which removed the private adviser exemption on which they currently rely.

We estimate that the internal cost to register with the Commission would be $15,077 on average for a private fund adviser, excluding the initial filing fees and annual filing fees to the Investment Adviser Registration Depository (“IARD”) system operator. These registration costs include the costs attributable to completing and periodically amending Form ADV, preparing brochure supplements, and delivering codes of ethics to clients. 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 $5,000 to $50,000.

New registrants would also face costs to bring their business operations into compliance with the Advisers Act and the rules thereunder. These costs, however, will vary significantly among advisers depending on the adviser’s size, the scope and nature of its business, and the sophistication of its compliance infrastructure, but in any case would be an ordinary business and operating expense of entering into any business that is regulated.

We estimated in the Proposing Release 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. Some commenters suggested that these estimates are too low. Commenters identifying themselves as “middle market private equity fund” advisers estimated that they would incur one-time registration and compliance costs ranging from $50,000 to $600,000, followed by ongoing annual compliance costs ranging from $50,000 to $500,000. Commenters identifying themselves as advisers to venture capital funds, however, provided much lower estimates for one-time registration and compliance costs ranging from $75,000 to $200,000, followed by ongoing annual compliance costs ranging from $50,000 to $150,000.

Although some advisers may incur these costs, the costs of compliance for a new registrant can vary widely among advisers depending on their size, activities, and the sophistication of their existing compliance infrastructure. Advisers, whether registered with us or not, may have established compliance infrastructures to fulfill their fiduciary duties towards their clients under the Advisers Act. Generally, costs will likely be less for new registrants that have already established sound compliance practices and more for new registrants that have not yet established sound practices.

For example, some commenters specifically included in their costs estimates compensation costs for hiring a dedicated chief compliance officer (“CCO”). Our compliance rule, however, does not require advisers to hire a new individual to serve as a full-time CCO, and the question of whether an adviser can look to existing staff to fulfill the CCO requirement internally is firm-specific.

Comment Letter of Crestview Advisors, LLC (Jan. 19, 2011) (“Crestview Letter”) (estimating annual costs of $300,000–$500,000); Comment Letter of Azealea Capital (Feb. 17, 2011) (“Azealea Letter”) (estimating $50,000 to $100,000 per year); Comment Letter of Gen Cap America, Inc. (Jan. 21, 2011) ("Gen Cap Letter") (estimating $150,000–$250,000 per year) (estimating between $500,000–$1,000,000 for annual registration and compliance costs ranging from $50,000 to $600,000 (exclusive of salary costs for a CCO)).
Although we recognize that some newly registering advisers will need to designate someone to serve as CCO on a full-time basis, we expect these will be larger advisers—those with many employees and a sizeable amount of investor assets under management. Because there is no currently-available comprehensive database of unregistered advisers, we cannot determine the number of these larger advisers in operation. These larger advisers that are not yet registered likely already have personnel who perform similar functions to a CCO, in order to address the adviser’s liability exposure and protect its reputation.

In smaller advisers, the designated CCO will likely also fill another function in the adviser, and perform additional alongside compliance matters. Advisers designating a CCO from existing staff may experience costs that result from shifting responsibilities among staff or additional compensation, to the extent the individual is taking on additional compliance responsibilities or giving up other non-compliance responsibilities. Costs will vary from adviser to adviser, depending on the extent to which an adviser’s staff is already performing some or all of the requisite compliance functions, the extent to which the CCO’s non-compliance responsibilities need to be lessened to permit allocation of more time to compliance responsibilities, and the value to the adviser of the CCO’s non-compliance responsibilities.

Some commenters asserted that the costs of ongoing compliance would be substantial. We anticipate that there may be a number of currently unregistered advisers whose 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. There likely are other currently unregistered advisers, however, who will face additional ongoing costs to conduct their operations in compliance with the Advisers Act, and these costs may be significant for some of these advisers.

We do not have access to information that would enable us to determine these additional ongoing costs, which are predominantly internal to the advisers themselves. Incremental ongoing compliance costs will vary from adviser to adviser depending on factors such as the complexity of each adviser’s activities, the business decisions it makes in structuring its response to its compliance obligations, and the extent to which it is already conducting its operations in compliance with the Advisers Act. Indeed, the broad range of estimated costs we received reflects the individualized nature of these costs and the extent to which they may vary even among the relatively small number of commenters who provided cost estimates.

Some commenters expressed concern that compliance costs would be prohibitive in relation to their revenues or in relation to their size or activities. We note, however, that an adviser is required to adopt policies and procedures that take into consideration the nature of that adviser’s operations. We have explained that, accordingly, we would expect smaller advisers without conflicting business interests to require much simpler policies and procedures than larger advisers that, for example, have multiple potential conflicts as a result of their other lines of business or their affiliations with other financial service firms. The preparation of these simpler policies and procedures and their administration should be much less burdensome.

We also note that approximately 570 smaller advisers currently are registered with us. These advisers have absorbed the compliance costs associated with registration, notwithstanding the fact that their assets under management are likely to be smaller than those of an adviser managing one venture capital fund of average size (e.g., with $107.8 million in venture capital under management) that may be required to register because it cannot rely on the venture capital exemption or the private fund adviser exemption. Moreover, as we explained in the Proposing Release, 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. Finally, as we noted in the Proposing Release, to the extent there would be an increase in registered advisers, there are benefits to registration for both investors and the Commission.

We do not believe that the 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 definition, as revised, reflects the way most venture capital funds currently operate. Thus, for example, we eliminated the managerial assistance criterion in the proposed definition, expanded the short-term instruments in which venture capital funds can invest and provided for a non-qualifying basket. These elements in the proposal could have resulted in costs to advisers that manage venture capital funds with business or cash management practices inconsistent with those proposed criteria and that sought to rely on the exemption. As a result, we expect that the 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 rule is likely to have a significant effect on overall capital formation.

Other Costs. Some commenters argued in favor of a narrow definition of venture capital fund in order to preclude advisers to other types of funds from relying on the definition.618 One commenter expressed the concern that the definition should be narrow so that advisers generally would be subject to a consistent regulatory regime,619 and another supported incorporating substantive Advisers Act rules, such as custody, as a condition for reliance on the various exemptions in order to protect investors.620 To the extent that our final rule includes broader criteria and results in fewer registrants under the Advisers Act, we acknowledge that this could have an adverse impact on investors.621

Moreover, to the extent that our final rule includes broader criteria and results in fewer registrants, this could also reduce the amount of information available to regulators with respect to venture capital advisers relying on the exemption. Under the final rule, immediately after it acquires any non-qualifying investment (excluding short-term holdings), no more than 20 percent of a qualifying fund’s capital commitments may be held in non-qualifying investments (excluding short-term holdings). As a result, initially, and possibly for a period of time during the fund’s term (subject to compliance with the other elements of the rule), it may be possible for non-qualifying investments to comprise most of a qualifying fund’s investment portfolio. The proposal would have required a qualifying fund to be comprised entirely of qualifying investments, which would have enabled regulators and investors to confirm with relative ease at any point in time whether a fund satisfied the definition. Modifying the definition to include a non-qualifying basket determined as a percentage of a qualifying fund’s capital commitments may increase the monitoring costs that regulators and investors may incur in order to verify that a fund satisfies the definition, depending on the length of the fund’s investment period and the frequency with which the fund invests in non-qualifying investments.

A number of commenters expressed concerns with certain elements of the proposed rule, which we are not modifying. Several commenters suggested that the rule specify that the leverage limit of 15 percent be calculated without regard to uncalled capital commitments because they were concerned about the potential for excessive leverage.622 We acknowledge that a leverage limitation which includes uncalled capital commitments could result in a fund incurring, in the early stages of the fund’s life, a significant degree of leverage by the fund relative to the fund’s overall assets. We believe, however, that the 120-day limit would mitigate the effects of any such leverage that is incurred by a venture capital fund seeking to satisfy the definition.

Several commenters also argued that the definition of qualifying portfolio company should include certain subsidiaries that may be owned by a publically traded company, such as research and development subsidiaries, that may seek venture capital funding.623 As a result of our final rule, these types of subsidiaries may have reduced access to capital investments by qualifying funds, although this cost would be mitigated by a qualifying fund’s investments made through the non-qualifying basket.

Other commenters argued that the definition of venture capital fund should include funds of venture capital funds.624 We have not modified the rule to reflect this request, because we do not believe that defining the term in this manner is consistent with the intent of Congress.625 To the extent that an advisor to a fund of venture capital funds ceases business or ceases to offer services or changes fund structure, the rule would require a reexamination of the advisor’s qualification to advise the fund of venture capital funds.626 As a result, it was not possible to conclude that the same amount of assets under management as reported by one of a fund of venture capital funds would be comparable because either adviser could have elected to exclude all or some portion of certain specified assets that it managed.

We expect that specifying in rule 203(m)–1 that assets under management must be calculated according to the instructions to Form ADV will increase administrative efficiencies for advisers because they will have to calculate assets under management only once for multiple purposes.628 In addition, we believe this

618 See supra note 43.
619 CalPERS Letter. See also NASAA Letter (supported adding substantive requirements to the grandfathering provision).
620 CPIC Letter.
621 See supra text accompanying and following note 575 (discussing benefits that result from registration).
622 AFR Letter; AVL–CIO Letter.
623 BCLBE Letter; Dechert General Letter; Gunderson Dettmer Letter.
624 See, e.g., Cook Children’s Letter; Merkl Letter; SVB Letter.
625 See supra notes 204–206.
626 See generally Merkl Letter; SVB Letter.
will minimize costs relating to software modifications, recordkeeping, and training required to determine assets under management for regulatory purposes. We also believe that the consistent calculation and reporting of assets under management will benefit investors and regulators because it will 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.

Many commenters generally expressed support for the implementation of a uniform method of calculating assets under management in order to maintain consistency for registration and risk assessment purposes.\(^632\) Indeed, even some commenters who suggested that we revise aspects of the method of calculating regulatory assets under management nonetheless recognized the benefits provided by a uniform method of valuing assets for regulatory purposes.\(^632\)

We believe that the valuation of private fund assets under rule 203(m)–1 will benefit advisers that seek to rely on the private fund adviser exemption. Under rule 203(m)–1, each adviser annually must determine the amount of its private fund assets, based on the market value of those assets, or the fair value of those assets where market value is unavailable.\(^633\) We are requiring advisers to fair value private fund assets so that, for purposes of the exemption, advisers value private fund assets on a meaningful and consistent basis. As we stated in the Proposing Release, 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 that require the use of fair value.\(^634\) We acknowledged in the Proposing Release 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.\(^635\)

### Frequency of Calculations and the Transition Period

Rule 203(m)–1(c) specifies that an adviser relying on the exemption must calculate its private fund assets annually, in accordance with General Instruction 15 to Form ADV, rather than quarterly, as proposed. Advisers registered with us and with the states, and now advisers relying on rule 203(m)–1, must calculate their assets under management for regulatory purposes annually in connection with their annual updating amendments to Form ADV. We expect that requiring these types of advisers to calculate their assets under management for regulatory purposes on the same schedule, and using the same method, will increase efficiencies for these advisers.

The annual calculation also will 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 valuations or, to a less significant extent, quarterly valuations as proposed.\(^636\) Annual calculations

---

\(^{632}\) See supra note 339.

\(^{633}\) See, e.g., Seward Letter ("We agree that a clear and unified approach for calculation of AUM is necessary and we believe that using as a standard the assets for which an adviser has ‘responsibility’ is appropriate"); O’Melveny Letter (argued that the calculation of regulatory assets under management as proposed “does not provide a suitable basis to determine whether a fund adviser should be subject to the SEC’s regulation” but also “agree[s] with the SEC 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 more coherent application of the Advisers Act’s regulatory requirements and of the SEC’s risk assessment program’"); 33

\(^{634}\) See rule 203(m)–1(c) (requiring an adviser to calculate private fund assets annually, in accordance with General Instruction 15 to Form ADV, which together with rule 204–4 requires advisers relying on the exemption to determine their private fund assets annually, in connection with the adviser’s annual updating amendments to its Form ADV. See also rules 203(m)–1(a)(2); 203(m)–1(b)(2); 203(m)–1(d)(1) (defining “assets under management” to mean “regulated assets under management” in item 5.F of Form ADV, Part 1A); 204–4 (requiring “private fund assets” to mean the “assets under management” attributable to a “qualifying private fund”). As discussed above, advisers are not required to fair value real estate assets in certain limited circumstances. See supra note 366 and accompanying text.

\(^{635}\) See Proposing Release, supra note 26, discussion at section V.B and n.196. See also ABA Letter (recommending that the Commission consider using a standard of “fair value” for valuing assets and further recommending that if assets were calculated on a net basis, private funds should be required to prepare audited annual financial statements in accordance with GAAP (or another accounting standard acceptable to the Commission), and to maintain such financial statements under section 203(m)(4)); O’Melveny Letter (agreeing with the statement in the Proposing Release that many private funds value assets based on fair value, and noting that private equity funds in particular are among the private funds that generally do not fair value).

\(^{636}\) See Proposing Release, supra note 26, discussion at section V.B. See also infra Section V.B.2.

\(^{637}\) See, e.g., ABA Letter (“[A] semi-annual or annual measurement period would perhaps be more appropriate, and [] a longer measuring period would provide an adviser that is exempt from registration under the Private Fund Adviser Regulation should 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 because of the lack of frequency with which such assets are traded.”).

\(^{638}\) An adviser relying on the exemption that reports private fund assets of $150 million or more in its annual updating amendment to its Form ADV will not be eligible for the exemption and must register under the Advisers Act unless it qualifies for another exemption. If the adviser has complied with all Commission reporting requirements applicable to an exempt reporting adviser as such, however, it may apply for registration under the Advisers Act up to 90 days after filing the annual updating amendment, and may continue to act as a private fund adviser, consistent with the requirements of rule 203(m)–1, during this transition period.

Exemption assistance in avoiding issues arising from temporary increases in asset values.

\(^{639}\) See ABA Letter ("Asset valuation is a substantial administrative task and is currently undertaken annually for other purposes (for example, Form ADV), so that a requirement for annual valuation would appear to strike a fair balance between ensuring that firms whose AUM is at or above the applicable threshold are ‘captured’ and avoiding both complications with short-term market value fluctuations and over-burdening investment advisers.").
The transition period should benefit certain advisers. As discussed above, an adviser that has “complied with all [Commission] reporting requirements applicable to an exempt reporting adviser as such” may apply for registration with the Commission up to 90 days after filing an annual updating amendment reflecting that the adviser has private fund assets of $150 million or more, and may continue to act as a private fund adviser, consistent with the requirements of rule 203(m)-1, during this transition period.\(^643\) In addition, by requiring annual calculations of private fund assets, we are allowing advisers to whom the transition period is available 180 days after their fiscal year-ends to register under the Advisers Act.\(^644\) We expect that providing these advisers additional time to register will reduce the burdens associated with registration by permitting them to register in a more deliberate and cost-effective manner, as suggested by some commenters.\(^645\)

**Assets under Management in the United States.** Under rule 203(m)-1(a), all of a fund assets of an adviser with a principal office and place of business in the United States are considered to be “assets under management in the United States,” even if the adviser has offices outside of the United States.\(^646\) A non-U.S. adviser must count only private fund assets it manages at a place of business in the United States toward the $150 million limit under the exemption.

As discussed below, we believe that this interpretation of “assets under management in the United States” offers greater flexibility to advisers and reduces many costs associated with compliance.\(^647\) 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 advisory services performed by employees located in another jurisdiction. Most commenters who addressed the issue supported the proposal to treat “assets under management in the United States” as those assets managed at a U.S. place of business.\(^648\)

To the extent that this interpretation may increase the number of advisers subject to registration under the Advisers Act, we anticipate that our rule also will benefit investors by providing more information about those advisers (e.g., information that would become available through Form ADV, Part I). We further believe that this will enhance investor protection by increasing the number of advisers registering pursuant to the Advisers Act and by improving our ability to exercise our 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.\(^649\)

---

\(^642\) See, e.g., Merkli Letter (stated that this interpretation would be easier to apply than the alternative interpretation about which we sought comment which looks to the source of the assets).

\(^643\) See, e.g., Debevoise Letter (“In particular, it is our view that the discussion of the proposed definition of the term ‘assets under management in the United States’ is a fair reflection of the policy underlying Section 203(m) of the Advisers Act (as amended by the Dodd-Frank Act) and is consistent with prior Commission and Staff statements concerning the territorial scope of the Advisers Act.”); MAPIsports Letter; Non-U.S. Adviser Letter (“By adopting a very pragmatic and sensible jurisdictional approach to regulation, the Commission is appropriately recognizing general principles of international comity and the fact that activities performed outside the United States are less likely to implicate U.S. regulatory interests.”). Cf. Sen. Levin Letter (stated that advisers managing assets in the United States of funds incorporated outside of the United States “are exactly the type of investment advisers to which the Dodd-Frank Act’s registration requirements are intended to apply”). See also supra note 386.

\(^645\) By contrast, a U.S. adviser may “solely advise private funds” as specified in the statute. Compare rule 203(m)-1(a)(1) with rule 203(m)-1(b)(1).

\(^646\) See supra note 393 and accompanying text.

\(^647\) See supra Section II.B.3.

\(^648\) See Implementing Adopting Release, supra note 32, discussion at section II.B.
approach to Advisers Act regulation.\textsuperscript{651} For example, one commenter stated that the “jurisdictional approach to only considering U.S. activities for non-U.S. advisors is prudent as it focuses on what causes systematic [sic] risks to the U.S.”\textsuperscript{652} Another noted that non-U.S. persons dealing with non-U.S. advisers would not expect to benefit from the protections provided by the Advisers Act.\textsuperscript{653} Another stated that this approach, together with our interpretation of “assets under management in the United States,” will “avoid the issues associated with conflicting and overlapping regulation.”\textsuperscript{654}

Rule 203(m)–1(b) uses the term “United States person,” which generally incorporates the definition of a “U.S. person” in Regulation S.\textsuperscript{655} We believe that generally incorporating the definition of a “U.S. person” in Regulation S will benefit advisers, because Regulation S provides a well-developed body of law that, in our view, appropriately addresses many of the questions that will arise under rule 203(m)–1. Moreover, advisers to private funds and their counsel currently must be familiar with the definition of “U.S. person” under Regulation S in order to comply with other provisions of the Federal securities laws. Commenters generally supported defining “United States person” by reference to Regulation S, confirming that the definition is well developed and understood by advisers.\textsuperscript{656}

We also are adding a note to rule 203(m)–1 that clarifies that a client will not be considered a United States person if the client was not a United States person at the time of becoming a client of the adviser.\textsuperscript{657} This will benefit non-U.S. advisers, which might, absent this note, incur costs in trying to determine whether they would be permitted to rely on rule 203(m)–1 if one of their existing non-U.S. clients that is not a private fund becomes a United States person, for example if a natural person client residing abroad relocates to the United States.\textsuperscript{658} The non-U.S. adviser could at that time be considered to have a United States person client other than a private fund.

Definition of a Qualifying Private Fund. We proposed to define a “qualifying private fund” as “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).”\textsuperscript{659} We are modifying rule 203(m)–1 to also permit an adviser to treat as a “private fund, and thus as a ‘qualifying private fund,’” an issuer that qualifies for an exclusion from the definition of “investment company,” as defined in section 3 of the Investment Company Act, in addition to those provided by section 3(c)(1) or 3(c)(7) of that Act.\textsuperscript{660} Absent this modification, an adviser to a section 3(c)(1) or 3(c)(7) fund would lose the exemption if the fund also qualified for another exclusion.\textsuperscript{661} For example, an adviser to a section 3(c)(1) or 3(c)(7) fund would lose the exemption if the fund also qualified for another exclusion, even though the adviser may be unaware of the fund so qualifying and the fund does not purport to rely on the other exclusion.

Expanding the range of potential “qualifying private funds,” therefore, should benefit advisers to funds that also qualify for other exclusions by permitting these advisers to rely on the exemption.\textsuperscript{662} It also will prevent advisers from violating the Advisers Act’s registration requirements solely because their funds qualify for another exclusion. In addition, advisers will not be required to recalculate the time and expense required to assess whether the funds they advise also qualify for an additional exclusion.

2. Costs

Assets under Management in the United States. As noted above, under rule 203(m)–1, we 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.\textsuperscript{663} Thus, a U.S. adviser must include all of 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 of the United States.\textsuperscript{664} A non-U.S. adviser therefore would count only the private fund assets it manages at a place of business in the United States, in determining the availability of the exemption. This approach is similar to the way we have identified the location of the adviser for regulatory purposes under our current rules,\textsuperscript{665} and we believe it is the way in which most advisers would have interpreted the exemption without our rule.\textsuperscript{666}

\textsuperscript{651} ABA Letter; Debevoise Letter; Dechert Foreign Adviser Letter; Gunderson Dettmer Letter; Katzen Foreign Advisers Letter; MAP Airports Letter; Merkl Letter; Wellington Letter.

\textsuperscript{652} Wellington Letter.

\textsuperscript{653} Debevoise Letter. See also ABA Letter (“When, in the private fund context, United States investors invest in a non-United States-based investment manager, they understand they are not being afforded the investor protection safeguards of the United States Investment Advisers Act.”); Avoca Letter (“It is reasonable to assume that U.S. investors who purchase shares of a private fund [as defined in section 202(a)(29)] will not expect an investment adviser that has no United States presence to be registered with the U.S. SEC as an investment adviser.”).

\textsuperscript{654} ABA Letter.

\textsuperscript{655} Rule 203(m)–1(d)(8) (defining a “United States person” as any person that is a “U.S. person” as defined in Regulation S, except that any discretionary 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 rule 203(m)–1 and is not organized, incorporated, or (if an individual) resident in the United States). As discussed above, two commenters that generally supported our proposal for the definition of the term “United States person” in Regulation S also urged us to modify our proposed definition in certain respects. See supra notes 409–413 and accompanying text. We decline to accept these suggestions for the reasons discussed in Section II.B.4, and we continue to believe that advisers will benefit from the efficiencies created by our general incorporation of the definition of “U.S. person” in Regulation S.

\textsuperscript{656} AIMA Letter; CompGVille Letter; Debevoise Letter; Dechert General Letter; Gunderson Dettmer Letter; Katzen Foreign Advisers Letter; O'Melveny Letter.

\textsuperscript{657} See supra Section II.B.4.

\textsuperscript{658} See EFAMA Letter (argued that an analogous note in the foreign private adviser exemption, revised consistent with its comments, “also should apply to the ‘private fund adviser exemption’ and the ‘venture capital fund exemption’ ”); FIC Letter (“We ask for clarification from the SEC as to whether it will apply the [analogous note to the foreign private adviser exemption] in other contexts for purposes of compliance with the U.S. Federal securities laws, including compliance with Rule 12g3–2(b) of the 1934 Act.”).

\textsuperscript{659} See proposed rule 203(m)–1(e)(5).

\textsuperscript{660} Rule 203(m)–1(d)(8). An adviser relying on this provision must treat the fund as a private fund under the Advisers Act and the rules thereunder for all purposes (e.g., reporting on Form ADV). Id.

\textsuperscript{661} A fund that qualifies for an additional exclusion would not be a private fund, because a “private fund” is a fund that would be an investment company as defined in section 3 of the Investment Company Act but for section 3(c)(1) or 3(c)(7) of that Act. See supra Section II.B.1. We are modifying rule 203(m)–1 to also permit an adviser to treat as a “private fund, and thus as a ‘qualifying private fund,’” an issuer that qualifies for an exclusion from the definition of “investment company,” as defined in section 3 of the Investment Company Act, in addition to those provided by section 3(c)(1) or 3(c)(7) of that Act. Absent this modification, an adviser to a section 3(c)(1) or 3(c)(7) fund would lose the exemption if the fund also qualified for another exclusion. For example, an adviser to a section 3(c)(1) or 3(c)(7) fund would lose the exemption if the fund also qualified for another exclusion, even though the adviser may be unaware of the fund so qualifying and the fund does not purport to rely on the other exclusion. Expanding the range of potential “qualifying private funds,” therefore, should benefit advisers to funds that also qualify for other exclusions by permitting these advisers to rely on the exemption. It also will prevent advisers from violating the Advisers Act’s registration requirements solely because their funds qualify for another exclusion. In addition, advisers will not be required to recalculate the time and expense required to assess whether the funds they advise also qualify for an additional exclusion.

\textsuperscript{662} See, e.g., Dechert General Letter (argued that advisers should be permitted to treat as a private fund for purposes of rule 203(m)–1 a fund that qualifies for another exclusion from the definition of “investment company” in the Investment Company Act in addition to section 3(c)(1) or 3(c)(7), such as section 3(c)(5)(C), which excludes certain real estate funds). See supra note 385 and accompanying text.

\textsuperscript{663} See supra note 385 and accompanying text.

\textsuperscript{664} See supra note 384 and accompanying text.

\textsuperscript{665} See supra note 385 and accompanying text.

\textsuperscript{666} 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...
We believe that our approach will promote efficiency because advisers are familiar with it, and we do not anticipate that U.S. 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 rule. As noted in the Proposing Release, we expect that non-U.S. advisers may, however, incur minimal costs to determine whether they have assets under management in the United States. We estimate that these costs would be no greater than $6,730 per adviser 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 rule.667

As noted above, because the rule is designed to encourage the participation of non-U.S. advisers in the U.S. market, we believe that it will have minimal regulatory and operational burdens on non-U.S. advisers and their U.S. clients. Non-U.S. advisers may rely on the rule if they manage U.S. private funds with more than $150 million in assets at a non-U.S. location as long as the private fund assets managed at 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.

In contrast to the many commenters who supported our approach, one commenter argued that treating U.S. and non-U.S. advisers differently would disadvantage U.S.-based advisers by permitting non-U.S. advisers to accept substantial amounts of money from U.S. investors without having to comply with certain U.S. regulatory requirements, and would cause advisers to move offshore or close U.S. offices to avoid regulation.668

As we explained in the Proposing Release, we believe that our interpretation recognizes that non-U.S. activities of non-U.S. advisers are less likely to implicate U.S. regulatory interests and is in keeping with general principles of international comity.669 The rule also 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 a non-U.S. adviser's non-U.S. advisory business.670

Non-U.S. advisers relying on rule 203(m)–1 will remain subject to the Advisers Act's antifraud provisions and will become subject to the requirements applicable to exempt reporting advisers. Moreover, the commenter appears to suggest that an adviser that moves offshore to avoid registering under the Advisers Act would not be subject to any regulation as an investment adviser, but we understand that most non-U.S. advisers to private funds locate in major financial centers in jurisdictions that regulate investment advisers. We therefore believe that any competitive consequences to U.S. advisers will be diminished.671

As we acknowledged in the Proposing Release, to avail themselves of rule 203(m)–1, some advisers might choose to move their principal offices and places of business outside of the United States and manage private funds at those locations.672 This could 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 purposes of avoiding registration, however, because, as we explained in the Proposing Release, we understand that the primary reasons for advisers to locate in a particular jurisdiction involve tax and other business considerations.673

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, as well as the costs of complying with the reporting requirements applicable to exempt reporting advisers, unless it also qualified for the foreign private adviser exemption. 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 rule is likely to have an adverse effect on capital formation.

One commenter also proposed that we adopt an alternative approach that would look to the source of the assets.674 Under this alternative 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, more U.S. advisers might be able to rely on rule 203(m)–1 under this alternative interpretation. To the extent that non-U.S. advisers have U.S. investors in private funds that they manage at a non-U.S. location, fewer non-U.S. advisers would be eligible for the exemption. Thus, this alternative could increase costs for those non-U.S. advisers that would have to register but reduce costs for those U.S. advisers that would not have to register. This alternative approach also could adversely affect U.S. investors to the extent that it discouraged U.S. advisers from managing U.S. investor assets. A U.S. adviser might avoid managing assets from U.S. investors because, under this alternative interpretation, the assets would be included in determining whether the adviser was eligible to rely on rule 203(m)–1. This could reduce competition for the management of assets from U.S. investors. The likelihood of U.S. advisers seeking to avoid registration in this way might be mitigated, however, to the extent that the loss of managed assets of U.S. investors would exceed the savings from avoiding registration. Method of Calculating Private Fund Assets. Rule 203(m)–1 incorporates the valuation methodology in the instructions to Form ADV, which requires advisers to use the market value of private fund assets, or the fair value of private fund assets where market value is unavailable, when determining regulatory assets under management and to include in the calculation certain types of assets advised to be permitted or required to be excluded. The revised instructions also clarify that this calculation must be done on a gross basis. We acknowledged in the Proposing Release that some private fund advisers may not use fair value methodologies.675 As we explained there, the costs incurred by those advisers to use fair value methodologies 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.676 Nevertheless, we continue to believe that the requirement to use fair value would not result in significant costs for these advisers, particularly in light of our decision to require annual, rather than quarterly, valuations. We also understand that private fund advisers, including those that do not use fair value methodologies for reporting purposes, perform administrative services, including valuing assets, internally as a matter of business practice.677

A number of commenters objected to the requirement to determine private fund assets based on fair value, generally arguing that the requirement would cause those advisers that did not use fair value methods to incur additional costs, especially if the private funds’ assets range are illiquid and therefore difficult to fair value.678 As discussed in Section II.B.2, we are sensitive to the costs this new requirement will impose, and we requested comment in the Proposing Release on our estimates concerning the costs related to fair value. Commission staff estimates that such an adviser would incur $1,320 in internal costs to conform its internal valuations to a fair value standard.679 In the event a fund

675 See Proposing Release, supra note 26, at n.323 and accompanying text.

676 See Proposing Release, supra note 32, at n.634–641 and accompanying text.

677 See supra note 634 and accompanying text.

678 For example, a hedge fund adviser may value fund assets for purposes of allowing new investments, fund liquidity 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 valuations 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 applicable to private fund assets.

679 See, e.g., Gunderson Dettmer Letter; Merkl Letter; O’Melveny Letter; Seward Letter; Wellington Letter.

680 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 a weekly or monthly basis. We understand that appraisals of privately placed equity securities may range from $500 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 may cost from $3,000 to $75,000 annually to reflect that rule 203(m)–1 requires advisers to calculate their private fund assets annually, rather than quarterly as proposed.

681 In addition, as discussed above, we have taken several steps to mitigate these costs. We did not receive any comments on these estimates. These estimates, however, assumed that an adviser would be required to calculate the fair value of its private fund assets quarterly, as required by rule 203(m)–1 as proposed. We are reducing the estimated range to $250 to $75,000 annually to reflect that rule 203(m)–1 requires advisers to calculate their private fund assets annually, rather than quarterly as proposed.680 While these other standards may not provide the quality of information in financial reporting (for

682 We estimated the Proposing Release that such an adviser would incur $1,224 in internal costs to conform its internal valuations to a fair value standard. See Proposing Release, supra note 26, at n.325. We received no comments on this estimate. We are, however, increasing this estimate slightly, to $1,320, to account for more recent salary data. We estimated the following calculation: 8 hours × $165/hour = $1,320. The hourly wage is based on data for a fund senior accountant from SIFMA’s Management & Professional Earnings in the Securities Industry 2010, modified by Commission staff to account for an 1800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead.

683 See supra note 64 and accompanying text.

684 See supra note 365 and accompanying text.

685 See supra note 64 and accompanying text.

686 See supra notes 363–366 and accompanying text.

687 See supra note 636 and accompanying text.
example, of private fund returns), we expect these calculations will provide sufficient consistency for the purposes that regulatory assets under management serve in our rules, including rule 203(m)–1.685

Use of the alternative approaches recommended by commenters (e.g., cost basis or any method required by the private fund’s governing documents other than fair value) would not meet our objective of having more meaningful and comparable valuation of private fund assets, and could result in a significant understatement of appreciated assets. Moreover, these alternative approaches could permit advisers to circumvent the Advisers Act’s registration requirements.

Permitting the use of any valuation standard set forth in the governing documents of the private fund other than fair value could effectively yield to the adviser the choice of the most favorable standard for determining its registration obligation as well as the application of other regulatory requirements. For these reasons and those discussed in the Implementing Adopting Release, commenters did not persuade us that the extent of the additional burdens as suggested by the fair value requirement would impose on some advisers to private funds would be inappropriate in light of the value of a more meaningful and consistent calculation by all advisers to private funds.

We also do not expect that advisers’ principals (or other employees) generally will cease to invest alongside the advisers’ clients as a result of the inclusion of proprietary assets, as some commenters suggested.686 If private fund investors value their advisers’ co-investment as suggested by these commenters, we expect that the investors will demand them and their advisers will structure their businesses accordingly.687

One commenter also argued that including proprietary assets would deter non-U.S. advisers that manage large sums of proprietary assets from establishing U.S. operations and employing U.S. residents.688 Such an adviser, however, would not be ineligible for the private fund adviser exemption merely because it established U.S. operations. As discussed in Section II.B, a non-U.S. adviser may rely on the private fund adviser exemption while also having one or more U.S. places of business, provided it complies with the exemption’s conditions.

Some commenters objected to calculating regulatory assets under management on the basis of gross, rather than net, assets. They argued, among other things, that gross asset measurements would be confusing,689 complex,690 and inconsistent with industry practice.691 However, nothing in the current instructions suggests that liabilities should be deducted from the calculation of an adviser’s assets under management. Indeed, since 1997, the instructions have stated that an adviser should not deduct securities purchased on margin when calculating its assets under management.692 Whether a client has borrowed to purchase a portion of the assets managed does not seem to us a relevant consideration in determining the amount an adviser has to manage, the scope of the adviser’s business, or the availability of the exemptions.693

Moreover, we are concerned that the use of net assets could permit advisers to highly leveraged funds to avoid registration under the Advisers Act even though the activities of such advisers may be significant and the funds they advise may be appropriate for systemic risk reporting.694 One commenter argued, in contrast, that it would be “extremely unlikely that a net asset limit of $150,000,000 in private funds could be leveraged into total investments that would pose any systemic risk.”695 But a comprehensive view of systemic risk requires information about certain funds that may not present systemic risk concerns when viewed in isolation, but nonetheless are relevant to an assessment of systemic risk across the economy. Moreover, because private funds are not subject to the leverage restrictions in section 18 of the Investment Company Act, a private fund with less than $150 million in net assets could hold assets far in excess of that amount as a result of its extensive use of leverage. In addition, under a net assets test such a fund would be treated similarly for regulatory purposes as a fundamentally different fund, such as one that did not make extensive use of leverage and had $140 million in net assets.

The use of gross assets also need not cause any investor confusion, as some commenters suggested.696 Although an adviser will be required to use gross (rather than net) assets for purposes of determining whether it is eligible for the private fund adviser or the foreign private adviser exemptions (among other purposes), we would not preclude an adviser from holding itself out to its clients as managing a net amount of assets as may be its custom.697

Definition of a Qualifying Private Fund. As discussed above, we modified the definition of a “qualifying private fund” to include an issuer that qualifies for an exclusion from the definition of “investment company,” as defined in section 3 of the Investment Company Act, in addition to those provided by section 3(c)(1) or 3(c)(7) of that Act. To the extent advisers are able to rely on the exemption as a result of this modification, investors and the Commission will lose the benefits registration would provide. This modification does, however, benefit advisers, as discussed above, and investors (and the Commission) will still have access to the information these advisers will be required to file as exempt reporting advisers.

Solely Advises Private Funds. Some commenters asserted, in effect, that advisers should be permitted to combine other exemptions with rule 203(m)–1 so that, for example, an adviser could advise venture capital funds with assets under management in excess of $150 million in addition to other, non-venture capital private funds with less than $150 million in assets under management.698 One commenter argued that, by declining to adopt this view, we are imposing unnecessary burdens, particularly on advisers who advise both small private funds and small business investment companies.699 But as we discuss in Section II.B.1, the approach the commenter suggests runs contrary to the language of section 203(m), which directs us to provide an exemption “to any investment adviser of private funds, if each of such investment adviser acts solely as an adviser to private funds and
has assets under management in the United States of less than $150,000,000.” Thus, we believe that the costs to advisers that may have to register because they do not advise solely private funds with assets under management in the United States of less than $150 million flow directly from the Dodd-Frank Act.

As proposed, we are omitting the “special rule” that allowed advisers not to count as a client any person for whom the adviser provides investment advisory services without compensation.711 Finally, the rule includes two provisions that clarify that advisers need not double-count private funds and their investors under certain circumstances.712

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 in the United States.” We are defining “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.713 We are also treating as investors beneficial owners of “short-term paper” issued by the private fund, who must be qualified purchasers under section 3(c)(7) but are not counted as beneficial owners for purposes of section 3(c)(1).714

Third, 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.715 In particular, we define “in the United States” in rule 202(a)(30)–1 to mean: (i) With respect to any place of business, any such place

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 assets of a similar nature; and (3) any general partner, managing member or other person acting as an investment adviser to a limited partnership or limited liability company to the partnership or limited liability company as a client.

715 See rule 203(b)(3)–1(b)(4); supra notes 425–427 and accompanying text.

716 See rule 202(a)(30)–1(b)(4) (an adviser is not required to count a private fund as a client if it counts any investor, as defined in the rule, in that private fund as an investor in the United States in that private fund); rule 202(a)(30)–1(b)(5) (an adviser is not required to count an investor as an investor if the adviser counts such person as a client in the United States). See also supra note 429.

717 See rule 202(a)(30)–1(c)(2); supra Section II.C.2. In order to avoid double-counting, the rule allows an adviser to treat as a single investor any person who is an investor in two or more private funds advised by the adviser. See rule 202(a)(30)–1, note to paragraph (c)(2).

718 See rule 202(a)(30)–1(c)(3); supra notes 453–462 and accompanying text. Consistently with section 3(c)(1) and section 3(c)(7) of the Investment Company Act, the final rule, unlike the proposed rule, does not treat knowledgeable employees as “investors.” Cf. proposed rule 202(a)(30)–1(c)(1)(I).

719 Rule 202(a)(30)–1(c)(3). See supra Section II.C.

720 We note that the advisers that gave us these estimates for registration costs have assets under management in excess of the $150 million threshold and are not representative of advisers that would qualify for the private fund adviser exemption. See supra notes 602–603 and accompanying text. We also note that approximately 570 smaller advisers currently are registered with us. See supra note 613 and accompanying text. These advisers have absorbed the compliance costs associated with registration, notwithstanding the fact that their revenues are likely to be smaller than those of a typical adviser that will be required to register as a result of Congress’s repeal of the private adviser exemption (e.g., an adviser to private funds with $150 million or more of assets under management in the United States, a “private fund adviser”). See, e.g., Atlas Letter (middle market private equity adviser with $386 million of assets under management); Cortec Letter (middle market private equity adviser with less than $750 million of assets under management).

For more information, please visit our website at regulations.gov.
located in the “United States,” as defined in Regulation S.716 (ii) with respect to any client or private fund investor in the United States, any person who is a “U.S. person” as defined in Regulation S.717 except that under the 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 defined in Regulation S.718

Fourth, rule 202(a)(30)–1 defines “place of business” to have the same meaning as in Advisers Act rule 222–1(a).719 Finally, for purposes of rule 202(a)(30)–1, we are defining “assets under management” by reference to “regulatory assets under management” as determined under Item 5 of Form ADV.720

1. Benefits

We are defining 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 foreign private adviser exemption. As noted above, our 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 non-U.S. advisers active in the U.S. capital markets.

As we discussed in the Proposing Release, we anticipate that by defining these terms we will benefit non-U.S. advisers by providing clarity with respect to the terms that advisers would otherwise be required to interpret (and which they would likely interpret with reference to the rules we reference).721

Our approach provides consistency among these other rules and the new exemption. This should limit non-U.S. advisers’ need to undertake additional analysis with respect to these terms for purposes of determining the availability of the foreign private adviser exemption.722 We believe that the consistency and clarity that results from the rule will promote efficiency for non-U.S. advisers and the Commission. Commenters that expressed support for the proposed definitions confirmed that the rule would allow advisers to apply existing concepts and maintain consistency with current interpretations.723

For example, for purposes of determining eligibility for the foreign private adviser exemption, advisers must count clients substantially in the same manner as they counted clients under the private adviser exemption.724

In identifying “investors,” advisers can generally rely on the determination made to assess whether the private fund meets the qualification requirements under section 3(c)(1) or 3(c)(7) of the Investment Company Act.725 In determining whether a client, 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 generally will apply the same analysis it would otherwise apply under Regulation S.726

In identifying whether it has a place of business in the United States, an adviser will use the definition of “place of business” as defined in Advisers Act rule 222–1, which is used to determine whether a state may assert regulatory jurisdiction over the adviser.727

721 See Proposing Release, supra note 26, at n.350 and accompanying text.
722 This is true for all of the definitions except for “assets under management.” An adviser that relies on the foreign private adviser exemption must calculate its assets under management according to the instructions to Item 5 of Form ADV only for purposes of determining the availability of the exemption. As discussed above, rule 202(a)(30)–1 includes a reference to Item 5 of Form ADV in order to provide for consistency in the calculation of assets under management for various purposes under the Advisers Act. See supra note 497 and accompanying text.
723 See, e.g., Dechert General Letter (with respect to the definition of “investor”); Dechert Foreign Adviser Letter and IFIC Letter (noting that the proposed definition of “in the United States” has the benefit of relying on existing guidance that is generally used by investment advisers); O’Melveny Letter (with respect to the definition of “U.S. person”).
724 See supra Section II.C.1.
725 See supra note 412 and accompanying text.
726 See supra notes 471–472 and accompanying text.
727 See supra Section II.C.4. 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.
728 See supra Sections II.C.2 and II.C.3.
729 See supra Section II.C.1.
730 See supra notes 453–462 and accompanying text and notes 474–477 and accompanying text. See also infra notes 744–747 for an estimate of the costs associated with registration.
731 See supra notes 448–452 and accompanying text.
732 See Seward Letter; Shearman Letter.

As not above, the definitions of “investor” and “United States” under our rule rely on existing definitions, with slight modifications.728 Our rule also incorporates the safe harbor that appeared in rule 203(b)(3)–1 for counting clients, except that it no longer allows an adviser to disregard clients for whom the adviser provides services without compensation.729 We are making these modifications (collectively, the “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.730 Without a definition of these terms, advisers would likely rely on the same definitions we reference in rule 202(a)(30)–1, but without the modifications. We expect, therefore, that the rule likely will have the practical effect of narrowing the scope of the exemption, and thus likely will result in more advisers registering than if it reflected no modifications from the current rules.

The final rule does not include one of the modifications we proposed. The final rule does not treat knowledgeable employees as investors, consistent with sections 3(c)(1) and 3(c)(7).731 As some commenters noted, treating knowledgeable employees in the same manner for purposes of the definition of investor and sections 3(c)(1) and 3(c)(7) will simplify advisers’ compliance with these regulatory requirements.732 In addition, as a result of this treatment of knowledgeable employees, more non-U.S. advisers will be able to rely on the exemption.

We believe that any increase in registration as compared to the number of non-U.S. advisers that might have registered if we had not adopted rule 202(a)(30)–1 will benefit investors. Investors whose assets are, directly or indirectly, managed by the non-U.S. advisers that will be required to register will 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.733

2. Costs

As discussed in the Proposing Release, we do not believe our definitions will result in significant costs for non-U.S. advisers.734 Non-U.S. advisers that seek to avail themselves of the foreign private adviser exemption will incur costs to determine whether they are eligible for the exemption. We expect that these advisers will 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 in the United States and investors in the United States. We estimate these costs will be $6,730 per adviser.735

Without the rule, we believe that most advisers would have interpreted the new statutory provision by reference to the same rules that rule 202(a)(30)–1 references. Without our rule, some advisers would have likely incurred additional costs because they would have sought guidance in interpreting the terms used in the statutory exemption. By defining the statutory terms in a rule, we believe that we are providing certainty for non-U.S. advisers and limiting the time, compliance costs and legal expenses non-U.S. advisers would have incurred in seeking an interpretation, all of which could have inhibited capital formation and reduced efficiency. Advisers will also be less likely to seek additional assistance from us because they can rely on relevant guidance that we have previously provided with respect to the definitions that rule 202(a)(30)–1 references. We also believe that non-U.S. advisers’ ability to rely on the definitions that the rule references and the guidance provided with respect to the referenced rules will reduce Commission resources that would have otherwise been applied to administering the foreign private adviser exemption, which resources can be allocated to other matters.

Our instruction allowing non-U.S. 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 acquires securities issued by the private fund should also reduce advisers’ costs.736 Advisers will make the determination only once and will not be required to monitor changes in the status of each client and private fund investor. Moreover, if a client or an investor moved to the United States, the adviser would not have to choose among registering with us, terminating the relationship with the client, or forcing the investor out of the private fund. Some commenters agreed that the instruction will benefit advisers.737

Some commenters disagreed with the Proposing Release’s explanation of how the exemption’s requirement that an adviser look through to private fund investors would apply with respect to certain structures, such as master-feeder funds and total return swaps.738 In both respects, we note that the obligation to look through certain transactions stems from section 208(d) of the Advisers Act (section 46(a) of the Investment Company Act with respect to sections 3(c)(1) and 3(c)(7)) as it applies to an adviser’s obligations to look through to private fund purposes of the foreign private adviser exemption. Thus, any costs associated with the statutory provisions that prohibit any person from doing indirectly or through or by another person anything that would be unlawful to do directly flow from those provisions, rather than any definitions we are adopting.

Some commenters expressed concern that the look-through requirement contained in the statutory definition of a “foreign private adviser” could impose significant burdens on advisers to non-U.S. funds, including non-U.S. retail funds publicly offered outside of the United States.739 Two of these commenters stated, for example, that in their view a non-U.S. fund could be considered a private fund as a result of independent actions of U.S. investors, such as if a non-U.S. shareholder of a non-U.S. fund moves to the United States and purchases additional shares.740 If these funds were “private funds,” their advisers would, if seeking to rely on the foreign private adviser exemption, be required to determine the number of private fund investors in the United States and the assets under management attributable to them.

As we explained above, if an adviser reasonably believes that an investor is not “in the United States,” the adviser may treat the investor as not being “in the United States.” Moreover, we understand that non-U.S. private funds currently count or qualify their U.S. investors in order to avoid regulation under the Investment Company Act.741 A non-U.S. adviser would need to count the same U.S. investors (except for holders of short-term paper with respect to a fund relying on section 3(c)(1)) in order to rely on the foreign private adviser exemption. In this respect, therefore, the look-through requirement of the foreign private adviser exemption will generally not impose any new burden on advisers to non-U.S. funds.

As discussed in the Proposing Release, the modifications will result in some costs for non-U.S. advisers who might change their business practices in order to rely on the exemption.742 Some non-U.S. advisers may have to choose to register under the Advisers Act or to limit the scope of their contacts with the United States in order to rely on the statutory exemption for foreign private advisers (or the private fund adviser exemption).743 As noted above, we have

733 See supra text accompanying and following note 575.
734 See Proposing Release, supra note 26, at section V.C.2.
735 See supra note 667 and accompanying text. As noted above, we are decreasing this estimate to $6,730 to account for more recent salary data. Id. We did not receive any comments on the costs we estimated advisers would incur to perform this internal review.
736 See rule 202(a)(30)–1, at note to paragraph (c)(3)(i); supra note 476 and accompanying text.
737 See Dechert General Letter (“The note provides helpful relief at a time when advisory clients often move across international borders while keeping an existing relationship with a financial institution.”); IFIC Letter (the proposed approach “is consistent with the current interpretations on which Canadian advisers have relied for many years, and will ensure continuity and certainty in their business operations.”).
738 See Dechert General Letter; EFAMA Letter. See also supra notes 442–444 and accompanying text. As we discussed above, for purposes of the look-through provision, the adviser to a master fund in a master-feeder arrangement must 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. In addition, an adviser must treat as an investor any owner of a total return swap on the private fund because that arrangement effectively provides the risks and rewards of investing in the private fund to the swap owner.
739 See AFG Letter; Dechert Foreign Adviser Letter; EFAMA Letter; Shearman Letter.
740 Dechert Foreign Adviser Letter; EFAMA Letter. See also supra note 464 and accompanying text.
741 This practice is consistent with positions our staff has taken in which the staff has stated it would not recommend enforcement action in certain circumstances. See, e.g., Goodman Procter No-Action Letter, supra note 294; Touche Remnant No-Action Letter, supra note 294. See also sections 7(d), 3(c)(1), and 3(c)(7) of the Investment Company Act. See also, e.g., Canadian Depository Retirement Savings Accounts Release, supra note 294, at n.23 (“The Commission and its staff have interpreted section 7(d) to generally prohibit a foreign fund from making a U.S. private offering if that offering would cause the securities of the fund to be beneficially owned by more than 100 U.S. residents.”).
742 See Proposing Release, supra note 26, at n. 362 and accompanying and following text.
743 See, e.g., O’Melveny Letter (argued that because the foreign private adviser is subject to a low statutory asset threshold, it is likely “that the
estimated the costs of registration to be $15,077.744 In addition, we estimate that 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 $50,000.745 Some commenters suggested that these estimates are too low, and estimated that they would incur one-time registration and compliance costs ranging from $50,000 to $600,000, followed by ongoing annual compliance costs ranging from $50,000 to $500,000.746 Although some advisers may incur these costs, we do not believe they are representative, as discussed above.747 Moreover, as discussed above, commenters identifying themselves as “middle market private equity fund” advisers provided the highest estimated costs, but these commenters generally would not qualify for the foreign private adviser exemption (e.g., because these advisers generally appear to have places of business in the United States). In any case, non-U.S. advisers will assess the costs of registering with the Commission relative to relying on the foreign private adviser or the private fund adviser exemption. This assessment will take into account many factors, which will 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 non-U.S. 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 or decreasing the availability of certain investment opportunities for U.S. investors. If the non-U.S. adviser chose to register, competition among registered advisers would increase. One commenter asserted that treating holders of short-term paper as investors could result in a U.S. commercial lender to a fund being treated as an investor, leading non-U.S. advisers to avoid U.S. lenders.748 To the extent that the modification included in the definition of “investor” causes a non-U.S. adviser seeking to rely on the foreign private adviser exemption to limit U.S. investors in a private fund’s short-term notes, the modification could have an adverse effect on capital formation and reduce U.S. lenders as sources of credit for non-U.S. funds. However, unless the extension of credit by a fund’s broker-dealer or custodian bank results in the issuance of a security by the fund to its creditor, the creditor would not be considered an investor for purposes of the foreign private adviser exemption.749

As a result of the rule’s reference to the method of calculating assets under management under Form ADV, non-U.S. advisers will 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.750 Among other things, these instructions require advisers to use the market value of private fund assets, or the fair value of private fund assets where market value is unavailable, when determining regulatory assets under management and to include in the calculation certain types of assets advisers previously were permitted to exclude.751 Most commenters addressed the components of the new method of calculation in reference to the calculation of “regulatory assets under management” under Form ADV, or with respect to the calculation of private fund assets for purposes of the private fund adviser exemption.752

As discussed in the Proposing Release, some non-U.S. advisers to private funds may value assets based on their fair value in accordance with GAAP or other international accounting standards that require the use of fair value, while other advisers to private funds currently may not use fair value methodologies.753 We noted above that the costs associated with fair valuation will 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 relies on a third party for valuation services.754 Nevertheless, we do not believe that the requirement to use fair value methodologies will result in significant costs for these advisers to these funds.755 Commission staff estimates that such advisers will each incur $1,320 in internal costs to conform its internal valuations to a fair value standard.756 In the event a fund does not have an internal capability for valuing illiquid assets, we expect that it will be able to obtain pricing or valuation services from an outside administrator or other service provider. Staff estimated that the annual cost of such a service will 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.757 We did not receive any comments on these estimates.

VI. Regulatory Flexibility Certification

The Commission certified in the Proposing Release, pursuant to section 605(b) of the Regulatory Flexibility Act, 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.758 As we explained in the Proposing Release, under Commission rules, for the purposes of the Advisers Act and the Regulatory Flexibility Act, an investment adviser generally is a small

See ABA Letter. This result, argues the commenter, will not be in the best interest of investors, who benefit from managers having “skin the game.” As discussed in Section II.B.2., if private fund investors value their advisers’ co-investments as suggested by the commenter, we expect that the investors will demand them and their advisers will structure their businesses accordingly.

753 See Proposing Release, supra note 26, at n.365 and accompanying text.

754 See supra section V.A.2.

746 See Reves v. Ernst & Young, 494 U.S. 56 (1990). See also supra note 458 and accompanying text.

755 See supra Section II.B.2.a.

748 See Implementing Adopting Release, supra note 32, discussion at section II.A.4. Among those commenters who addressed the components specifically with respect to the foreign private adviser exemption, one noted that because of the requirement to include proprietary assets in the calculation, “managers, in order to qualify for the [exemption], will have an incentive to reduce their personal commitments to the private funds, and manage their own assets individually.”

756 See supra note 679.

757 See supra note 680.

758 5 U.S.C. 605(b).

759 See Proposing Release, supra note 26, at section VI.
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”).

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. 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 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 implemented by 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 rule 203(m)–1. Thus, we believe that small advisers solely to venture capital funds and small advisers to other private funds will 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 capital fund adviser 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 rules. For these reasons, we certified in the Proposing Release that 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. Although we requested written comments regarding this certification, no commenters responded to this request.

VII. Statutory Authority

The Commission is adopting 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 adopting 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 adopting 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.

Text of Rules

For reasons set out in the preamble, the Commission amends 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:


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, spousal equivalent, or relative of the spouse or of the spousal equivalent 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)(1)(ii) 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;

(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)(2) of this section, in that private fund as an investor in the United States in that private fund; and

(5) You are not required to count a person as an investor, as that term is defined in paragraph (c)(2) of this section, in a private fund you advise if you count such person as a client in the United States.

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

2. Investor means:
(i) 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 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)); 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)(2): You may treat as a single investor any person who is an investor in two or more private funds you advise.

3. In the United States means with respect to:
(i) Any client or investor, any person who 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 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, as defined in § 275.206(4)–2(d)(7), 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)(3)(i): A person who 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, each time the investor acquires 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.

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

5. Spousal equivalent has the same meaning as in § 275.202(a)(11)(G)–1(d)(9).

6. 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 pursues a venture capital strategy;

(2) Immediately after the acquisition of any asset, other than qualifying investments or short-term holdings, holds no more than 20 percent of the amount of the fund’s aggregate capital contributions and uncalled committed capital in assets (other than short-term holdings) that are not qualifying investments, valued at cost or fair value, consistently applied by the fund;

(3) 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, except that any guarantee by the private fund of a qualifying portfolio company’s obligations up to the amount of the value of the private fund’s investment in the qualifying portfolio company is not subject to the 120 calendar day limit;

(4) 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

(5) 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:

(i) Has represented to investors and potential investors at the time of the offering of the private fund’s securities that it pursues a venture capital strategy;

(ii) Prior to December 31, 2010, has sold securities to one or more investors that are not related persons, as defined in § 275.206(4)–2(d)(7), of any investment adviser of the private fund; and

(iii) 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:

(i) Acquire an interest in the private fund; or

(ii) Make capital contributions to the private fund.

(2) Equity security 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) Qualifying investment means:

(i) An equity security issued by a qualifying portfolio company that has been acquired directly by the private fund from the qualifying portfolio company;

(ii) Any equity security issued by a qualifying portfolio company in exchange for an equity security issued by the qualifying portfolio company described in paragraph (c)(3)(i) of this section; or

(iii) Any equity security issued by a company of which a qualifying portfolio company is a majority-owned subsidiary, as defined in section 2(a)(24) of the Investment Company Act of 1940 (15 U.S.C. 80a–2(a)(24)), or a predecessor, and is acquired by the private fund in exchange for an equity security described in paragraph (c)(3)(i) or (c)(5)(ii) of this section.

(4) Qualifying portfolio company means any company that:

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

(ii) Does not borrow or issue debt obligations in connection with the private fund’s investment in such company and distribute to the private fund the proceeds of such borrowing or issuance in exchange for the private fund’s investment; and

(iii) 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 of this chapter, or a commodity pool.

(5) Reporting or foreign 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.

(6) **Short-term holdings** means cash and cash equivalents, as defined in §270.2a51–1(b)(7)(i) of this chapter, U.S. Treasuries with a remaining maturity of 60 days or less, and shares of an open-end management investment company registered under section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a–8) that is regulated as a money market fund under §270.2a–7 of this chapter.

**Note:** For purposes of this section, an investment adviser may treat as a private fund any issuer formed under the laws of a jurisdiction other than the United States that has not offered or sold its securities in the United States or to U.S. persons in a manner inconsistent with being a private fund, provided that the adviser treats the issuer as a private fund under the Act (15 U.S.C. 80b) and the rules thereunder for all purposes.

■ 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:

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 at 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.

(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 at 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) **Frequency of Calculations.** For purposes of this section, calculate private fund assets annually, in accordance with General Instruction 15 to Form ADV (§279.1 of this chapter).

(d) **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). For purposes of this section, an investment adviser may treat as a private fund an issuer that qualifies for an exclusion from the definition of an “investment company,” as defined in section 3 of the Investment Company Act of 1940 (15 U.S.C. 80a–3), in addition to those provided by section 3(c)(1) or 3(c)(7) of that Act (15 U.S.C. 80a–3(c)(1) or 15 U.S.C. 80a–3(c)(7)), provided that the investment adviser treats the issuer as a private fund under the Act (15 U.S.C. 80b) and the rules thereunder for all purposes.

(e) **Related person** has the same meaning as in §275.206(4)–2(d)(7).

(f) **United States** has the same meaning as in §230.902(l) of this chapter.

(g) **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.

**Note to paragraph (d)(8):** A client will not be considered a United States person if the client was not a United States person at the time of becoming a client.

Dated: June 22, 2011.

By the Commission.

Elizabeth M. Murphy,
Secretary.