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

**SECURITIES AND EXCHANGE COMMISSION**

**17 CFR Part 275**

**[Release No. IA–3222; File No. S7–37–10]**

**RIN 3235–AK81**

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

**AGENCY:** Securities and Exchange Commission.

**ACTION:** 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'').[1]

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## I. Background

On July 21, 2010, President Obama signed into law the Dodd-Frank Act,[2] which, among other things, repeals section 203(b)(3) of the Advisers Act.[3] 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'').[4] 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.[5]

The primary purpose of Congress in repealing section 203(b)(3) was to require advisers to ''private funds'' to register under the Advisers Act.[6] 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[7] (''Investment Company Act'') by reason of section 3(c)(1) or 3(c)(7) of such Act.[8] Section 3(c)(1) is available to a fund that does not publicly offer the securities it issues[9] and has 100 or fewer beneficial owners of its outstanding securities.[10] A fund relying on section 3(c)(7) cannot publicly offer the securities it issues[11] and generally must limit the owners of its outstanding securities to ''qualified purchasers.''[12]

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

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

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

[4] 15 U.S.C. 80b–3(b)(3) as in effect before July 21, 2011.

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

[6] *See* S. Rep. No. 111–176, at 71–3 (2010) (''S. Rep. No. 111–176''); H. Rep. No. 111–517, at 866 (2010) (''H. Rep. No. 111–517''). H. Rep. No. 111–517 contains the conference report accompanying the version of H.R. 4173 that was debated in conference. While the Senate voted to exempt private equity fund advisers in addition to venture capital fund advisers from the requirement to register under the Advisers Act, the Dodd-Frank Act exempts only venture capital fund advisers. Compare Restoring American Financial Stability Act of 2010, S. 3217, 111th Cong. § 408 (2010) (as passed by the Senate) with The Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. (2009) (as passed by the House) (''H.R. 4173'') *and* Dodd-Frank Act (2010), *supra* note 2.

[7] 15 U.S.C. 80a.

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

[9] 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. 78o(a)). The Exchange Act generally defines a ''broker'' as any person engaged in the business of effecting transactions in securities for the account of others. Section 3(a)(4)(A) of the Exchange Act (15 U.S.C. 78c(a)(4)(A)). *See also Definition of Terms in and Specific Exemptions for Banks, Savings Associations, and Savings Banks Under Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934,* Exchange Act Release No. 44291 (May 11, 2001) [66 FR 27759 (May 18, 2001)], at n.124 (''Solicitation is one of the most relevant factors in determining whether a person is effecting transactions.''); *Political Contributions by Certain Investment Advisers,* Investment Advisers Act Release No. 3043 (July 1, 2010) [75 FR 41018 (July 14, 2010)], n.326 (''Pay to Play Release'').

[10] *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.'').

[11] *See supra* note 9.

[12] *See* section 3(c)(7) of the Investment Company Act (providing an exclusion from the definition of

Each private fund advised by an adviser has typically qualified as a single client for purposes of the private adviser exemption.[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.[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.[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.[16] These amendments become effective on July 21, 2011.[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.[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'').[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.'' [20]

Section 203(b)(3) of the Advisers Act, as amended by the Dodd-Frank Act, provides an exemption for certain foreign private advisers (the ''foreign private adviser exemption'').[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,[22] and less than $25 million in aggregate assets under management from such clients and investors.[23]

These new exemptions are not mandatory.[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.[25]

On November 19, 2010, the Commission proposed three rules that would implement these exemptions.[26] First, we proposed rule 203(l)–1 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.[27] On the same day, we

''investment company'' for any ''issuer, the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers, and which is not making and does not at that time propose to make a public offering of such securities.''). The term ''qualified purchaser'' is defined in section 2(a)(51) of the Investment Company Act.

[13] *See* rule 203(b)(3)–1(a)(2) as in effect before July 21, 2011.

[14] *See* Staff Report to the United States Securities and Exchange Commission, Implications of the Growth of Hedge Funds, at 21 (2003), *http://www.sec.gov/news/studies/hedgefunds0903.pdf* (discussing section 203(b)(3) of the Advisers Act as in effect before July 21, 2011). Concern about this lack of Commission oversight led us to adopt a rule in 2004 extending registration to hedge fund advisers. *See Registration Under the Advisers Act of Certain Hedge Fund Advisers,* Investment Advisers Act Release No. 2333 (Dec. 2, 2004) [69 FR 72054 (Dec. 10, 2004)] (''Hedge Fund Adviser Registration Release''). This rule was vacated by a Federal court in 2006. *Goldstein v. Securities and Exchange Commission,* 451 F.3d 873 (D.C. Cir. 2006) (''Goldstein'').

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

[16] Title IV also created exemptions and exclusions in addition to the three discussed at length in this Release. *See, e.g.,* sections 403 and 409 of the Dodd-Frank Act (exempting advisers to licensed small business investment companies from registration under the Advisers Act and excluding family offices from the definition of ''investment adviser'' under the Advisers Act). We are adopting a rule defining ''family office'' in a separate release (*Family Offices,* Investment Advisers Act Release No. 3220 (June 22, 2011)).

[17] Section 419 of the Dodd-Frank Act (specifying the effective date for Title IV).

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

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

[20] *See* sections 407 and 408 of the Dodd-Frank Act.

[21] 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. *See supra* note 5.

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

[23] The exemption is not available to an adviser that ''acts as—(I) an investment adviser to any investment company registered under the [Investment Company Act]; or (II) a company that has elected to be a business development company pursuant to section 54 of [that Act], and has not withdrawn its election.'' Section 202(a)(30)(D)(ii). We interpret subparagraph (II) to mean that the exemption is not available to an adviser *that advises* a business development company. This exemption also is not available to an adviser that holds itself out generally to the public in the United States as an investment adviser. Section 202(a)(30)(D)(i).

[24] 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 (exempting from state regulatory requirements 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).

[25] Section 203A(a)(1) of the Advisers Act generally prohibits an investment adviser regulated by the state in which it maintains its principal office and place of business from registering with the Commission unless it has at least $25 million of assets under management. Section 203A(b) preempts certain state laws regulating advisers that are registered with the Commission. Section 410 of the Dodd-Frank Act amended section 203A(a) to also prohibit generally an investment adviser from registering with the Commission if the adviser has assets under management between $25 million and $100 million and the adviser is required to be registered with, and if registered, would be subject to examination by, the state security authority where it maintains its principal office and place of business. *See* section 203A(a)(2) of the Advisers Act. In each of subparagraphs (1) and (2) of section 203A(a), additional conditions also may apply. *See* Implementing Adopting Release, *infra* note 32, at section II.A.

[26] *Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less than $150 Million in Assets under Management, and Foreign Private Advisers,* Investment Advisers Act Release No. 3111 (Nov. 19, 2010) [75 FR 77190 (Dec. 10, 2010)] (''Proposing Release'').

[27] Proposed rule 202(a)(30)–1 included definitions for the following terms: (i) ''Client;'' (ii) ''investor;'' (iii) ''in the United States;'' (iv) ''place of business;'' and (v) ''assets under management.'' *See* discussion in section II.C of the Proposing Release, *supra* note 26. We proposed rule 202(a)(30)–1, in part, pursuant to section 211(a) of

Continued

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 investor 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 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

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.

[28] *Rules Implementing Amendments to the Investment Advisers Act of 1940,* Investment Advisers Act Release No. 3110 (Nov. 19, 2010) [75 FR 77052 (Dec. 10, 2010)] (''Implementing Proposing Release'').

[29] The comment letters on the Proposing Release (File No. S7–37–10) 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.

[30] *See, e.g.,* Comment Letter of Biotechnical Industry Organization (Jan. 24, 2011) (''BIO Letter''); Comment Letter of Coalition of Private Investment Companies (Jan. 28, 2011) (''CPIC Letter''); Comment Letter of European Private Equity and Venture Capital Association (Jan. 24, 2011 (''EVCA Letter''); Comment Letter of O'Melveny & Myers LLP (Jan. 25, 2011) (''O'Melveny Letter''); Comment Letter of Norwest Venture Partners (Jan. 24, 2011) (''Norwest Letter'').

[31] *See, e.g.,* Comment Letter of the American Federation of Labor and Congress of Industrial Organizations (Jan. 24, 2011) (''AFL–CIO Letter''); Comment Letter of Americans for Financial Reform (Jan. 24, 2011) (''AFR Letter''); Comment Letter of The California Public Employees Retirement System (Feb. 10, 2011) (''CalPERS Letter''). *See also, e.g.,* Comment Letter of Adams Street Partners (Jan. 24, 2011); Comment Letter of Private Equity Investors, Inc. (Jan. 21, 2011) (''PEI Funds Letter'') (letters from advisers of funds that invest in other venture capital and private equity funds).

[32] *Rules Implementing Amendments to the Investment Advisers Act of 1940,* Investment Advisers Act Release No. 3221 (June 22, 2011).

[33] Rule 203(l)–1.

[34] Rule 203(l)–1(a).

[35] Rule 203(l)–1(b).

[36] *See* Proposing Release, *supra* note 26, at n.38 and accompanying and following text.

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

[38] 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.

[39] *See* BIO Letter; Comment Letter of Charles River Ventures (Jan. 21, 2011) (''Charles River Letter''); NVCA Letter.

[40] *See, e.g.,* Comment Letter of Abbott Capital Management, LLC (Jan. 24, 2011) (''Abbott Capital Letter''); Comment Letter of DLA Piper LLP (Jan. 24, 2011) (''DLA Piper VC Letter''); Comment Letter of InterWest General Partners (Jan. 21, 2011) (''InterWest Letter''); NVCA Letter; Comment Letter of Oak Investment Partners (Jan. 24, 2011) (''Oak Investment Letter''); Comment Letter of Pine Brook Road Advisors, LP (Jan. 24, 2011) (''Pine Brook Letter'').

[41] *See* AFR Letter; AFL–CIO Letter; EVCA Letter; Comment Letter of U.S. Senator Carl Levin (Jan. 25, 2011) (''Sen. Levin Letter'').

[42] AFL–CIO Letter.

[43] 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.

Unlike the commenters who 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 funds from 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

[44] Comment Letter of Lowenstein Sandler PC (Jan. 4, 2011) (''Lowenstein Letter''); Comment Letter of Keith Bishop (Jan. 17, 2011).

[45] *See* Proposing Release, *supra* note 26, at n.72 and accompanying and preceding 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.

[48] *See* Comment Letter of National Association of Small Business Investment Companies and Small Business Investor Alliance (Jan. 24, 2011) (''NASBIC/SBIA Letter'') (supported a definition of ''small'' company by reference to the standards set forth in the Small Business Investment Act regulations). *But cf.* Lowenstein Letter; Comment Letter of Quaker BioVentures (Jan. 24, 2011) (''Quaker BioVentures Letter''); Comment Letter of Venrock (Jan. 23, 2011) (''Venrock Letter'') (each of which supported a definition of small company based on the size of its public float). *See also* Comment Letter of Georg Merkl (Jan. 25, 2011) (''Merkl Letter'') (referring to ''young, negative EBITDA [earnings before interest, taxes, depreciation and amortization] companies'').

[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.

[51] *See, e.g.,* Comment Letter of the Committee on Federal Regulation of Securities of the American Bar Association (Jan. 31, 2011) (''ABA Letter''); ATV Letter; BIO Letter; NVCA Letter; Comment Letter of Proskauer LLP (Jan. 23, 2011); Comment Letter of Union Square Ventures, LLC (Jan. 24, 2011) (''Union Square Letter'').

[52] *See, e.g.,* Comment Letter of Advanced Technology Ventures (Jan. 24, 2011) (''ATV Letter''); BIO Letter; NVCA Letter; Comment Letter of Sevin Rosen Funds (Jan. 24, 2011) (''Sevin Rosen Letter''). One commenter argued that the rule ''should not bar the occasional, but also quite ordinary, financial activities'' of a venture capital fund. Charles River Letter.

[53] *See, e.g.,* Comment Letter of Dechert LLP (Jan. 24, 2011) (''Dechert General Letter''); Comment Letter of First Round Capital (Jan. 24, 2011) (''First Round Letter''); Sevin Rosen Letter.

[54] *See, e.g.,* Comment Letter of BioVentures Investors (Jan. 24, 2011) (''BioVentures Letter''); Charles River Letter; Comment Letter of Davis Polk & Wardwell LLP (Jan. 24, 2011) (''Davis Polk Letter''); Merkl Letter.

[55] *See, e.g.,* Comment Letter of Cardinal Partners (Jan. 24, 2011) (''Cardinal Letter''); Davis Polk Letter; Comment Letter of Gunderson Dettmer Stough Villeneuve Franklin & Hachigian (Jan. 24, 2011) (''Gunderson Dettmer Letter''); Merkl Letter.

[56] *See, e.g.,* NVCA Letter; Comment Letter of Bessemer Venture Partners (Jan. 24, 2011) (''Bessemer Letter''); Oak Investment Letter. *See also supra* note 51.

[57] *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'').

[58] *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.

[59] 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.''); Merkl Letter (''The Commission should not regulate from whom the [portfolio company] securities can be acquired or how the [company's] capital can be used.'').

[60] *See, e.g.,* Oak Investment Letter; Sevin Rosen Letter.

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 some 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 commenters 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 large 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.,*

[61] For example, one commenter suggested that the definition of venture capital fund include a fund that incurs leverage of up to 20% of fund capital commitments without limit on duration and invests up to 20% of fund capital commitments in publicly traded securities and an additional 20% of fund capital commitments in non-conforming investments. Charles River Letter. Under these guidelines, it would be possible to structure a fund that borrows up to 20% of the fund's ''capital commitments'' to acquire highly leveraged derivatives and publicly traded debt securities. If the fund only calls 20% of its capital, fund indebtedness would equal 100% of fund assets, all of which would be in derivative instruments or publicly traded debt securities.

[62] *See supra* note 58.

[63] First Round Letter.

[64] *See, e.g., generally* NVCA Letter. *See also* Merkl Letter.

[65] *See, e.g.,* Abbott Capital Letter; ATV Letter; Bessemer Letter; BioVentures Letter; Cardinal Letter; Charles River Letter; Comment Letter of CompliGlobe Ltd. (Jan. 24, 2011) (''CompliGlobe Letter''); Davis Polk Letter; First Round Letter; NVCA Letter; Comment Letter of PTV Sciences (Jan. 24, 2011) (''PTV Sciences Letter''); Quaker BioVentures; Comment Letter of Santé Ventures (Jan. 24, 2011) (''Santé Ventures Letter''); Sevin Rosen Letter; SV Life Sciences; Comment Letter of U.S. Venture Partners (Jan. 24, 2011) (''USVP Letter''); Venrock Letter.

[66] Advisers Act section 202(a)(22) (defining a ''business development company'' as any company that meets the definition set forth in section 2(a)(48) of, and complies with section 55 of, the Investment Company Act, except that a BDC under the Advisers Act is defined to mean a company that invests 60% of its total assets in the assets specified in section 55 of the Investment Company Act).

[67] *See, e.g.,* NVCA Letter (more than 25 comment letters expressed general support for the comments raised in the NVCA Letter). Two commenters expressed support for a 30% basket for non-qualifying investments. *See* Comment Letter of Shearman & Sterling LLP (Jan. 24, 2011) (''Shearman Letter'') (citing, in support of this position, the BDC definition under the Investment Company Act, which specifies a threshold of 30% for non-qualifying activity); Quaker BioVentures Letter (citing, in support of this position, the BDC definition under the Investment Company Act and the BDC definition under the Advisers Act which increased the non-qualifying activity threshold to 40%).

[68] Norwest Letter; Sevin Rosen Letter (noting that a 20% limit is ''low enough to ensure that only true [venture capital funds] are able to qualify for the [venture capital] exemption.''). *See also* NVCA Letter.

[69] We did, however, receive much anecdotal evidence of particular advisers' experiences with non-qualifying investments. *See, e.g.,* Cardinal Letter (''In a very limited number of cases, it has been necessary for us to purchase securities from current shareholders of the portfolio company in order for the financing to be completed. However, in NO case have purchases from existing shareholders ever exceeded 15% of the total investment by Cardinal in a proposed financing.''); Charles River Letter (''The vast majority of our investments are in the form of Convertible Preferred Stock. * * * However, very rarely—but more often than never—- we invest in the form of a straight, non-convertible Demand Note.''); Pine Brook Letter (''Our fund documents provide for investments outside of our core investing practice of up to 25% of our committed capital.''). *But cf.* Mesirow Financial Private Equity Advisors, Inc. (Jan. 24, 2011) (''Mesirow Letter'') (a Commission-registered adviser that advises funds that invest in other venture capital and private equity funds stated that ''[s]ince the main purpose of [venture capital funds] is to invest in and help build operating companies, we believe their participation in non-qualifying activity will be rare.'').

[70] *See supra* note 67.

[71] *See supra* note 43.

[72] *See, e.g.,* ATV Letter; Charles River Letter; Sevin Rosen Letter. At least one commenter stated that the minimum threshold limit for the non-qualifying basket should be 20%. Charles River Letter (''we believe anything less than 20% would be inadequate'').

[73] *See supra* note 66.

[74] A larger non-qualifying basket of 40% could have the result of changing the fundamental underlying nature of the investments held by a qualifying fund, such as for example increasing the extent to which non-qualifying investments may contribute to the returns of the fund's portfolio.

non-qualifying investments).[75] 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.'' [76] 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,[77] but setting the limit at 20 percent gives the investment company management flexibility.[78] 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.[79]

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).[80] 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.[81]

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.[82]

We proposed to define ''equity security'' by reference to the Exchange Act.[83] 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.[84] 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,[85] for working capital needs [86] or for tax or structuring reasons.[87] 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,[88] interests in other pooled investment funds (including other venture capital funds) [89] and publicly offered securities.[90] Commenters argued that these types of investments facilitate access to capital for a company's expansion,[91] offer qualifying funds flexibility to structure investments 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,[92] and enable a portfolio company to seek such financing from venture capital funds if the company is unable to obtain financing from traditional lending sources.[93]

We recognize that a venture capital fund may, on occasion, make investments other than in equity securities.[94] Under the rule, as discussed above, a venture capital fund may make these investments (as well as other types of investments that commenters may not have suggested) to the extent there is room in the fund's non-qualifying basket. Hence, we are adopting the definition of equity security as proposed.

The final rule incorporates the definition of equity security in section 3(a)(11) of the Exchange Act and rule 3a11–1 thereunder.[95] Accordingly,

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[75] Rule 35d–1(a)(2) under the Investment Company Act (''a materially deceptive and misleading name of a [registered investment company] includes * * * [a] name suggesting that the [registered investment company] focuses its investments in a particular type of investment or investments, or in a particular industry or group of industries, unless: (i) The [registered investment company] has adopted a policy to invest, under normal circumstances, at least 80% of the value of its [total assets] in the particular type of investments, or in investments in the particular industry or industries, suggested by the [registered investment company's] name * * *''). 17 CFR 270.35d–1(a)(2).

[76] *Investment Company Names,* Investment Company Act Release No. 24828 (Jan. 17, 2001) [66 FR 8509, 8511 (Feb. 1, 2001), correction 66 FR 14828 (Mar. 14, 2001)] (''Names Rule Adopting Release'').

[77] Names Rule Adopting Release, *supra* note 76, at text accompanying n.3 and text following n.7.

[78] *See* Names Rule Adopting Release, *supra* note 76, at text accompanying n.14. *See also* NVCA Letter; Sevin Rosen Letter (citing rule 35d–1 in support of recommending that the rule adopt a non-qualifying basket); Quaker BioVentures Letter (citing the approach taken by the staff generally limiting an investment company excluded by reason of section 3(c)(5)(C) of the Investment Company Act to investing no more than 20% of its assets in non-qualifying investments).

[79] A number of commenters recommended that the rule specify a range for the non-qualifying basket, arguing that this approach would provide advisers to venture capital funds with better flexibility to manage their investments over time. *See, e.g.,* DLA Piper VC Letter; DuFauchard Letter; Norwest Letter; Oak Investment Letter. As we discuss in greater detail below, the non-qualifying basket is determined as of the time immediately following each investment and hence a range is not necessary.

[80] Rule 203(l)–1(a)(2). The rule specifies that ''immediately after the acquisition of any asset (other than qualifying investments or short-term holdings)'' no more than 20% of the fund's aggregate capital contributions and uncalled committed capital may be held in assets (other than short-term holdings) that are not qualifying investments.'' *See infra* Section II.A.1.c. for a discussion on the operation of the 20% limit.

[81] *See* Sections II.A.1.b.

[82] Rule 203(l)–1(a)(2) (specifying the investments of a venture capital fund); (c)(3) (defining ''qualifying investment''); and (c)(6) (defining ''short-term holdings'').

[83] Proposed rule 203(l)–1(c)(2).

[84] Several commenters opposed any restriction on the definition of equity security. *See, e.g.,* Bessemer Letter; ESP Letter; NVCA Letter.

[85] ATV Letter; NVCA Letter.

[86] Comment Letter of Cook Children's Health Care Foundation Investment Committee (Jan. 20, 2011) (''Cook Children's Letter''); Comment Letter of Leland Fikes Foundation, Inc. (Jan. 21, 2011) (''Leland Fikes Letter'').

[87] Bessemer Letter; Merkl Letter.

[88] *See, e.g.,* Comment Letter of CounselWorks LLC (Jan. 24, 2011); ESP Letter; Comment Letter of McGuireWoods LLP (Jan. 24, 2011) (''McGuireWoods Letter''); NVCA Letter; Oak Investment Letter. *See also* BioVentures Letter (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* Pine Brook Letter.

[89] *See, e.g.,* Cook Children's Letter; Leland Fikes Letter; PEI Funds Letter; Comment Letter of SVB Financial Group (Jan. 24, 2011) (''SVB Letter'').

[90] *See, e.g.,* ATV Letter; BIO Letter (noted that investments by venture capital funds in ''PIPEs'' (*i.e.,* ''private investments in public equity'') are ''common'').

[91] *See, e.g.,* Lowenstein Letter; Comment Letter of John G. McDonald (Jan. 21, 2011) (''McDonald Letter''); Quaker BioVentures Letter; Comment Letter of Trident Capital (Jan. 24, 2011) (''Trident Letter'').

[92] *See, e.g.,* Merkl Letter; Oak Investments Letter; Sevin Rosen Letter; Comment Letter of Vedanta Capital, LP (Jan. 24, 2011) (''Vedanta Letter'').

[93] NVCA Letter; Trident Letter.

[94] *See, e.g.,* ESP Letter; Leland Fikes Letter; McGuireWoods Letter; NVCA Letter; Oak Investment Letter. *See also supra* Section II.A.

[95] Rule 203(l)–1(c)(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.''). *See* 15 U.S.C. 78c(a)(11) (defining ''equity security'' as ''any stock or similar security; or any security future on any such security; or any security convertible, with or without consideration, into such a security, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right; or any other security which the Commission

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equity security includes common stock as well as preferred stock, warrants and other securities convertible into common stock in addition to limited partnership interests.[96] 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 private 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.[97]

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.[98] 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.[99]

A few commenters objected to any limitation on secondary market purchases of a qualifying portfolio company's shares,[100] 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.[101] 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.[102] 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.[103] 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,[104] or 80 percent of the fund's total capital commitments.[105] 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.[106]

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.[107] 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 equities issued by the same qualifying portfolio company.[108] This revision was suggested by a number of

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

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

[97] 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.

[98] Proposing Release, *supra* note 26, at text accompanying n.104.

[99] Proposed rule 203(l)–1(a)(2).

[100] *See, e.g.,* ESP Letter; Merkl Letter.

[101] *See also* Proposing Release, *supra* note 26, at section II.A.1.d.

[102] *See id.,* at n.112 and accompanying text.

[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%, consistent with rules 3a–1 and 3c–5 under the Investment Company Act). *See also* ABA Letter (supported lowering the threshold from 80% to 70%); NVCA Letter; Mesirow 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; Merkl Letter.

[105] ATV Letter; Bessemer Letter; Charles River Letter; Davis Polk Letter; First Round Letter; Gunderson Dettmer Letter; InterWest Letter; Mesirow Letter; Norwest Letter; NVCA Letter; Oak Investment Letter; Sevin Rosen Letter; SVB Letter; Union Square Letter; Vedanta Letter. *See also* Comment Letter of Alta Partners (Jan. 24, 2011) (''Alta Partners Letter''); USVP Letter.

[106] *See, e.g.,* Bessemer Letter; Norwest Letter; Sevin Rosen Letter.

[107] *See* Proposing Release, *supra* note 26, at n.112 and accompanying text.

[108] Under rule 203(l)–1(c)(3)(ii), ''qualifying investments'' include any equity security issued by a qualifying portfolio company in exchange for an equity security issued by the qualifying portfolio company that is directly acquired. *See infra* note 113.

commenters to enable a qualifying fund to participate in the reorganization of the capital structure of a portfolio company, which may require the fund, along with other existing security holders, to accept newly issued equity securities in exchange for previously issued equity securities.[109]

The rule similarly treats as a qualifying investment any equity security issued by another company in exchange for directly acquired equities of a qualifying portfolio company, provided that the qualifying portfolio company becomes a majority-owned subsidiary of the other company or is a predecessor company.[110] This provision enables a qualifying fund to acquire securities in connection with the acquisition (or merger) of a qualifying portfolio company by another company,[111] without jeopardizing the fund's ability to satisfy the definition of venture capital fund. A venture capital fund's acquisition of publicly offered securities in these circumstances may not present the same degree of interconnectedness with the public markets as secondary acquisitions through the open markets that are typical of other types of leveraged buyout private funds.[112] As a result of the modification to the proposed rule, a venture capital fund could hold equity securities of a company subject to reporting under the Exchange Act, if such equity securities were issued to the fund in exchange for directly acquired equities of a qualifying portfolio company that became a majority-owned subsidiary of the reporting company.[113]

c. Operation of the 20 Percent Limit

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)(iii), ''qualifying investments'' include 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), or a predecessor company, and that is acquired by the private fund in exchange for an equity security described in paragraph (c)(3)(i) or (c)(3)(ii) of the rule. *See infra* note 113.

A ''majority-owned subsidiary'' is defined by reference to section 2(a)(24) of the Investment Company Act, (15 U.S.C. 80a2(a)(24), which defines a ''majority-owned subsidiary'' 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''); Mesirow 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* Mesirow Letter.

[113] 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 reporting or foreign traded company), subject to the non-qualifying basket.

[114] Rule 203(l)–1(a)(2). The calculation of the 20% limit operates in a fashion similar to the diversification and ''Second Tier Security'' tests of rule 2a–7 under the Investment Company Act. 17 CFR 270.2a–7(a)(24). *See Revisions to Rules Regulating Money Market Funds,* Investment Company Act Release No. 18005 (Feb. 20, 1991) [56 FR 8113, 8118 (Feb. 27, 1991)].

[115] *See supra* note 67.

[116] Sevin Rosen Letter. *See also* BioVentures Letter (endorsing the NVCA Letter supporting a non-qualifying basket determined 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'').

[117] Capital commitments that have been called but returned to investors and subject to a future call would be treated as uncalled capital commitments. Capital commitments that are no longer subject to a call by the fund would not be treated as uncalled capital commitments.

[118] See *generally infra* notes 240–243 (discussing the use of a qualifying fund's capital commitments to determine the fund's compliance with the leverage criterion). *See also* DLA Piper VC Letter.

[119] *See generally supra* note 67. For purposes of reporting its ''regulatory assets under management'' on Form ADV, an adviser would include uncalled capital commitments of a private fund advised by the adviser.

[120] *See* AFL–CIO Letter; AFR Letter (discussing issues associated with specifying leverage as a percentage of fund capital commitments).

[121] *See infra* Section II.A.7.

[122] The Commission does not need to demonstrate that an adviser violating rule 206(4)–8 acted with *scienter. See Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles,* Investment Advisers Act Release No. 2628 (Aug. 3, 2007) [72 FR 44756 (Aug. 9, 2007)] (''Pooled Vehicles Release'').

1.[123] 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.[124]

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,[125] 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.[126] 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.[127]

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.[128] 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 commenters cited the ERISA rule in connection with comments on other proposed criteria,[130] 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.[131] 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.[132]

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,[133] any U.S. Treasury without regard to maturity,[134] debt issued by foreign governments,[135] repurchase agreements,[136] and certain highly rated corporate commercial paper.[137] 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

[123] *See also Investment Adviser Performance Compensation,* Investment Advisers Act Release No. 3198 (May 10, 2011) [76 FR 27959 (May 13, 2011)] at n.17 (in determining whether a person holds the requisite amount of assets under management, an investment adviser may include ''assets that a client is contractually obligated to invest in private funds managed by the adviser. Only *bona fide* contractual commitments may be included, *i.e.,* those that the adviser has a reasonable belief that the investor will be able to meet.'').

[124] Similarly, fee waivers or reductions for the purpose of inducing investors to increase the size of their capital commitments with an understanding that they will not be called (and hence enable the adviser to increase the size of the non-qualifying basket) would indicate that the commitments are not *bona fide.* In addition, the amount of capital commitments and contributions made by investors and the investments made by the fund are indispensable to the functioning of a venture capital fund, and we understand advisers to venture capital funds typically maintain records reflecting them. *See generally supra* note 5 (describing the Commission's authority to examine the records of advisers relying on the venture capital exemption). We note that a person claiming an exemption under the Federal securities laws has the burden of proving it is entitled to the exemption. *See, e.g., SEC* v. *Ralston Purina Co.,* 346 U.S. 119, 126 (1953); *Gilligan, Will & Co.* v. *SEC,* 267 F.2d 461, 466 (2d Cir. 1959); *Swenson v. Engelstad,* 626 F.2d 421, 425 (5th Cir. 1980); *SEC* v. *Wall St. Transcript Corp.,* 454 F. Supp. 559, 566 (S.D.N.Y. 1978) (stating that the defendant publisher ''must register unless it can be shown that it is'' entitled to rely on an exclusion from the definition of ''investment adviser'').

[125] Rule 203(l)–1(c)(6) (''Short-term holdings'' means cash and cash equivalents as defined in § 270.2a51–1(b)(7)(i), 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.'').

[126] A qualifying investment that is acquired as a result of an exchange of equity securities provided by rule 203(l)–1(c)(3)(ii) and (iii) would not result in a requirement to calculate the 20% limit under rule 203(l)–1(a)(2).

[127] Rule 203(l)–1(a)(2).

[128] *Id.*

[129] Under U.S. Department of Labor regulations, a venture capital operating company (''VCOC'') is any entity that, as of the date of the first investment (or other relevant time), has at least 50% of its assets (other than short-term investments pending long-term commitment or distribution to investors), valued at cost, invested in venture capital investments. 29 CFR 2510.3–101(d). *See also* Proposing Release, *supra* note 26, at n.70.

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

[131] Rule 203(l)–1(c)(6).

[132] Rule 203(l)–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(l)–1(a)(2)(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(l)–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.

[133] Comment Letter of Federated Investors, Inc. (Jan. 18, 2011); IVP Letter; Merkl Letter.

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

[135] Dechert General Letter; Commenter Letter of European Fund and Asset Management Association (Jan. 24, 2011) (''EFAMA Letter''); Merkl Letter.

[136] IVP Letter; NVCA Letter.

[137] Sevin Rosen Letter.

investors and invested in instruments that may provide higher returns than the cash items identified in the proposed rule.[138]

The Commission recognizes that a broader definition of short-term holdings could yield venture capital funds greater returns.[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.[140] Advisers 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,[141] which we understand are commonly held for purposes of cash management.[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.[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).[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.[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).[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.[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.[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.[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.[150] Unlike

[138] NVCA Letter.

[139] *See, e.g.,* NVCA Letter.

[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 II.A.7.

[141] Rule 203(l)–1(c)(6).

[142] *See, e.g.,* NVCA Letter.

[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) [b]ank deposits, certificates of deposit, bankers acceptances and similar bank instruments held for investment purposes; and (ii) [t]he net cash surrender value of an insurance policy.'' 17 CFR 270.2a51–1(b)(7).

[144] *See generally* sections 2(a)(51) and 3(c)(7) of the Investment Company Act; 17 CFR 270.2a51–1(b) and (c).

[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 open-end investment companies to value them using amortized cost value rather than market value. *See Valuation of Debt Instruments by Money Market Funds and Certain Other Open-End Investment Companies,* Investment Company Act Release No. 9786 (May 31, 1977) [42 FR 28999 (June 7, 1977)]. We believe that the same consideration warrants treating U.S. Treasury securities with a remaining maturity of 60 days or less as more akin to cash equivalents than Treasuries with longer maturities for purposes of the definition of venture capital fund.

[146] Rule 203(l)–1(c)(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)(3) and (4).

[147] *See* Proposing Release, *supra* note 26, sections II.A.1.a.–II.A.1.e.

[148] Rule 203(l)–1(c)(4)(i); 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).

[149] Rule 203(l)–1(c)(4)(i) (defining a qualifying portfolio company as any company that at the time of any investment by a venture capital fund is not a reporting or foreign traded company).

[150] *See* Testimony of James Chanos, Chairman, Coalition of Private Investment Companies, July 15, 2009, at 4 (''[V]enture capital funds are 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. Fenn, Nellie Liang and Stephen Prowse, The Economics of the Private Equity Market, December 1995, 22, n.61 and accompanying text (''Fenn *et al.*'') (''Private sales'' are not normally the most important type of exit strategy as compared to IPOs, yet of the 635 successful portfolio company exits by venture capitalists between 1991–1993 ''merger and acquisition transactions accounted for 191 deals and IPOs for 444 deals.'' Furthermore, between 1983 and 1994, of the 2,200 venture capital fund exits, 1,104 (approximately 50%) were attributed to mergers and acquisitions of venture-backed firms.). *See also* Jack S. Levin, Structuring Venture Capital, Private Equity and Entrepreneurial Transactions, 2000 (''Levin'') at 1–2 to 1–7 (describing the various types of venture capital and private equity investment business but stating that ''the phrase 'venture capital' is sometimes used narrowly to refer only to financing the start-up of a new

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.[151] As of year-end 2010, U.S. venture capital funds managed approximately $176.7 billion in assets.[152] In comparison, as of year-end 2010, the U.S. publicly traded equity market had a market value of approximately $15.4 trillion,[153] whereas global hedge funds had approximately $1.7 trillion in assets under management.[154] The aggregate amount invested in venture capital funds is considerably smaller.[155] Congressional testimony asserted that these funds may be less connected with the public markets and may involve less potential for systemic risk.[156] This appears to be a key consideration by Congress that led to the enactment of the venture capital exemption.[157] 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.[158] 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.[159]

Several commenters asserted that the definition should not exclude securities of reporting companies.[160] 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 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.[161] 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.[162] 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.[163]

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.[164]

business''); Anna T. Pinedo & James R. Tanenbaum, Exempt and Hybrid Securities Offerings (2009), Vol. 1 at 12–2 (discussing the role initial public offerings play in providing venture capital investors with liquidity).

[151] *See* Testimony of Trevor Loy, Flywheel Ventures, before the Senate Banking Subcommittee on Securities, Insurance and Investment Hearing, July 15, 2009 (''Loy Testimony''), at 5 (''We do not trade in the public markets.''). *See also* Testimony of Terry McGuire, General Partner, Polaris Venture Partners, and Chairman, National Venture Capital Association, before the U.S. House of Representatives Committee on Financial Services, October 6, 2009 (''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).

[152] National Venture Capital Association Yearbook 2011 (''NVCA Yearbook 2011'') at 9, Fig. 1.0.

[153] Bloomberg Terminal Database, WCAUUS <Index> Bloomberg United States Exchange Market Capitalization).

[154] Credit Suisse, *2010 Hedge Fund Industry Review,* Feb. 2011 (''Credit Suisse Report''), at 1.

[155] In 2010, investors investing in newly formed funds committed approximately $12.3 billion to venture capital funds compared to approximately $85.1 billion to private equity/buyout 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 1.

[156] *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 advisers are required to register with the SEC under this title [IV]. Their activities are not interconnected with the global financial system, and they generally rely on equity funding, so that losses that may occur do not ripple throughout world markets but are borne by fund investors alone. Terry McGuire, Chairman of the National Venture Capital Association, wrote in congressional testimony that 'venture capital did not contribute to the implosion that occurred in the financial system in the last year, nor does it pose a future systemic risk to our world financial markets or retail investors.' ''). *See also* Loy Testimony, *supra* note 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).

[157] *See supra* note 156.

[158] *See* Proposing Release, *supra* note 26, at n.43 and n.60 and following text.

[159] Most commenters did not express any objection to our proposed definition of ''publicly traded,'' although one commenter did disagree 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.

[160] *See* Bessemer Letter; IVP Letter (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) (''BCLBE Letter''). *See also* Dechert General Letter (argued that restricting the application of the control element may be necessary because an adviser to a venture capital fund could be controlled by a public company, and might 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.

[161] ATV Letter; BIO Letter; NVCA Letter. *See also* Davis Polk Letter; InterWest Letter; McDonald Letter; Mesirow Letter; PTV Sciences Letter. A number of commenters supported expanding the proposed definition but without additional conditions. *See, e.g.,* BioVentures Letter; ESP Letter; Quaker BioVentures Letter; SV Life Sciences Letter.

[162] *See, e.g.,* Alta Partners Letter; Gunderson Dettmer Letter; InterWest Letter; McDonald Letter; NVCA Letter; Quaker BioVentures Letter. *See also* Bessemer Letter; BIO Letter; Lowenstein Letter.

[163] Alta Partners Letter (supported limiting investments in public companies to 15% of fund capital commitments); Gunderson Dettmer Letter (supported limiting investments in public securities to 20% of fund capital commitments). *See also* Davis Polk Letter (supported limiting investments in public companies to 20% of fund capital commitments provided the fund continues to hold a majority of its original investment in the company when it was private); SVB Letter (supported investments in public securities but did not identify a percentage threshold).

[164] *See supra* Section II.A.1.b. One commenter argued that, in addition to funds that would satisfy the proposed definition, a venture capital fund should include any fund that invests at least 75% of its capital in privately held ''domestic small business'' as defined in the Small Business Investment Act (the ''SBIA'') regulations, regardless of the equity/debt nature of the investment. *See* NASBIC/SBIA Letter. In the Proposing Release, we noted our concerns with adopting a definition for a ''small'' company, including reliance on the SBIA regulatory standards for treatment as a ''small''

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.[165] 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.[166] 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 security 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.[167] 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.[168] Under the final rule, a qualifying fund would not be in the position of having to dispose of securities of a qualifying portfolio company that subsequently becomes a reporting company.

b. Portfolio Company Leverage

Rule 203(l)–1 defines a qualifying portfolio company for purposes of the exemption as one that does not borrow or issue debt obligations in connection with the venture capital fund's investment in the company and distribute to the fund the proceeds of such borrowing or issuance in exchange for the fund's investment.[169] As a consequence, certain types of funds that use leverage or finance their investments in portfolio companies or the buyout of existing investors with borrowed money (*e.g.*, leveraged buyout funds, which are a different subset of private equity funds) would not meet the rule's definition of a venture capital fund.[170] As discussed in greater detail below and in the Proposing Release, we believe that Congress did not intend the venture capital fund definition to apply to these types of private equity funds.[171]

We proposed to define a qualifying portfolio company as a company that does not borrow ''in connection'' with a venture capital fund investment. We also 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).[172] 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.[173] 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,[174] and the testimony before Congress that stressed the lack of leverage in venture capital investing.[175]

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.[176] Most of the commenters who addressed the issue opposed a definition that excluded any buyouts of portfolio company securities by venture capital funds.[177] 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.[178] Some commenters stated that buyouts are an important means of providing liquidity to portfolio company founders, employees, former employees and vendors/service providers,[179] while others argued that

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. *See* Proposing 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.

[165] *See* rule 203(l)–1(c)(4)(i).

[166] PTV 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] *See* Proposing 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).

[169] Rule 203(l)–1(c)(4)(ii).

[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 acquired companies * * *'' U.S. Govt. Accountability Office, Private Equity: Recent Growth in Leveraged Buyouts Exposed Risks that Warrant Continued Attention (2008) (''GAO Private Equity Report''), at 1. A leverage buyout fund in 2005 typically financed a deal with 34% equity and 66% debt. *Id.* at 13. *See also* Fenn *et al., supra* note 150, at 23 (companies that have been taken private in a leveraged buyout (or ''LBO'') transaction generally ''spend less on research and development, relative to assets, and have a greater proportion of fixed assets; their debt-to-assets ratios are high, above 60 percent, and are two to four times those of venture-backed firms.'' Moreover, compared to venture capital backed companies, LBO-private equity backed companies that are taken public typically use proceeds from an IPO to reduce debt whereas new venture capital backed firms tend to use proceeds to fund growth.); Testimony of Mark Tresnowksi, General Counsel, Madison Dearborn Partners, LLC, on behalf of the Private Equity Council, before the Senate Banking Subcommittee on Securities, Insurance and Investment, July 15, 2009, at 2 (indicating that portfolio companies in which private equity funds invest typically have 60% debt and 40% equity).

[171] *See* discussion in section II.A.1.c. and d. of the Proposing Release, *supra* note 26.

[172] Proposed rules 203(l)–1(a)(2)(i); (c)(4)(ii) and (c)(4)(iii).

[173] *See generally* Proposing Release, *supra* note 26, at sections II.A.1.c. and d.

[174] *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.''); *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] *See* Proposing 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. Mesirow Letter. *See also* McGuireWoods Letter; NVCA Letter (discussing some interpretative issues with the ''in connection with'' language).

[178] ATV Letter; NVCA Letter. *See also* ABA 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[180] or conversions of permissible bridge loans [181] should not preclude a fund from relying on the definition.[182]

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.[183]

One of the distinguishing features of venture capital funds is that, unlike many hedge funds and private equity funds, they invest capital directly in portfolio companies for the purpose of funding the expansion and development of the company's business rather than buying out existing security holders, otherwise purchasing securities from other shareholders, or leveraging the capital investment with debt financing.[184] Testimony received by Congress and our research suggest that venture capital funds provide capital to many types of businesses at different stages of development,[185] generally with the goal of financing the expansion of the company [186] 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.[187]

In contrast, private equity funds that are identified as buyout funds typically provide capital to an operating company in exchange for majority or complete ownership of the company,[188] generally achieved through the buyout of existing shareholders or other security holders and financed with debt incurred by the portfolio company,[189] and compared to venture capital funds, hold the investment for shorter periods of time.[190] As a result of the use of the capital provided and the incurrence of this debt, following the buyout fund investment, the operating company may carry debt several times its equity and may devote significant levels of its cash flow and corporate earnings to repaying the debt financing, rather than investing in capital improvement or business operations.[191]

Some commenters agreed that distinguishing between venture capital and other private funds with reference to a portfolio company's leverage and indirect buyouts is important.[192] 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.[193] 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.[194] Nevertheless, the majority of commenters who addressed this criterion supported a leverage criterion that would be more specific, or

[180] Alta Partners Letter; BioVentures Letter.

[181] ATV Letter; NVCA Letter.

[182] *See also* Pine Brook Letter (suggesting ''careful drafting'' that would not preclude transactions in the normal course of business by defining a set of prohibited buyout transactions (*e.g.,* ''leveraged dividend recapitalizations'')).

[183] *See supra* note 174 and accompanying text.

[184] *See* Loy Testimony, *supra* note 151, at 2 (''Although venture capital funds may occasionally borrow on a short-term basis immediately preceding the time when the cash installments are due, they do not use debt to make investments in excess of the partner's capital commitments or 'lever up' the fund in a manner that would expose the fund to losses in excess of the committed capital or that would result in losses to counter parties requiring a rescue infusion from the government.''). *See also infra* notes 189–191; Mark Heesen & Jennifer C. Dowling, National Venture Capital Association, *Venture Capital & Adviser Registration* (October 2010), materials submitted in connection with the Commission's Government-Business Forum on Small Business Capital Formation (summarizing the differences between venture capital funds and buyout and hedge funds), *available at http://www.sec.gov/info/smallbus/2010gbforumstatements.htm.*

[185] *See, e.g.,* McGuire Testimony, *supra* note 151, at 1; NVCA Yearbook 2010, *supra* note 150; PricewaterhouseCoopers/National Venture Capital Association MoneyTree Report, Q4 2009/Full-year 2009 Report (providing data on venture capital investments in portfolio companies); James Schell, Private Equity Funds: Business Structure and Operations (2010), at § 1.03[1] (''Schell''), at § 1.03[1]; *Paul A. Gompers & Josh Lerner, The Venture Capital Cycle*, at 459 (MIT Press 2004), at 178, 180 table 8.2 (displaying percentage of annual venture capital investments by stage of development and classifying ''early stage'' as seed, start-up, or early stage and ''late stage'' as expansion, second, third, or bridge financing).

[186] *See* McGuire Testimony, *supra* note 151, at 1; Loy Testimony, *supra* note 151, at 3 (''Once the venture fund is formed, our job is to find the most promising, innovative ideas, entrepreneurs, and companies that have the potential to grow exponentially with the application of our expertise and venture capital investment.''). *See also* William A. Sahlman, *The Structure and Governance of Venture-Capital Organizations,* Journal of Financial Economics 27 (1990), at 473, 503 (''Sahlman'') (noting venture capitalists typically invest more than once during the life of a company, with the expectation that each capital investment will be sufficient to take the company to the next stage of development, at which point the company will require additional capital to make further progress).

[187] *See* Sahlman, *supra* note 186, at 503; Loy Testimony, *supra* note 151, at 3 (''[W]e continue to invest additional capital into those companies that are performing well; we cease follow-on investments into companies that do not reach their agreed upon milestones.'').

[188] 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.'').

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

[190] Unlike venture capital funds, which generally invest in portfolio companies for 10 years or more, private equity funds that use leveraged buyouts invest in their portfolio companies for shorter periods of time. *See* Loy Testimony, *supra* note 151, at 3 (citing venture capital fund investments periods in portfolio companies of five to 10 years or longer); van den Burg, *supra* note 189, at 19 (noting that LBO investors generally retain their investment in a listed company for 2 to 4 years or even less after the company goes public). *See also* Paul A. Gompers, *The Rise and Fall of Venture Capital,* Business And Economic History, vol. 23, no. 2, Winter 1994, at 17 (stating that ''an LBO investment is significantly shorter than that of a comparable venture capital investment. Assets are sold off almost immediately to meet debt burden, and many companies go public again (in a reverse LBO) in a very short period of time.'').

[191] *See* Barrett *et al., supra* note 189. *See also* Fenn *et al., supra* note 150, at 23 (companies that have been taken private in an LBO transaction generally ''spend less on research and development, relative to assets, and have a greater proportion of fixed assets; their debt-to-assets ratios are high, above 60%, and are two to four times those of venture-backed firms.'' Moreover, compared to venture capital backed companies, LBO-private equity backed companies that are taken public typically use proceeds from an IPO to reduce debt whereas new venture capital backed firms tend to use proceeds to fund growth.).

[192] *See, e.g.,* AFL–CIO Letter; Sen. Levin Letter; Pine Brook Letter.

[193] *See, e.g.,* ATV Letter; Charles River Letter; NVCA Letter; Oak Investment Letter; Pine Brook Letter.

[194] *See, e.g.,* NVCA Letter; Pine Brook Letter; SV Life Sciences Letter; Vedanta Letter.

limited, in scope,[195] focusing on the use of proceeds derived from portfolio company leverage.[196] 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[197] or for returning capital to the fund,[198] and not, for example, define leverage to include indebtedness incurred to pay for a qualifying portfolio company's operating expenses.[199]

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.[200] 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.[201]

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 venture 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.[202] Under the rule, a qualifying portfolio company could not be another private fund, a commodity pool or other ''investment companies.''[203] We are adopting this criterion because Congress did not express an intent to include venture capital funds of funds within the definition.[204] 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''[205] 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.[206]

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.[207] 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

[195] *See, e.g.,* ATV Letter; Charles River Letter (supports modifying the rule so that up to 20% of fund capital commitments may be invested in portfolio companies that do not adhere to the leverage condition provided that the venture capital fund is not the party providing the leverage to the company); NVCA Letter; Comment Letter of the Securities Regulation Committee of the Business Law Section of the New York State Bar Association, Apr. 1, 2011 (''NYSBA Letter''); SVB Letter.

[196] Although two commenters supported the leverage limitation as proposed (*see* AFL–CIO Letter (also supporting a specific prohibition on borrowing by a portfolio company to pay dividends or fees to the venture capital fund); Sen. Levin Letter (together with the equity investment requirement, the definition appropriately excludes leveraged buyout funds)), two other commenters opposed it, arguing that qualifying portfolio company leverage should not be restricted at all (*see* ESP Letter (limits on leverage would prevent portfolio companies from receiving lending from venture debt funds and state governments and lenders rather than regulators should determine the appropriate level of portfolio company debt); Merkl Letter (young negative EBITDA companies would not be able to obtain significant amounts of debt and hence no leverage prohibition is required)). *See also* NASBIC/SBIA Letter (portfolio companies should not be precluded from accessing leverage); Sevin Rosen Letter, Pine Brook Letter (each expressed support for a use of proceeds approach).

[197] *See, e.g.,* Gunderson Dettmer Letter; McDonald Letter; NVCA Letter; SVB Letter.

[198] *See, e.g.,* McDonald Letter; NVCA Letter.

[199] Gunderson Dettmer Letter; Pine Brook Letter; Trident Letter; Vedanta Letter. One commenter suggested that a use of proceeds test would be difficult to enforce because such a test would need to be extremely detailed in order to prevent circumvention. *See* Merkl Letter.

[200] *See, e.g.,* Merkl Letter; Sevin Rosen Letter; SVB Letter.

[201] *See, e.g.,* ABA Letter; ATV Letter; Bessemer Letter; Mesirow Letter; NVCA Letter; SV Life Sciences Letter. *See also* Proposing Release, *supra* note 26, discussion at section II.A.1.c.

[202] Rule 203(l)–1(c)(4)(iii). For this purpose, pooled investment vehicles include investment companies, issuers relying on rule 3a–7 under the Investment Company Act and commodity pools. 17 CFR 270.3a–7.

[203] Under the ''holding out'' criterion (discussed in Section II.A.7. below), a fund that represents itself as pursuing a venture capital strategy to investors implies that the fund invests primarily in operating companies and not for example in entities that hold oil and gas leases.

[204] One commenter agreed that ''there is no indication that Congress intended the venture capital exemption to apply to 'funds of funds,''' but argued that the qualifying portfolio company definition was ''unduly restrictive'' because it would exclude such funds of funds and discourage use of special purpose vehicles. ABA Letter.

[205] S. Rep. No. 111–176, *supra* note 6, at 74.

[206] *See generally* Loy Testimony, *supra* note 151, and McGuire Testimony, *supra* note 151.

[207] One commenter indicated that it was ''sympathetic'' to the Commission's concerns about the use of fund of funds structures to circumvent the intended purpose of the exemption, and agreed that such ''investments would unacceptably heighten the possibility for abuse.'' *See* NVCA Letter (suggesting that the Commission address this concern by applying the venture capital fund leverage limit on a full ''look-through'' basis to the underlying funds).

investments.[208] 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.[209]

Many commenters opposed the operating company criterion and recommended that the rule include fund of venture capital fund structures.[210] Some commenters supported no limits on investments in other pooled investment vehicles,[211] 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)[212] or (ii) investment in underlying funds does not exceed a specified threshold (such as a percentage of fund capital).[213] Commenters argued that broadening the definition of qualifying portfolio company was necessary in order to accommodate current business practices,[214] or was appropriate because funds of funds (including secondary funds) provide investors with liquidity or do not pose systemic risk.[215] 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.[216]

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.[217]

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.[218] 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.[219] 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.[220]

Commenters 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;[221] 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;[222] 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.[223]

Most commenters sought guidance on determining what activities would constitute managerial assistance or ''control.''[224] Other commenters specifically requested confirmation that a management rights letter for purposes of ''venture capital operating company'' status under ERISA would be sufficient.[225] Finally, some commenters recommended that the rule address syndicated transactions,[226] and provide that the managerial assistance criterion would be satisfied if one fund within the syndicate provided the requisite assistance or control.[227]

[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.

[209] *See* Proposing Release, *supra* note 26, at nn.70–72 (discussing the California venture capital exemption and the VCOC definition under ERISA, 29 CFR 2510.3–101(d)).

[210] *See, e.g.,* NVCA Letter; Sevin Rosen Letter; Comment Letter of VCFA Group (Jan. 21, 2011).

[211] *See, e.g.,* Cook Children's Letter; Leland Fikes Letter; Merkl Letter.

[212] *See, e.g.,* ATV Letter, Charles River Letter, NVCA Letter, Sevin Rosen Letter (specifically in the context of funds of ''seed'' funds); SVB Letter, Vedanta Letter (85% cap for investments in rule 203(l)–1 compliant, unleveraged funds). *See also* Dechert General Letter (suggested that funds investing solely in venture capital funds should be permitted or, in the alternative, investments of up to 20% of committed capital should be permitted in ''incubator'' funds).

[213] First Round Letter (supported investments in underlying funds representing no more than 10% of a fund's called capital, measured at the end of the fund's term); ATV Letter and Charles River Letter (supported investments in underlying funds representing no more than 20% of a fund's committed capital subject to other conditions); PEI Funds Letter (supports ''substantial'' investment in venture capital investments rather than a specific numerical threshold); Comment Letter of Private Equity Investors, Inc. and Willowbridge Partners, Inc. (Jan. 7, 2011) (''PEI/Willowbridge Letter'') (supported investments in other qualifying funds representing at least 50% of the qualifying fund's assets or committed capital) and Comment Letter of Venture Investment Associates (Jan. 24, 2011) (''VIA Letter'') (supported investments in underlying funds representing at least 50% of a qualifying fund's capital commitments).

[214] *See, e.g.,* ATV Letter, Charles River Letter, Cook Children's Letter, Leland Fikes Letter (each of which cited the use of technology incubators).

[215] *See, e.g.,* PEI/Willowbridge Letter and VIA Letter.

[216] *See, e.g.,* ABA Letter; Davis Polk Letter; NVCA Letter.

[217] *See, e.g.*, Davis Polk Letter for a discussion of these considerations.

[218] *See* Proposing Release, *supra* note 26, section II.A.2.

[219] *See id.,* at n.123.

[220] *See id.,* at section II.A.2.

[221] 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).

[222] ESP Letter.

[223] Sevin Rosen Letter.

[224] BCLBE Letter; Gunderson Dettmer Letter; McGuireWoods Letter; Shearman Letter. Shearman 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 the ''offer-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).

[225] ATV Letter; Charles River Letter; NVCA Letter; Oak Investment Letter; Santé Ventures Letter; Sevin Rosen Letter; Village Ventures Letter.

[226] ABA Letter; ESP Letter; McGuireWoods Letter.

[227] ABA Letter (asserted that most deals are syndicated deals). *See also* Dechert General Letter; ESP Letter (indicating that in syndicated

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 commenters generally supported the leverage criterion as proposed,[231] many commenters sought to broaden it in several ways. Two commenters that generally supported the leveraged 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 commenters 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 commenter sought to increase the leverage threshold from 15 percent to 20 percent.[235] One commenter, on behalf of many venture capital advisers, however, agreed with the proposed leverage criterion, arguing that venture capital fund financing would generally not exceed 15 percent of fund capital commitments or remain outstanding for longer than 120 days.[236]

We decline to increase the leverage threshold for a qualifying fund under the rule or exclude other certain types of borrowings as requested by some commenters. Our rule defines a venture capital fund by reference to a maximum of 15 percent of borrowings based on our understanding that venture capital funds typically would not incur borrowings in excess of 10 to 15 percent of the fund's total capital contributions and uncalled capital commitments,[237] which commenters have confirmed.[238] We believe that imposing a maximum at the upper range of borrowings typically used by venture capital funds will accommodate existing practices of the vast majority of industry participants.

Our rule specifies that the 15 percent calculation must be determined based on the fund's aggregate capital contributions and uncalled capital commitments.[239] Unlike most registered investment companies or hedge funds, venture capital funds rely on investors funding their capital commitments from time to time in order to acquire portfolio companies.[240] A capital commitment is a contractual obligation to acquire an interest in, or provide the total commitment amount over time to, a fund, when called by the fund. Accordingly, an adviser to venture capital funds manages the fund in anticipation of all investors fully funding their commitments when due and typically has the right to penalize investors for failure to do so.[241] Venture

transactions, there may be varying degrees of managerial involvement by funds participating in the transactions; one fund may take an active role, with the other funds taking a more passive role with respect to portfolio companies).

[228] For example, one commenter 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).

[230] *Id.*

[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 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] *See* 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).

[236] NVCA Letter. *See also* Merkl Letter.

[237] *See* Loy Testimony, *supra* note 151, at 6 (''[M]any venture capital funds significantly limit borrowing such that all outstanding capital borrowed by the fund, together with guarantees of portfolio company indebtedness, does not exceed the lesser of (i) 10–15% of total limited partner commitments to the fund and (ii) undrawn limited partner commitments.'').

[238] NVCA Letter. *See also* Merkl Letter; Oak Investments Letter.

[239] Rule 203(l)–1(a)(3).

[240] Schell, *supra* note 185, at § 1.03[8] (''The typical Venture Capital Fund calls for Capital Contributions from time to time as needed for investments.''); *id.* at § 2.05[2] (stating that ''[venture capital funds] begin operation with Capital Commitments but no meaningful assets. Over a specific period of time, the Capital Commitments are called by the General Partner and used to acquire Portfolio Investments.'').

[241] *See* Loy Testimony, *supra* note 151, at 5 (''[Limited partners] make their investment in a venture fund with the full knowledge that they generally cannot withdraw their money or change their commitment to provide funds. Essentially they agree to ''lock-up'' their money for the life of the fund * * *''). *See also* Stephanie Breslow & Phyllis Schwartz, Private Equity Funds, Formation and

Continued

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.[242] 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.[243] These factors would lead to the conclusion that, in contrast to other types of private funds, such as hedge funds, which trade on a more frequent basis, a venture capital fund would view the fund's total capital commitments as the primary metric for managing the fund's assets and for determining compliance with investment guidelines. Hence, we believe that calculating the leverage threshold to include uncalled capital commitments is appropriate, given that capital commitments are already used by venture capital funds themselves to measure investment guideline compliance.

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.[244] 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.[245] Others seeking to accommodate business practices and provide maximum flexibility for venture capital fund debt investments in portfolio companies recommended excluding guarantees of portfolio company debt by a venture capital fund from the 120-day limit.[246] Other commenters argued that guarantees of portfolio company obligations would not result in qualifying funds incurring extensive leverage.[247]

We understand that guarantees of portfolio company leverage by a venture capital fund are typically limited to the value of the fund's investment in the company (often through a pledge of the fund's interest in the company).[248] Such guarantees by a qualifying fund may help a qualifying portfolio company obtain credit for working capital purposes, rather than be used by the fund to leverage its investment in the company.[249] We are persuaded that such guarantees of portfolio company indebtedness do not present the same types of risks identified by Congress. Congress cited the implementation of trading strategies that use financial leverage by certain private funds as creating a potential for systemic risk.[250] In testimony before Congress, the venture capital industry identified the lack of financial leverage in venture capital funds as a basis for exempting advisers to venture capital funds [251] in contrast with other types of private funds such as hedge funds, which may engage in trading strategies that may contribute to systemic risk and affect the public securities markets.[252] For this reason, our proposed rule was designed to address concerns that financial leverage may contribute to systemic risk by excluding funds that incur more than a limited amount of leverage from the definition of venture capital fund.[253] We believe that the alternative approach to fund leverage we have adopted in the final rule better reflects industry practice while still addressing Congress' concern that the use of financial leverage may create the potential for systemic risk.

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.[254] Unlike hedge funds, a venture capital fund does not typically permit investors to redeem their interests during the life of the fund,[255] but rather distributes assets generally as investments mature.[256]

Operation 2010 (''Breslow & Schwartz''), at § 2:5.6 (discussing the various remedies that may be imposed in the event an investor fails to fund its contractual capital commitment, including, but not limited to, ''the ability to draw additional capital from non-defaulting investors;'' ''the right to force a sale of the defaulting partner's interests at a price determined by the general partner;'' and ''the right to take any other action permitted at law or in equity'').

[242] *See, e.g.,* Breslow & Schwartz, *supra* note 241, at § 2:5.7 (noting that a cap of 10% to 25% of remaining capital commitments is a common limitation for follow-on 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.

[243] *See, e.g.,* NVCA Yearbook 2010, *supra* note 150, at 16; John Jannarone, *Private Equity's Cash Problem,* Wall St. J., June 23, 2010, *http://online.wsj.com/article/SB10001424052748704853404575323073059041024.html#printMode.*

[244] Rule 203(l)–1(a)(3).

[245] *See, e.g.,* NVCA Letter; Davis Polk Letter; Bessemer Letter.

[246] Cook Children's Letter; Leland Fikes Letter; Gunderson Dettmer Letter; Oak Investment Letter; SVB Letter. *See also* ABA Letter.

[247] *See, e.g.,* SVB Letter.

[248] *See also* NVCA Letter.

[249] *See, e.g.,* Oak Investments Letter; SVB Letter.

[250] *See* Proposing Release, *supra* note 26, at n. 136 and accompanying text.

[251] *See* McGuire Testimony, *supra* note 151, at 7 (''Venture capital firms do not use long term leverage, rely on short term funding, or create third party or counterparty risk * * *. [F]rom previous testimony submitted by the buy-out industry, the typical capital structure of the companies acquired by a buyout fund is approximately 60% debt and 40% equity. In contrast, borrowing at the venture capital fund level, if done at all, typically is only used for short-term capital needs (pending drawdown of capital from its partners) and does not exceed 90 days. Not only are our partnerships run without debt but our portfolio companies are usually run without debt as well.''); Loy Testimony, *supra* note 151, at 2 (''Although venture capital funds may occasionally borrow on a short-term basis immediately preceding the time when the cash installments are due, they do not use debt to make investments in excess of the partner's capital commitments or 'lever up' the fund in a manner that would expose the fund to losses in excess of the committed capital or that would result in losses to counter parties requiring a rescue infusion from the government.'').

[252] *See* S. Rep. No. 111–176, *supra* note 6, at 74–75.

[253] In proposing an exemption for advisers to private equity funds, which would have required the Commission to define the term ''private equity fund,'' the Senate Banking Committee noted the difficulties in distinguishing some private equity funds from hedge funds and expected the Commission to exclude from the exemption private equity funds that raise significant potential systemic risk concerns. S. Rep. No. 111–176, *supra* note 6, at 75. *See also* G20 Working Group 1, Enhancing Sound Regulation and Strengthening Transparency, at 7 (March 25, 2009) (noting that unregulated entities such as hedge funds may contribute to systemic risks through their trading activities).

[254] Rule 203(l)–1(a)(4).

[255] *See* Schell, *supra* note 185, at § 1.03[7] (venture capital fund ''redemptions and withdrawals are rarely allowed, except in the case of legal compulsion''); Breslow & Schwartz, *supra* note 241, at § 2:14.2 (''the right to withdraw from the fund is typically provided only as a last resort'').

[256] Loy Testimony, *supra* note 151, at 2–3 (''As portfolio company investments are sold in the later years of the [venture capital] fund—when the company has grown so that it can access the public markets through an initial public offering (an IPO) or when it is an attractive target to be bought–the liquidity from these 'exits' is distributed back to the limited partners. The timing of these distributions is subject to the discretion of the general partner, and limited partners may not otherwise withdraw capital during the life of the venture [capital] fund.''). *Id.* at 5 (Investors ''make their investment in a venture [capital] fund with the full knowledge that they generally cannot withdraw their money or change their commitment to provide funds.

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.[257] 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.[258] 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.[259] 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,[260] (ii) specifying redemption rights for certain categories of investors under certain circumstances[261] or (iii) specifying opt-out rights for investors.[262] Several commenters, however, indicated that the term ''extraordinary circumstances'' is sufficiently clear,[263] 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.[264] 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.[265] 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.[266] 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.[267] 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.[268]

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

Essentially they agree to 'lock-up' their money for the life of the fund, generally 10 or more years as I stated earlier.''). *See also* Dow Jones Report, *supra* note 242, at 60 (noting that an investor in a private equity or venture capital fund typically does not have the right to transfer its interest). *See generally* Proposing Release, *supra* note 26, section II.A.4.

[257] *See* Hedge Fund Adviser Registration Release, *supra* note 14, at n.240 and accompanying text (''Many partnership agreements provide the investor the opportunity to redeem part or all of its investment, for example, in the event continuing to hold the investment became impractical or illegal, in the event of an owner's death or total disability, in the event key personnel at the fund adviser die, become incapacitated, or cease to be involved in the management of the fund for an extended period of time, in the event of a merger or reorganization of the fund, or in order to avoid a materially adverse tax or regulatory outcome. Similarly, some investment pools may offer redemption rights that can be exercised only in order to keep the pool's assets from being considered 'plan assets' under ERISA [Employee Retirement Income Security Act of 1974].''). *See, e.g.,* Breslow & Schwartz, *supra* note 241, at § 2:14.1 (''Private equity funds generally provide for mandatory withdrawal of a limited partner [*i.e.,* investor] only in the case where the continued participation by a limited partner in a fund would give rise to a regulatory or legal violation by the investor or the fund (or the general partner [*i.e.,* adviser] and its affiliates). Even then, it is often possible to address the regulatory issue by excusing the investor from particular investments while leaving them otherwise in the fund.'').

[258] *See, e.g.,* Breslow & Schwartz, *supra* note 241, at § 2:14.2 (''The most common reason for allowing withdrawals from private equity funds arises in the case of an ERISA violation where there is a substantial likelihood that the assets of the fund would be treated as 'plan assets' of any ERISA partner for purposes of Title I of ERISA or section 4975 of the Code.''). *See also* Schell, *supra* note 185, at § 9.04[3] (''Exclusion provisions allow the General Partner to exclude a Limited Partner from participation in any or all investments if a violation of law or another material adverse effect would otherwise occur.''); *id.* at Appendix D–31 (attaching model limited partnership agreement providing ''The General Partner at any time may cancel the obligations of all Partners to make Capital Contributions for Portfolio Instruments if * * * changes in applicable law * * * make such cancellation necessary or advisable * * *'').

[259] A number of commenters agreed with the redeemability criterion. *See, e.g.,* ATV Letter; Charles River Letter; Gunderson Dettmer Letter. However, one commenter argued that a fund's redeemability is not necessarily characteristic of venture capital funds. Comment Letter of Cooley LLP (Jan. 21, 2011).

[260] *See, e.g.,* NVCA Letter. The rule specifies that a qualifying fund is a private fund that ''issues securities the terms of which do not provide a holder with any right, except in extraordinary circumstances, to withdraw * * *'' If a general partner interest is not a ''security,'' then the redeemability criterion of the rule would not be implicated. Whether or not a general partner interest is a ''security'' depends on the particular facts and circumstances. *See generally Williamson* v. *Tucker,* 645 F.2d 404 (5th Cir. 1981), *cert. denied,* 454 U.S. 897 (1981).

[261] ABA Letter (sought guidance on whether granting redemption rights to certain types of investors such as ERISA funds and state plans, in the event of certain ERISA, tax or regulatory changes would be considered extraordinary).

[262] McGuireWoods Letter.

[263] *See* Gunderson Dettmer Letter; Merkl Letter; SVB Letter.

[264] *See, e.g., id.*

[265] *See supra* notes 255–256 and accompanying text.

[266] For example, in the Proposing Release, we stated that a private fund's governing documents might provide that investors do not have any right to redeem without the consent of the general partner. In practice, if the general partner typically permits investors to redeem their otherwise non-redeemable interests on a periodic basis, then the fund would not be considered to have issued securities that ''do not provide a holder with any right, except in extraordinary circumstances, to withdraw.'' Rule 203(l)–1(a)(4). *See* Proposing Release, *supra* note 26, at n.154.

[267] *See* NVCA Letter (disagreeing with statements in the Proposing Release regarding the *de facto* creation of redemption rights but generally agreeing with the general prohibition on redemptions except in extraordinary circumstances).

[268] Section 208(d) of the Advisers Act.

the imposition of such conditions,[269] 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.[270] 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).[271] We believe that only funds that do not significantly differ from the common understanding of what a venture capital fund is,[272] 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 203(l)–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.'' [273] Although several commenters generally supported the ''holding out'' criterion as proposed,[274] 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.[275] Several commenters argued that historically, some funds have avoided referring to themselves as ''venture capital funds.'' [276] 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.[277]

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.[278] 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.[279] The appropriate framework for analyzing whether a qualifying 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.[280] 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.[281] 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.[282] 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,[283] referring to venture capital funds as a ''subset of private investment funds.'' [284] The comment letters that addressed this proposed criterion generally supported it.[285]

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

[269] *See, e.g.,* SVB Letter (expressing opposition to a rule that would limit redemptions following a minimum investment period or limit redemptions to a specified maximum threshold).

[270] Rule 203(1)–1(a)(1).

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

[272] *See* Proposing Release, *supra* note 26, at n.157.

[273] Proposed Rule 203(l)–1(a)(1).

[274] *See* Gunderson Dettmer Letter; Sen. Levin Letter; Merkl Letter.

[275] *See, e.g.,* IVP Letter; Comment Letter of MissionPoint Capital Partners, Jan. 24, 2011; PEI Funds Letter.

[276] *See, e.g.,* NVCA Letter; Pine Brook Letter. *See also* IVP Letter; PEI Funds Letter.

[277] *See* Pine Brook Letter.

[278] Similarly, misleadingly including the words ''venture capital'' in the name of a fund pursuing a different strategy would not satisfy the definition.

[279] One commenter requested confirmation and examples of what constituted appropriate representations to investors given that ''many'' venture capital funds do not use private placement memoranda or other offering materials during fundraising. *See* Gunderson Dettmer Letter (expressed the view that the following would be sufficient: (i) Checking the ''venture capital'' box on Form D or (ii) stating on the adviser's Web site that all of the funds advised by the adviser are venture capital funds). As we noted above, whether or not a venture capital fund satisfies the ''holding out'' criterion will depend on the particular facts and circumstances surrounding all of the statements and omissions made by the fund in light of the circumstances under which they were made. Moreover, a venture capital fund that seeks to rely on the safe harbor for non-public offerings under rule 506 of Regulation D is subject to all of the conditions of such rule, including the prohibition on general solicitation and general advertising applicable to statements attributable to the fund on a publicly available Web site. *See* 17 CFR 230.502(c).

[280] 17 CFR 275.206(4)–8.

[281] *See* Pooled Vehicles Release, *supra* note 122, at n.27 (''A fact is material if there is a substantial likelihood that a reasonable investor in making an investment decision would consider it as having significantly altered the total mix of information available,'' citing *Basic, Inc.* v. *Levinson,* 485 U.S. 224, 231–32 (1988)).

[282] Rule 203(l)–1(a) and (a)(5). *See also* discussion *infra* note 319.

[283] Legislative history does not indicate that Congress addressed this matter, nor does testimony before Congress suggest that this was contemplated. *See, e.g.,* McGuire Testimony, *supra* note 151, at 3 (noting that venture capital funds are not directly accessible by individual investors); Loy Testimony, *supra* note 151, at 2 (''Generally * * * capital for the venture fund is provided by qualified institutional investors such as pension funds, universities and endowments, private foundations, and to a lesser extent, high net worth individuals.''). *See generally* section 202(a)(29) of the Advisers Act (definition of ''private fund'').

[284] *See* S. Rep. No. 111–176, *supra* note 6, at 74 (describing venture capital funds as a subset of ''private investment funds'').

[285] Gunderson Dettmer Letter; Merkl Letter; NYSBA Letter; Sen. Levin Letter.

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.[286] 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.[287] 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.[288] 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.[289] 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.[290] One commenter suggested that the same policy rationale underlying the private fund adviser exemption justified this approach to the venture capital exemption.[291] 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.[292]

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.[293] 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 private fund.[294] A non-U.S. fund that does not use 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.[295] 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.[296]

In light of this result, we asked in the Proposing Release whether we should adopt a broader interpretation of the term ''private fund.'' [297] 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.[298] 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.[299] Moreover, a non-U.S. fund that is treated as a private fund under these circumstances by an adviser relying on the venture capital

[286] *See* section 203(l) of the Advisers Act; H. Rep. No. 111–517, *supra* note 6, at 867; S. Rep. No. 111–176, *supra* note 6, at 74–75.

[287] *See* Loy Testimony, *supra* note 151, at 4–5; McGuire Testimony, *supra* note 151, at 5–6.

[288] *See, e.g.,* Bessemer Letter; EVCA Letter; McDonald Letter; Merkl Letter; NVCA Letter; SV Life Sciences Letter.

[289] *See* McGuireWoods Letter; Shearman Letter. *See also* EFAMA Letter (also noting that as a practical matter, the rule should account for non-U.S. specific practices so that non-U.S. advisers could rely on the exemption); Gunderson Dettmer Letter (exemption should be available to non-U.S. advisers even if non-U.S. funds do not satisfy definitional elements); Dechert General Letter (non-U.S. advisers that manage funds that are not venture capital funds outside of the U.S. should be able to rely on rule 203(l) for funds that are managed in the U.S. or that are marketed to U.S. investors).

[290] *See* 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, 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,* Securities Act Release No. 7656 (Mar. 19, 1999) [64 FR 14648 (Mar. 26, 1999)] (''Canadian Tax-Deferred Retirement Savings Accounts Release''), at nn.10, 20, 23; *Statement of the Commission Regarding Use of Internet Web Sites to Offer Securities, Solicit Securities Transactions or Advertise Investment Services Offshore,* Securities Act Release No. 7516 (Mar. 23, 1998) [63 FR 14806 (Mar. 27, 1998)], at n.41. *See also* Dechert LLP, SEC Staff No-Action Letter (Aug. 24, 2009) at n.8; Goodwin, Procter & Hoar LLP, SEC Staff No-Action Letter (Feb. 28, 1997) (''Goodwin Procter 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.

[295] *See* Proposing Release, *supra* note 26, at nn.175 and 188 and accompanying text.

[296] 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.

[297] *See* Proposing Release, *supra* note 26, at section II.A.8 (''[S]hould a non-U.S. fund be a private fund under the proposed rule if the non-U.S. fund would be deemed a private fund upon conducting a private offering in the United States in reliance on sections 3(c)(1) or 3(c)(7)?'').

[298] *See, e.g.,* Dechert General Letter; EFAMA Letter; Gunderson Dettmer Letter; McGuireWoods Letter; Shearman Letter.

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

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'').[300] 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.[301] 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,[302] two commenters indicated that the proposed grandfathering provision was too restrictive because of the holding out criterion.[303] 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).[304]

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,''[305] 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,''[306] which commenters asserted is typical of some older funds. No commenter addressed the dates proposed in the grandfathering provision.[307]

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.[308] 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.[309]

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.[310] 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.[311]

*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 has less than $150 million in assets under management in the United States.[312] Rule 203(m)–1, which we are

[300] Rule 203(l)–1(b).

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

[302] Comment Letter of AustinVentures (Jan. 21, 2011) (''AV Letter''); Norwest Letter; NYSBA Letter. *See also* NVCA Letter.

[303] DLA Piper VC Letter; Pine Brook Letter.

[304] Comment Letter of North American Securities Administrators Association, Inc., Feb. 10, 2011 (''NASAA Letter'').

[305] Davis Polk Letter; DLA Piper VC Letter; Pine Brook Letter.

[306] Davis Polk Letter; Gunderson Dettmer Letter; IVP Letter; Norwest Letter; NVCA Letter.

[307] The NVCA specifically stated that other than clarification on the names that venture capital funds may use to identify themselves, no ''further changes to the grandfathering proposal are necessary or appropriate and [we] do not believe that this criterion, as it exists for new funds, presents problems to the industry.'' *See* NVCA Letter.

[308] *See supra* discussion at Section II.A.7.

[309] *Id.*

[310] *See id.*

[311] One commenter agreed that it may be difficult for a qualifying fund seeking to rely on the grandfathering provision to change fund terms and liquidate its positions to the possible detriment of the fund and its investors. AV Letter.

[312] Section 408 of the Dodd-Frank Act, which is codified in section 203(m) of the Advisers Act. *See supra* note 19.

adopting 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.[313] 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. These ''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

[313] *See* rule 203(m)–1(a) and (b). Section 202(a)(29) of the Advisers Act defines the term ''private fund'' as ''an issuer that would be an investment company, as defined in section 3 of the Investment Company Act of 1940 (15 U.S.C. 80a–3), but for section 3(c)(1) or 3(c)(7) of that Act.'' 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.175 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.

[315] Rule 203(m)–1(b)(1). As discussed below, 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. *See infra* note 403.

[316] These considerations have, for example, been incorporated in our rules 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(b)(5) (''If you have your principal office and place of business outside the United States, you are not required to count clients that are not United States residents, but if your principal office and place of business is in the United States, you must count all clients.''). *See infra* note 392. The Dodd-Frank Act repeals the private adviser exemption as of July 21, 2011, and we are rescinding rule 203(b)(3)–1 in the Implementing Adopting Release. *See* Implementing Adopting Release, *supra* note 32, at section II.D.2.a.

[317] *See, e.g.,* ABA Letter; Comment Letter of Debevoise & Plimpton LLP (Jan. 24, 2011) (''Debevoise Letter''); Comment Letter of Dechert LLP (on behalf of Foreign Adviser) (Jan. 24, 2011) (''Dechert Foreign Adviser Letter''); Gunderson Dettmer Letter; Merkl Letter; Comment Letter of Katten Muchin Rosenman LLP (on behalf of Certain Non-U.S. Advisers) (Jan. 24, 2011) (''Katten Foreign Advisers Letter''); Comment Letter of MAp Airports Limited (Jan. 24, 2011) (''MAp Airports Letter''); Comment Letter of Wellington Financial LP (Jan. 24, 2011) (''Wellington Letter'').

[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 be permitted to engage in ''some activities that do not involve advising clients and have no effect on assets under management,'' such as providing research to institutional investors).

[319] 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 Horan & Camerini LLP (Dec. 22, 2010). *See also supra* notes 294 and 313. We agree.

[320] In contrast to the foreign private adviser exemption discussed in Section II.C, a non-U.S. adviser relying on the private fund 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.

[321] NASBIC/SBIA 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 in reliance on 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'') (sought guidance concerning single-investor funds and managed accounts structured as funds); Commenter Letter of Managed Funds Association (Jan. 24, 2011) (''MFA Letter'') (asserted that single-investor funds are ''private funds'').

[324] 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*

Continued

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), such 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 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. 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.[329] 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.[331] 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 deducting 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

*of Funds or Securities of Clients by Investment Advisers,* Investment Advisers Act Release No. 2968 (Dec. 30, 2009) [75 FR 1456 (Jan. 11, 2010)] at n.132 (the use of a special purpose vehicle in certain circumstances could constitute a violation of section 208(d) of the Advisers Act). Thus, for example, an adviser would not be eligible for the exemption if it advises what is nominally a ''private fund'' but that in fact operates as a means for providing individualized investment advice directly to the investors in the ''private fund.'' In this case, the investors would also be clients of the adviser. *Cf.* Advisers Act rule 202(a)(30)–1(b)(1) (an adviser ''must count an owner [of a legal organization] as a client if [it] provide[s] investment advisory services to the owner separate and apart from the investment advisory services [it] provide[s] to the legal organization'').

[325] For example, a fund that seeks to raise capital from multiple investors but has only a single, initial investor for a period of time could be a private fund, as could a fund in which all but one of the investors have redeemed their interests.

[326] Dechert General Letter. *See also* Comment Letter of Baker McKenzie LLP (Jan. 26, 2011) (submitted in connection with the Implementing Proposing Release, avail. at *http://www.sec.gov/comments/s7-36-10/s73610.shtml*) (recommended that the Commission revise the calculation of assets under management on Form ADV to exclude assets in certain funds relying on section 3(c)(5)(C) of the Investment Company Act); Comment Letter of DLA Piper LLP (US) (submitted by John H. Heuberger and Hal M. Brown) (similarly sought to exempt advisers to certain funds relying on section 3(c)(5)(C)).

[327] Section 202(a)(29) of the Advisers Act (defining the term ''private fund'').

[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 ''assets under management'' to mean ''regulatory assets under management'' in item 5.F of Form ADV, Part 1A); 203(m)–1(d)(4) (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 securities 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).

[333] *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).

[334] *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.

[335] 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, then 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.*

[336] *See* Form ADV: Instructions for Part 1A, instr. 5.b.(2), (4). *See also* Implementing Adopting Release, *supra* note 32, discussion at section II.A.3.

[337] *See* Proposing Release, *supra* note 26, discussion at section II.B.2. *See also* Implementing Adopting Release, *supra* note 32, discussion at section II.A.3.

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.''); Dechert General Letter (commented on particular aspects of the proposed uniform method but stated ''[w]e generally agree with the Commission's initiative in creating a single uniform method of calculating an adviser's assets under management ('AUM') for purposes of determining an adviser's registration status ('Regulatory AUM')''). *See also* Implementing Adopting Release, *supra* note 32, at n.68 and accompanying text.

[340] *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 that capital and would be given responsibility for management of those assets).

[341] *See also* Implementing Adopting Release, *supra* note 32, discussion at section II.A.3.

[342] *See, e.g.,* Dechert General Letter; Seward Letter. *See also* ABA Letter; AIMA 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. places of business, provided it complies with the exemption's conditions. *See infra* Section II.B.3.

[343] *See* Implementing Adopting Release, *supra* note 32, at n.74 and accompanying text. Several commenters also asserted that including proprietary assets as proposed would in effect require a wholly owned control affiliate to register as an investment adviser. *See, e.g.,* Comment Letter of American Insurance Association (Jan. 24, 2011) (''AIA Letter''); Comment Letter of Katten Muchin Rosenman LLP (on behalf of APG Asset Management US Inc.) (Jan. 21, 2011); Comment Letter of Katten Muchin Rosenman LLP (Jan. 24, 2011) (on behalf of Certain Non-U.S. Insurance Companies) (''Katten Foreign Insurance Letter''). Whether a control affiliate is deemed to be an ''investment adviser'' under the Advisers Act because, among other things, it ''engages in the business of advising others'' will 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.

[344] *See* sections 203(m) and 202(a)(30) of the Advisers Act.

[345] *See also* Implementing Adopting Release, *supra* note 32, at n.75 and accompanying text (explaining that ''the management of 'proprietary' assets or assets for which the adviser may not be compensated, when combined with other client assets, may suggest that the adviser's activities are of national concern or have implications regarding the reporting for the assessment of systemic risk'').

[346] *See, e.g.,* ABA Letter; Katten Foreign Advisers Letter; Seward Letter.

[347] Moreover, we note that an adviser seeking to rely on rule 203(m)–1 may have only private fund clients and must include the assets of all of its private fund clients when determining if it remains under the rule's $150 million threshold.

[348] ABA Letter; Dechert General Letter; Merkl Letter; MFA Letter; Seward Letter; Shearman Letter.

[349] Dechert General Letter. *See also* Implementing Adopting Release, *supra* note 32, at n.80 and accompanying text.

[350] MFA Letter.

[351] *See, e.g.,* Merkl Letter; Shearman Letter. One commenter asserted that the ''inclusion of borrowed assets may create an incentive for an adviser to reduce client borrowings to qualify for an exemption from registration even though reducing leverage may not be in the best interest of its clients,'' and that it ''could encourage advisers to use methods other than borrowing to obtain financial leverage for their clients (*e.g.,* through swaps or other derivative products, which could be disadvantageous to clients due to the counterparty risks and increased costs that they entail).'' Seward Letter. *See also* Gunderson Dettmer Letter. We note that advisers, as fiduciaries, may not subordinate clients' interests to their own such as by altering their investing behavior in a way that is not in the client's best interest in an attempt to remain under the exemption's $150 million threshold. Another commenter argued that a gross assets calculation would make calculations of regulatory assets under management more volatile. *See* Dechert General Letter. As discussed in more detail below, we are permitting advisers relying on rule 203(m)–1 to calculate their private fund assets annually, rather than quarterly as proposed, and are extending the period during which certain advisers may file their registration applications if their private fund assets exceed the exemption's $150 million threshold. *See infra* Section II.B.2.b. We believe these measures will substantially mitigate or eliminate any volatility that may be caused by using a 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.[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.[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.[354] 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.'' [355] 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.[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.[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.[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.[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.[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.[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 [362] and we have taken several steps to mitigate them.[363]

While many advisers will calculate fair value in accordance with GAAP or another international accounting standard,[364] other advisers acting consistently and in good faith may utilize another fair valuation standard.[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)–1.[366]

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

[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.A.3.

[353] *See id.*

[354] *See id.,* at n.82 and preceding and accompanying text.

[355] ABA Letter.

[356] *See, e.g.,* Dechert General Letter. *See also* Implementing Adopting Release, *supra* note 32, at n.80 and accompanying text.

[357] In addition, in response to commenters seeking clarification of the application of the gross assets calculation to mutual funds, short positions and leverage, we expect that advisers will continue to calculate their gross assets as they do today, even if they currently only calculate gross assets as an intermediate step to compute their net assets. *See* Implementing Adopting Release, *supra* note 32, at n.83. In the case of pooled investment vehicles with a balance sheet, for instance, an adviser could include in the calculation the total assets of the entity as reported on the balance sheet. *Id.*

[358] *See* Merkl Letter.

[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.

[360] *See, e.g.,* Gunderson Dettmer Letter; Merkl Letter; O'Melveny Letter; Seward Letter; Wellington Letter.

[361] *See* Proposing Release, *supra* note 26, at n.196 and accompanying text.

[362] *See id.,* at n.326 and accompanying text.

[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).

[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.

[365] *See id.,* at n.99 and accompanying text. Consistent with this good faith requirement, we would expect that an adviser that calculates fair value in accordance with GAAP or another basis of accounting for financial reporting purposes will also use that same basis for purposes of determining the fair value of its regulatory assets under management. *Id.*

[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 are not, however, 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.

[367] Dechert Foreign Adviser Letter; EFAMA Letter.

[368] Merkl Letter; Wellington Letter.

[369] AIMA Letter; MFA Letter; Seward Letter.

[370] O'Melveny Letter.

fund.[371] Use of these approaches would limit our ability to compare data from different advisers and thus would be inconsistent with our goal of achieving more consistent asset calculations and reporting across the industry, as discussed above, and also could result in advisers managing comparable amounts of assets under management being subject to different registration requirements. 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 as we proposed, rule 203(m)–1 requires advisers to calculate the value of private fund assets pursuant to the instructions in Form ADV.

b. Frequency of Calculation and Transition Period

An adviser relying on the exemption provided by rule 203(m)–1 must annually calculate the amount of the private fund assets it manages and report the amount in its annual updating amendments to its Form ADV.[372] 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 private fund adviser exemption.[373] Advisers thus may be required to register under the Advisers Act as a result of increases in their private fund assets that occur from year to year, but changes in the amount 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.[374] 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 shorter-term fluctuations in assets under management.[375] 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 from state to Commission registration.[376]

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 and must register under the Advisers Act unless it qualifies for another 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.[377] 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.[378] 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.[379] 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.[380]

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.[381] The transition period is a safe harbor that provides advisers flexibility in

[371] Gunderson Dettmer Letter.

[372] An adviser relying on rule 203(m)–1 must file an annual updating amendment to its Form ADV within 90 days after the end of its fiscal year, and must calculate its private fund assets in the manner described in the instructions to Form ADV within 90 days prior to the date it makes the filing. *See* rule 203(m)–1(c); rule 204–4(a); General Instruction 4 to Form ADV; Form ADV: Instructions for Part 1A, instr. 5.b. The adviser must report its private fund assets on Section 2.B of Schedule D to Form ADV. Advisers also must report their private fund assets when they file their initial reports as exempt reporting advisers. *See* Implementing Adopting Release, *supra* note 32, discussion at section II.B.

[373] Under Item 2.B of Part 1A of Form ADV, an adviser relying on rule 203(m)–1 must complete Section 2.B of Schedule D, which requires the adviser to provide the amount of the ''private fund assets'' it manages. A note to Section 2.B of Schedule D provides that ''private fund assets'' has the same meaning as under rule 203(m)–1, and that non-U.S. advisers should only include private fund assets that they manage at a place of business in the United States. *See also infra* notes 377–378 and accompanying text.

[374] A number of commenters argued, among other things, that calculating private fund assets quarterly would: (i) Impose unnecessary costs and burdens on advisers, some of whom might not otherwise perform quarterly valuations; and (ii) inappropriately permit shorter-term fluctuations in assets under management to require advisers to register. *See* ABA Letter; AIMA Letter; Dechert Foreign Adviser Letter; Dechert General Letter; EFAMA Letter; Katten Foreign Advisers Letter; Merkl Letter; NASBIC/SBIA Letter; Seward Letter.

[375] As discussed above, an adviser relying on rule 203(m)–1 must calculate its private fund assets in the manner described in the instructions to Form ADV within 90 days prior to the date it files its annual updating amendment to its Form ADV.

[376] *See* General Instruction 4 to Form ADV; Form ADV: Instructions for Part 1A, instr. 5.b.; rule 203A–1(b). *See also* ABA Letter (''We believe an annual measurement would be most appropriate, especially since advisers exempt from registration because they do not meet the $100,000,000 asset threshold will calculate their assets for this purpose annually, and an annual test for both purposes has a compelling consistency.'').

[377] General Instruction 15 to Form ADV. *See also* Implementing Adopting Release, *supra* note 32, discussion at section II.B.5. We removed what was proposed rule 203(m)–1(d), which contained the proposed transition period, and renumbered the final rule accordingly. The transition period as adopted is described in General Instruction 15 to Form ADV. Rule 203(m)–1(c) refers advisers to this instruction. This transition period is available to an adviser that has complied with ''all [Commission] reporting requirements applicable to an exempt reporting adviser as such,'' rather than ''all applicable Commission reporting requirements,'' as proposed. This condition reflects the importance of the Advisers Act reporting requirements applicable to advisers relying on the private fund adviser exemption.

[378] General Instruction 15 to Form ADV. *See also* Implementing Adopting Release, *supra* note 32, discussion at section II.B.5. An adviser would lose the exemption immediately upon accepting a client that is not a private fund. Accordingly, for the adviser to comply with the Advisers Act, the adviser's Commission registration must be approved before the adviser accepts a client that is not a private fund. Moreover, even an adviser to whom the transition period is available could not, consistent with the Advisers Act, accept a client that is not a private fund until the Commission approves its registration. These same limitations apply to non-U.S. advisers with respect to their clients that are United States persons.

[379] ABA Letter; AIMA Letter; CompliGlobe Letter; Gunderson Dettmer Letter; Katten Foreign Advisers Letter; Sadis & Goldberg Implementing Release Letter; Seward Letter; Shearman Letter.

[380] An adviser must file its annual Form ADV updating amendment within 90 days after the end of its fiscal year and, if the transition period is available, may apply for registration up to 90 days after filing the amendment. *See also supra* note 378.

[381] Shearman Letter.

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 outside of 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 Depositary 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 230.902(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.

[386] ABA Letter; Comment Letter of Association Française de la Gestion financière (Jan. 24, 2011) (''AFG Letter'') (sought clarification that assets managed from non-U.S. offices are exempted); AIMA Letter; Comment Letter of Avoca Capital Holdings (Dec. 21, 2010) (''Avoca Letter''); Debevoise Letter; Dechert Foreign Adviser Letter; EFAMA Letter; Gunderson Dettmer Letter; Katten Foreign Advisers Letter; MAp Airports Letter; Merkl Letter; Comment Letter of Non-U.S. Adviser (Jan. 24, 2011) (''Non-U.S. Adviser Letter''). *Cf.* Sen. Levin Letter (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'').

[387] Katten Foreign Advisers Letter.

[388] *See* Proposing Release, *supra* note 26, at nn.204–205 and accompanying text.

[389] *See infra* Section II.C.

[390] 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).

[391] Portfolio Manager Letter. *See also* Comment Letter of Tuttle (Nov. 30, 2010) (submitted in connection with the Implementing Adopting Release, avail. at *http://www.sec.gov/comments/s7–35–10/s73510.shtml*) (''Tuttle Implementing Release Letter'') (argued that businesses may move offshore if they become too highly regulated in the United States).

[392] *See* Proposing Release, *supra* note 26, at n.207 (identifying Regulation S and Exchange Act rule 15a–6 as examples of Commission rules that adopt a territorial approach).

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

[394] Comment Letter of Richard Dougherty (Dec. 14, 2010) (''Dougherty Letter'').

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] No commenter suggested this would occur. We continue to believe that rule 203(m)–1 will have only a limited effect on multi-national advisory 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 account is held for the benefit of a United States person by a non-U.S. fiduciary who is a related person of the adviser.[409] One

[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,'' may be 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.

[403] 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 not a United States 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 when an adviser must determine if a person is ''in the United States'' for purposes of that exemption. *See infra* Section II.C.3.

[404] 17 CFR 230.902(k)(1)(i).

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

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

[407] 17 CFR 230.902(k)(1)(vii).

[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) provides that a ''United States person means any person that is a 'U.S. person' as defined in [Regulation S], 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 [rule 203(m)–1] and is not organized, incorporated,

Continued

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 subadvisory relationships between non-U.S. advisers and their U.S. adviser affiliates.[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.[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 and corporations as U.S. persons if they are organized or incorporated in the United States.[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.[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).[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;[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;[416] and (iv) does not hold itself out generally to the public in the United States as an investment adviser.[417] Section 202(a)(30) authorizes the Commission to increase the $25 million threshold ''in accordance with the purposes of this title.''[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.''[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.[420] The commenter that generally addressed this aspect of our proposed rule agreed with our approach,[421] which was designed to apply a well-developed body of law to

or (if an individual) resident in the United States.'' In contrast, under Regulation S, a discretionary account maintained by a non-U.S. fiduciary (such as an investment adviser) is not a ''U.S. person'' even if the account is owned by a U.S. person. *See* 17 CFR 230.902(k)(1)(vii); 17 CFR 230.902(k)(2)(i).

[410] Katten Foreign Advisers Letter; AIMA Letter (noting that the special rule should be narrowly drawn but also stating that ''[w]e understand the rationale for the special rule proposed by the Commission for discretionary accounts maintained outside the US for the benefit of US persons and we believe that that is an appropriate safeguard against avoidance of the registration requirement'').

[411] *See* Proposing Release, *supra* note 26, discussion at section II.B.4.

[412] Debevoise Letter (noted that, for example, ''a private fund, or an entity that is organized as part of a private fund, may be organized under Delaware law to meet certain regulatory and tax objectives, but the fund's principal office and place of business in fact may be outside the U.S.'').

[413] The commenter asserted that this approach ''would not be inconsistent with Regulation S itself, which treats a partnership or corporation organized under the laws of a foreign jurisdiction as a U.S. person if it was '[f]ormed by a U.S. person principally for the purpose of investing in securities not registered under the [Securities] Act, unless it is organized or incorporated, and owned, by accredited investors * * * who are not natural persons, estates or trusts.''' *See also* Comment Letter of Fulbright & Jaworski L.L.P. (on behalf of a German asset manager) (Jun. 15, 2011) (''Fulbright Letter'').

[414] Section 402 of the Dodd-Frank Act (providing a definition of ''foreign private adviser,'' to be codified at section 202(a)(30) of the Advisers Act). *See supra* notes 22 and 23 and accompanying text.

[415] One commenter suggested that a non-U.S. adviser with no place of business in the United States would not be subject to the Advisers Act unless the adviser has at least one direct U.S. client. *See* Katten Foreign Advisers Letter. *See also* ABA Letter. We note that section 203(a) of the Advisers Act provides that an adviser may not, unless registered, make use of any means or instrumentality of interstate commerce in connection with its business as an investment adviser. Hence, whether a non-U.S. adviser with no place of business in the United States and no U.S. clients would be subject to registration depends on whether there is sufficient use of U.S. jurisdictional means. *See also supra* note 334.

[416] Subparagraph (B) of section 202(a)(30) refers to the number of ''clients and investors in the United States in private funds,'' while subparagraph (C) refers to assets of ''clients *in the United States* and investors in the United States in private funds'' (emphasis added). 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.

[417] 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.

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

[419] Rule 202(a)(30)–1(c).

[420] 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* rule 203(b)(3)–1(b)(5). 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 where the client resides 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 must determine if a client or investor is ''in the United States'' for purposes of the exemption. *See infra* note 476 and accompanying text.

[421] *See* Katten 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.[423] Rule 202(a)(30)–1 also permits an adviser to treat as a single ''client'' (i) a corporation, general partnership, limited partnership, limited liability company, trust, or other legal organization to which the adviser provides investment advice based on the legal organization's investment objectives, and (ii) two or more legal organizations that have identical shareholders, partners, limited partners, members, or beneficiaries.[424]

As proposed, we are omitting the ''special rule'' providing advisers with the option of not counting as a client any person for whom the adviser provides investment advisory services without compensation.[425] 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.[428] 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 exemption.[429] 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.[431] 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.[432] In addition, a beneficial owner of short-term paper issued by the private fund also is an ''investor,'' notwithstanding that holders of short-term paper need not be counted for purposes of section 3(c)(1).[433] Finally, in order to avoid double-counting, the rule clarifies that an adviser may treat as a single investor any person who is an investor in two or more private funds advised by the investment adviser.[434] 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.'' [435]

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 202(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)(1). 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(a)(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 partnership, limited partnership, limited liability company, trust, or other legal organization, as a client if the adviser provides investment advisory services to the owner separate and apart from the investment advisory services provided to the legal organization; (2) an adviser is not required to count an owner as a client solely because the adviser, on behalf of the legal organization, offers, promotes, or sells interests in the legal organization to the owner, or reports periodically to the owners as a group solely with respect to the performance of or plans for the legal organization's assets or similar matters; and (3) any general partner, managing member or other person acting as an investment adviser to a limited partnership or limited liability company must count the partnership or limited liability company as a client.

[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 the firm and 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: Glossary (stating that for purposes of Form ADV, the term ''client'' ''includes clients from which [an adviser] receives no compensation * * *.''). 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)(B) 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 the private fund when determining whether the 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.

[431] *See* rule 202(a)(30)–1(b)(5).

[432] *See* rule 202(a)(30)–1(c)(2)(i); *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).[436] 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).[437] 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.[438] Holders of both equity and debt securities must be counted as investors.[439]

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.[440] 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).[441] 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.[442] 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 owner.[443] 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.[444] 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).[445]

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.[446] 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.[447] Similarly, 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.''

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'').[448] 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). *See generally* sections 3(c)(1) and 3(c)(7) of the Investment Company Act.

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

[440] *See* section 208(d) of the Advisers Act; section 48(a) of the Investment Company Act.

[441] As noted above, we have recognized that in certain circumstances it is appropriate to ''look through'' an investor (*i.e.,* attribute ownership of a private fund to another person who is the ultimate owner). *See, e.g., Privately Offered Investment Companies,* 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 is wholly owned by a Prospective Qualified Purchaser who makes all the decisions with respect to such investments), it would be appropriate to attribute the investments held by such entity to the Prospective Qualified Purchaser.'').

[442] A ''master-feeder fund'' is an arrangement in which one or more funds with the same or consistent investment objectives (''feeder funds'') invest all or substantially all of their assets in a single fund (''master fund'') with the same or consistent investment objective and strategies. We have taken the same approach within our rules that require a private fund to ''look through'' any investor that is formed or operated for the specific purpose of investing in a private fund. *See* rule 2a51–3(a) under the Investment Company Act (17 CFR 270.2a51–3(a)) (a company is not a qualified purchaser if it is ''formed for the specific purpose of acquiring the securities'' of an investment company that is relying on section 3(c)(7) of the Investment Company Act, unless each of the company's beneficial owners is also a qualified purchaser). *See also* NSMIA Release, *supra* note 441 (explaining that rule 2a51–3(a) would limit the possibility that ''a company will be able to do indirectly what it is prohibited from doing directly [by organizing] * * * a 'qualified purchaser' entity for the purpose of making an investment in a particular Section 3(c)(7) Fund available to investors that themselves did not meet the definition of 'qualified purchaser' '').

[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 2a51–1(h) treat as qualified purchasers those persons they reasonably believe are qualified purchasers. Persons who must be qualified purchasers for purposes of section 3(c)(7) generally would be the same as those who must be counted for purposes of section 3(c)(1). Accordingly, advisers may, for purposes of determining their investors in the United States under rule 202(a)(30)–1, treat as an investor a person the adviser reasonably believes is the actual investor.

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

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.[449] A number of commenters opposed our proposal.[450] 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.[451]

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.[452] 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'' [453] issued by the private fund.[454] 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).[455] 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.[456] 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.[457] 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.[458]

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.[459] 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.[460] 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.[461] 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.[462] 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.[463] 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.[464] If these funds were ''private

[449] *See* Proposing Release, *supra* note 26, at n.250 and accompanying text.

[450] *See* Dechert General Letter; Katten Foreign Advisers Letter; Seward Letter; Shearman Letter.

[451] *See, e.g.,* Dechert General Letter (''[The] Commission promulgated the knowledgeable employee safe-harbors for sections 3(c)(1) and 3(c)(7) in response to the Congressional mandate in the National Securities Markets Improvement Act of 1996 to allow certain informed insiders to invest in a private fund without causing the fund to lose its exception under the 1940 Act.''); Shearman Letter (the proposed approach is ''contrary to a long history of recognizing that knowledgeable employees should be treated differently than other investors and that their privileged status with their organizations in terms of influence and access to information reasonably limits the public's interest in their protection'').

[452] *See* Advisers Act rule 205–3(d)(1)(iii) (specifying that knowledgeable employees are included among the types of clients to whom the adviser may charge performance fees); Advisers Act rule 202(a)(11)(G)–1 (permitting a family office excluded from the definition of investment adviser under the Advisers Act to provide investment advice to its knowledgeable employees). These provisions reflect a policy determination that knowledgeable employees are likely to be in a position or have a level of knowledge and experience in financial matters sufficient to be able to evaluate the risks and take steps to protect themselves.

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

[454] *See* rule 202(a)(30)–1(c)(2)(ii).

[455] *See* sections 3(c)(1) and 3(c)(7) of the Investment Company Act.

[456] *See* ABA Letter (''[H]olders of short-term securities do not view themselves as making an investment decision in connection with their extension of credit, but rather assess the risk of holding a private fund's short-term paper based on credit risk.''); Shearman Letter (''[A] lender to a fund, while it makes a 'credit analysis,' does not deploy capital based on the perceived skill of the fund manager and so is not an investor by any traditional measure.'').

[457] *See* Shearman Letter.

[458] *See Reves* v. *Ernst & Young,* 494 U.S. 56 (1990).

[459] *See* Proposing Release, *supra* note 26, at n. 251 and accompanying text. One commenter agreed that we should not treat short- and longer-term debt holders differently for purposes of the exemption. *See* ABA Letter (asking that we exclude all holders of conventional debt from the definition of investor).

[460] 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 August 2007. At that time, structured investment vehicles (''SIVs''), which are off-balance sheet funding vehicles sponsored by financial institutions, issued commercial paper to finance the acquisition of long-term assets, including residential mortgages. As a result of problems in the residential home mortgage market, short-term investors began to avoid asset-backed commercial paper tied to residential mortgages, regardless of whether the securities had substantial exposure to sub-prime mortgages. Unable to roll over their commercial paper, SIVs suffered severe liquidity problems and significant losses. *See Money Market Fund Reform,* Investment Company Act Release No. 28807 (June 30, 2009) [74 FR 32688 (July 8, 2009)] (''Money Market Fund Reform Release'') at nn. 37–39 and preceding and accompanying text; *Marcin Kacperczyk And Philipp Schnabl, When Safe Proved Risky: Commercial Paper During the Financial Crisis Of 2007–2009* (Nov. 2009).

[461] 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).

[462] Congress added section 3(c)(7) to the Investment Company in 1996 as part of the National Securities Markets Improvement Act of 1996. Section 3(c)(1) was included in the Investment Company Act when it was enacted in 1940.

[463] *See* AFG Letter; Dechert Foreign Adviser Letter; EFAMA Letter; Shearman Letter.

[464] Dechert Foreign Adviser Letter; EFAMA Letter. *See also* Comment Letter of Association Française de la Gestion financière (Jun. 14, 2011) (recommended that ''investment funds that already are strictly regulated and supervised by European Union regulators should be excluded from the

Continued

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]

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

scope of Title IV of the Dodd Frank Act and should not be considered as 'private funds''' because, among other reasons, the commenter's management company members ''very often'' do not know the identities of their funds' investors, and ''therefore should not [] be held responsible if, unbeknownst to them, US persons decide to invest in their funds'').

465 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.,* Goodwin 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 Tax-Deferred 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.'').

466 *See* section 402 of the Dodd-Frank Act.

467 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 203(m)–1. *See supra* Section II.B.4.

468 *See* 17 CFR 230.902(l).

469 *See* 17 CFR 230.902(k).

470 *See* 17 CFR 230.902(l).

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 when determining whether a non-U.S. private fund meets 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. 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).

475 Rule 202(a)(30)–1(c)(3)(i). *See supra* note 409.

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)(2)(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.[479] 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.[480] 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 Canadian retirement accounts (''Participants'') after having moved to the United States.[481] The commenters noted that this treatment would be consistent with rule 7d–2 under the Investment Company Act and certain related rules.[482] 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,[483] but we have previously stated that Participants need not be counted toward the 100-investor limit for purposes of section 3(c)(1).[484] 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(a)(30)–1 with respect to investments they make after moving to the United States if the fund is in compliance with rule 7d–2.[485]

4. Place of Business

New rule 202(a)(30)–1, by reference to rule 222–1,[486] defines ''place of business'' to mean any office where the investment adviser regularly provides advisory services, solicits, meets with, or otherwise communicates with clients, and any location held out to the public as a place where the adviser conducts any such activities.[487] 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(a)(30) of the Advisers Act and thus provides a basis for an adviser to determine whether it can rely on the exemption in section 203(b)(3) of the Advisers Act for foreign private advisers. 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,[488] 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.[489]

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.[490] 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.[491] 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.[492] 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.[493] 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.[494] There is no 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.[495] A non-U.S. adviser might be deemed to have a place of business in

[479] *See* Dechert Foreign Adviser Letter; Dechert General Letter; EFAMA Letter.

[480] *See* Investment Funds Institute of Canada, SEC Staff No-Action Letter (Mar. 4, 1996) (staff also stated its belief that, to the extent that a dividend reinvestment plan of a non-U.S. fund is consistent with the requirements of Securities Act Release No. 929 (July 29, 1936), such a plan would not involve an offer for purposes of Section 7(d) of the Investment Company Act). *See also* Goodwin Procter No-Action Letter, *supra* note 294; Touche Remnant No-Action Letter, *supra* note 294.

[481] *See* IFIC Letter; Comment Letter of Investment Industry Association of Canada (Jan. 18, 2011) (''IIAC Letter'').

[482] We adopted rule 7d–2, along with rule 237 under the Securities Act, in order to allow Participants who move to the United States to continue to manage their Canadian retirement accounts. *See Offer and Sale of Securities to Canadian Tax-Deferred Retirement Savings Accounts,* Securities Act Release No. 7860 (June 7, 2000) [65 FR 37672 (June 15, 2000)]. U.S. registration requirements were affecting those Participants' ability to purchase or exchange securities for such accounts. Rule 7d–2 generally allows non-U.S. funds to treat as a private offering certain offerings to Participants who are in the United States.

[483] *See supra* notes 294 and 313.

[484] *See* Canadian Tax-Deferred Retirement Savings Accounts Release, *supra* note 294, at n.23.

[485] This interpretation only applies with respect to Participants' investments in Eligible Securities issued by a Qualified Company, as these terms are defined in rule 7d–2.

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

[487] Rule 202(a)(30)–1(c)(4).

[488] *See* Proposing Release, *supra* note 26, at n.265 (explaining that, under section 222(d) of the Advisers Act, a state may not require an adviser to register if the adviser does not have a ''place of business'' within, and has fewer than six clients resident in, the state).

[489] *See* ABA Letter (''[W]e believe that the definition of place of business set forth in Rule 222–1 is appropriate * * *''); AIMA Letter (''We consider the definition of 'place of business' by reference to Rule 222–1 of the Advisers Act both logical and appropriate.'').

[490] *See, e.g.,* ABA Letter; AIMA Letter.

[491] As discussed above, investment advisers will also apply this provision for purposes of the private fund adviser exemption. *See supra* Section II.B.3.

[492] Rule 222–1 does not distinguish between U.S. and non-U.S. clients.

[493] That would include, for example, research conducted in order to produce non-public information relevant to the investments of, or the investment recommendations for, any of the adviser's clients.

[494] *See, e.g.,* Debevoise Letter; Dechert Foreign Adviser Letter; EFAMA Letter.

[495] See *infra* note 506.

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 assets under management, we believe that all advisers should use the same method for calculating assets under management to determine if they are required to register or may be eligible for the exemption.[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.[503]

*D. Subadvisory Relationships and Advisory Affiliates*

We generally interpret advisers as including subadvisers,[504] 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.

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 Release without taking into account the activities of its affiliates. The adviser, for example, might have advisory affiliates that are registered or that provide advisory services that 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. Such a result 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

[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 (and therefore 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 representative 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.'' *Id. See also infra* Section II.D.

[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.

[498] *See supra* Section II.B.2.a; Implementing Adopting Release, *supra* note 32, discussion at section II.A.3.

[499] According to the statutory definition of ''foreign private adviser,'' a non-U.S. adviser calculating the assets relevant for purposes of the foreign private adviser exemption would only include those assets under management (*i.e.,* regulatory assets under management) that are ''attributable to clients in the United States and investors in the United States in private funds advised by the investment adviser.'' *See supra* notes 416 and 429 and accompanying text and note 417.

[500] *See supra* Section II.B.2.a; Implementing Adopting Release, *supra* note 32, discussion at section II.A.3.

[501] *See* Seward Letter.

[502] *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).

[503] *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); AFG 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. *See* ABA 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'').

[504] *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.

[505] *See, e.g.,* AFG 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 the context of rule 203(m)–1).

[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

acknowledged this, but urged that, in the case of a non-U.S. advisory affiliate, the Commission affirm the staff's positions developed in the *Unibanco* line of no-action letters (''*Unibanco* letters'').[507] In the *Unibanco* letters,[508] the staff provided assurances that it would not recommend enforcement action, subject to certain conditions, against a non-U.S. unregistered adviser that is affiliated with a Commission-registered adviser, despite sharing personnel and resources.[509]

The *Unibanco* letters grew out of recommendations in a 1992 staff study, and sought to limit the extraterritorial application of the Advisers Act while also protecting U.S. investors and markets.[510] In these letters, the staff provided assurances that it would not recommend enforcement action of the substantive provisions of the Advisers Act with respect to a non-U.S. adviser's relationships with its non-U.S. clients.[511] 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 affiliate registering under the Advisers Act.[512] 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.[513]

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.[514] 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.[515] However, the *Unibanco* letters were developed by the staff in the context of the private adviser exemption,[516] which Congress repealed. Nothing in the rules we are today adopting in this Release is intended to withdraw any prior statement of the Commission or the views of the staff as expressed in the *Unibanco* letters. We expect that the staff will provide guidance, as appropriate, based on facts that may be presented to the staff regarding the application of the *Unibanco* letters in the context of the new foreign private adviser exemption and the private fund adviser exemption.

## 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.[517] This requirement does not apply, however, if the rule is a substantive rule which grants or recognizes an exemption or relieves a restriction or is an interpretative rule.[518]

As discussed above, effective July 21, 2011, the Dodd-Frank Act amends the Advisers Act to eliminate the private adviser exemption in pre-existing section 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.[519] 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

businesses of two separately formed affiliates may be required to be integrated is based on the facts and circumstances. Our staff has taken this position in Richard Ellis, Inc., SEC Staff No-Action Letter (Sept. 17, 1981) (discussing the staff's views of factors relevant to the determination of whether a separately formed advisory entity operates independently of an affiliate). *See also* discussion *infra* following note 515.

[507] *See, e.g.,* AIMA Letter, Commenter Letter of Bank of Montreal, Royal Bank of Canada and The Toronto-Dominion Bank (Jan. 24, 2011) (''Canadian Banks Letter''); CompliGlobe Letter; Debevoise Letter; Dechert General Letter (also supported extending the *Unibanco* letters to U.S. advisers); Dechert Foreign Adviser Letter; EFAMA Letter; Katten Foreign Advisers Letter; McGuireWoods Letter; MFA Letter; Comment Letter of MFS Investment Management (Jan. 24, 2011) (''MFS Letter''); Comment Letter of Ropes & Gray LLP (Jan. 24, 2011).

[508] *See, e.g.,* ABA Subcommittee on Private Investment Entities, SEC Staff No-Action Letter (Dec. 8, 2005) (''ABA No-Action Letter''); Royal Bank of Canada, SEC Staff No-Action Letter (Jun. 3, 1998); ABN AMRO Bank, N.V., SEC Staff No-Action Letter (Jul. 7, 1997); Murray Johnstone Holdings Limited, SEC Staff No-Action Letter (Oct. 7, 1994); Kleinwort Benson Investment Management Limited, SEC Staff No-Action Letter (Dec. 15, 1993); Mercury Asset Management plc, SEC Staff No-Action Letter (Apr. 16, 1993); and Uniao de Bancos de Brasileiros S.A., SEC Staff No-Action Letter (Jul. 28, 1992) (''Unibanco No-Action Letter''). *See also* 1992 Staff Report, *supra* note 393, at Section III.D.

[509] 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 affiliate is staffed with personnel (located in the U.S. or abroad) who are capable of providing investment advice; all personnel of the participating affiliate involved in U.S. advisory activities are deemed ''associated persons'' of the registered affiliate; and the Commission has adequate access to trading and other records of the participating affiliate and to its personnel to the extent necessary to enable it to identify conduct that may harm U.S. clients or markets. *See supra* note 508; Hedge Fund Adviser Registration Release, *supra* note 14, at n.211 and accompanying text.

[510] *See* 1992 Staff Report, *supra* note 393, at section III.D. In enacting the private fund adviser exemption and the foreign private adviser exemption, both of which focus on an adviser's activities in, or contacts with, the United States, Congress has addressed issues similar to those described in the 1992 Staff Report. *See* section 408 of the Dodd-Frank Act (directing the Commission to exempt private fund advisers with less than ''$150 million in assets under management *in the United States''*) (emphasis added); sections 402 and 403 of the Dodd-Frank Act (exempting from registration foreign private advisers with no *place of business in the United States* that have a limited number of *clients in the United States and investors in the United States* in private funds and a limited amount of assets attributable to these clients and investors, among other conditions).

[511] *See supra* note 508. *See also infra* note 515.

[512] *See supra* note 508.

[513] *See, e.g.,* Canadian Banks Letter; CompliGlobe Letter; MFA Letter; MFS Letter.

[514] *See, e.g.,* Canadian Banks Letter; MFA Letter. *See also supra* notes 510 and 316 and accompanying text.

[515] *See* Hedge Fund Adviser Registration Release, *supra* note 14, at nn.211 and 216–222 and accompanying text (noting that this policy was first set forth in the Unibanco No-Action Letter). Although the rules contained in the Hedge Fund Adviser Registration Release were vacated by a Federal court in *Goldstein, supra* note 14, the court's decision did not address our statement in that release that 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. In addition, our staff expressed this view in a 2006 no-action letter issued in response to a request for the staff's views on matters affecting investment advisers to certain private funds that arose as a result of the *Goldstein* decision. *See* ABA Subcommittee on Private Investment Companies, SEC Staff No-Action Letter (Aug. 10, 2006) (Commission staff expressed the view that the substantive provisions of the Advisers Act do not apply to offshore advisers with respect to such advisers' dealings with offshore funds and other offshore clients to the extent described in prior staff no-action letters and the Hedge Fund Adviser Registration Release, *supra* note 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.).

[516] Our staff has provided assurances that it would not recommend enforcement action when no participating affiliate has any U.S. clients other than clients of the registered affiliate, consistent with the private adviser exemption, which was conditioned on the number of a non-U.S. adviser's U.S. clients. *See supra* notes 508–509; Hedge Fund Adviser Registration Release, *supra* note 14, at n.211 and accompanying text. Under the *Unibanco* letters, participating affiliates only share personnel with, and provide certain services through, their registered adviser affiliates. *See supra* notes 508–509.

[517] *See* 5 U.S.C. 553(d).

[518] The statute also provides an exception if the agency finds good cause to make the rule effective less than 30 days after its date of publication in the **Federal Register**. *Id.*

[519] *See* sections 403 of the Dodd-Frank Act; sections 203(b)(3) of the Advisers Act; Section I *supra.*

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).[520] Thus, these interpretive 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 interpretive 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.[521] 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.[522] 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.[523] 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.[524]

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 proposals, offer flexibility and 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 understand 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.[525]

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).[526] 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).[527]

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'').[528] 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 fund or the grandfathering provision.

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[520] As discussed above, the Dodd-Frank Act amended the Advisers Act to define ''foreign private adviser'' in section 202(a)(30).

[521] 44 U.S.C. 3501.

[522] As we discuss above, although most venture capital advisers agreed with our proposed approach to the definition of venture capital fund, a number of commenters disagreed with our approach to the proposed definition, and argued that it should be expanded to include investments in small companies (regardless of whether they satisfy our definition of qualifying portfolio company) and investments in other private funds. *See, e.g.,* NASBIC/SBIA Letter; PEI Funds/Willowbridge Letter; VIA Letter. We do not believe that these more expansive positions are consistent with the intended scope of the venture capital exemption as expressed by Congress. *See supra* note 204 and accompanying text. Thus, we believe that the costs of registration for advisers to funds that would not satisfy the definition because they hold such investments are attributable to the Dodd-Frank Act.

[523] *See supra* note 5.

[524] The benefits and costs of the reporting requirements applicable to advisers relying on the venture capital exemption and the private fund adviser exemption are discussed in greater detail in the Implementing Adopting Release, *supra* note 32, discussion at sections V.A.2 and V.B.2.

[525] Rule 203(l)–1(a).

[526] Rule 203(l)–1(c)(3).

[527] Rule 203(l)–1(c)(4). *See also* text accompanying note 148.

[528] Rule 203(l)–1(b).

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.[529] 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.[530] The final rule defines the term venture capital fund consistently with what we believe Congress understood venture capital funds to be,[531] and in light of other concerns expressed by Congress with respect to the intended scope of the venture capital exemption.[532]

Approximately 26 comment letters addressed the costs and benefits of the proposed rule defining venture capital fund.[533] 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.[534] Several commenters agreed that the proposed rule is consistent with Congressional intent.[535] Many venture capital advisers and related industry groups acknowledged that the proposed definition would generally encompass most venture capital investing activity that typically occurs,[536] 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.[537] 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.[538]

For the reasons discussed above, we have modified the definition of venture capital fund. Our modifications include specifying a non-qualifying basket[539] and excluding from the 120-day limit with respect to leverage certain guarantees of portfolio company obligations by a qualifying fund.[540] For the reasons discussed in greater detail above, we are adopting a limit of 20 percent for non-qualifying investments.[541] In summary, the non-qualifying basket is designed to address commenters' concerns regarding occasional deviations from typical venture capital investing activity,[542] inadvertent violations of the definitional criteria[543] and flexibility to address evolving or future business practices.[544] We considered these comments in light of our concerns that the exemption not be expanded beyond what we believe was the intent of Congress[545] and that the definition not operate to foreclose investment funds from investment opportunities that would benefit investors but would not change the character of the fund.[546] We concluded that a non-qualifying basket limit of 20 percent would provide the flexibility sought by many venture capital fund commenters while appropriately limiting the scope of the exemption.[547]

We believe that the final rule (including the modifications from the proposal) better describes the existing venture capital industry and provides venture capital advisers with greater flexibility to accommodate existing (and potentially evolving or future) business practices and take advantage of investment opportunities that may arise. We also believe that the criteria under the final rule will facilitate transition to the new exemption, because it minimizes the extent to which an adviser seeking to rely on the venture capital exemption would need to alter its existing business practices, thus, among other things, reducing the likelihood of inadvertent non-compliance.[548]

As we discuss in greater detail above, many commenters arguing in favor of the modifications that we are adopting generally cited these benefits to support their views.[549] Specifically, several commenters asserted that providing a limited basket for non-qualifying investments would benefit venture capital advisers relying on the venture capital exemption, and the U.S. economy, by facilitating job creation and capital formation[550] and minimizing the extent to which a venture capital fund would need to alter

[529] *See* Proposing Release, *supra* note 26, discussion at text immediately preceding text accompanying n.273.

[530] *See generally* Section II.A.1.

[531] *See supra* notes 36–37 and accompanying and following text. *See also infra* note 535.

[532] *See supra* discussion at Section II.A.

[533] *See, e.g.,* NVCA Letter; NYSBA Letter; Oak Investments Letter; Sevin Rosen Letter; SVB Letter; Trident Letter.

[534] Proposing Release, *supra* note 26, at section IV.A.1.

[535] 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 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.'').

[536] *See, e.g.,* 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; DLA Piper VC Letter.

[537] *See, e.g.,* ATV Letter; BIO Letter; NVCA Letter; Sevin Rosen Letter.

[538] *See, e.g.,* NVCA Letter; Oak Investments Letter.

[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 control each qualifying portfolio company in which the fund invests. A number of commenters indicated that venture capital funds may not provide sufficient 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 money market funds from the non-qualifying basket. A number of commenters indicated that money 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 adviser'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 (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'').

its typical business practices.[551] 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.[552]

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.[553] 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.[554] 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.[555] 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.[556] In addition, permitting qualifying funds to invest in other underlying private funds could facilitate capital formation and enhance liquidity for the underlying private funds.[557] 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[558] and prevent dilution of the venture capital fund's investment in the portfolio company.[559]

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 basket remains available for new investments. 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 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.[560] 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.[561] 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.[562]

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.[563] 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.[564] Thus, we believe this provision, which is designed to accommodate existing business practices typical of venture capital funds, may contribute to efficiency, competition and capital formation.

The final rule excludes from the definition of qualifying portfolio company any company that borrows or issues debt if the proceeds of such borrowing or debt are distributed to the venture capital fund in exchange for the fund's investment in the company. This will allow qualifying funds to provide financing on a short-term basis to portfolio companies as a ''bridge'' between funding rounds.[565] 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.[566] 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.[567]

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[551] *See, e.g.,* McDonald Letter; Pine Brook Letter.

[552] *See, e.g.,* DuFauchard Letter; Merkl Letter.

[553] Rule 203(l)–1(a)(2) (specifying that a qualifying fund must hold, immediately after the acquisition of any asset (excluding short-term holdings) no more than 20% of its committed capital in assets that are not qualifying investments); rule 203(l)–1(c)(3) (defining ''qualifying investment'').

[554] *See, e.g.,* Lowenstein Letter; McDonald Letter; Mesirow Letter; Quaker BIO Letter; Trident Letter.

[555] *See, e.g.,* Merkl Letter; Oak Investments Letter; Sevin Rosen Letter; Vedanta Capital Letter.

[556] NVCA Letter; Trident Letter.

[557] *See, e.g.,* Cook Children's Letter; Leland Fikes Letter; Merkl Letter; SVB Letter.

[558] Sevin Rosen Letter.

[559] SVB Letter.

[560] The rule requires a qualifying fund at the time it acquires an asset, to have no more than 20% of its capital commitments invested in assets that are not qualifying investments. Rule 203(l)–1(a)(2).

[561] *See supra* note 109 and following text.

[562] *See, e.g.,* NVCA Letter; PTV Sciences Letter. The final rule defines equity securities broadly to cover many types of equity securities in which venture capital funds typically invest, rather than limit the definition solely to common stock. *See supra* notes 95–96 and accompanying text. Our definition of qualifying portfolio company is similarly broad because it does not restrict qualifying companies to ''small or start-up'' companies. As we have noted in the Proposing Release and above, we believe that such definitions would be too restrictive and provide venture capital fund advisers with too little flexibility and limited options with respect to potential portfolio company investments. *See supra* discussion in Section II.A.1.a.

[563] Rule 203(l)–1(a)(3).

[564] Oak Investments Letter; SVB Letter.

[565] *See, e.g., supra* note 181 and accompanying and following text.

[566] *See, e.g.,* NVCA Letter; SVB Letter.

[567] As discussed above, we have imposed this limitation on qualifying portfolio companies

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.[568] 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,[569] 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 certain 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) to determine and confirm an adviser's rationale for remaining unregistered with the Commission.[570]

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 benefit investment advisers that seek to rely on the venture capital exemption because they will be able 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.[571] 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.[572] 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 funds that may not meet the definition.[573] It also will allow advisers to funds that were launched by December 31, 2010 and can meet the other requirements of the grandfathering provision to rely on the exemption without the potential costs of having to renegotiate with potential investors and restructure those funds within the limited period before the rule 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 specify the basis for the exemption. We are adopting, however, rules that would require exempt reporting advisers to identify the exemption(s) on which they are relying.[574] 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

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. *See supra* notes 174 and 175.

[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,[575] 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,[576] and the testimony before Congress that stressed the lack of leverage in venture capital investing.[577] 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.[578] 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.[579] We estimate that currently there are 791 advisers to venture capital funds.[580] 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.[581] 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.[582]

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.[583] 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[584] and the typical fundraising period for a venture capital fund is approximately 12 months.[585] 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.[586] As we

[575] *See infra* text following notes 585, 597–600 and accompanying text for a discussion of potential costs for advisers that would have to choose between registering or restructuring venture capital funds formed in the future.

[576] *See supra* note 174.

[577] *See supra* note 175.

[578] *See* S. Rep. No. 111–176, *supra* note 6, at 39 (explaining the requirement that private funds disclose information regarding their investment positions and strategies, including information on fund size, use of leverage, counterparty credit risk exposure, trading and investment positions and any other information that the Commission in consultation with the Financial Stability Oversight Council determines is necessary and appropriate to protect investors or assess systemic risk).

[579] Proposing Release, *supra* note 26, at text immediately preceding text accompanying n.273.

[580] *See* NVCA Yearbook 2011, *supra* note 152, at Fig. 1.04 (providing the number of ''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).

[581] We estimate that these advisers (and any other adviser that seeks to remain unregistered in reliance on the exemption under section 203(l) of the Advisers Act 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 $279 to prepare and submit annual amendments to the report. These estimates are based on the following calculations: $2,032 = ($4,064,000 aggregate costs ÷ 2000 advisers); $279 = ($558,800 aggregate costs ÷ 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 $188 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.

[582] As discussed in the Proposing Release, we expect that a venture capital adviser would need no more than 2 hours of legal advice to learn the differences between its current business practices and the conditions for reliance on the proposed grandfathering provision. We estimate that this advice would cost $400 per hour per firm based on our understanding of the rates typically charged by outside consulting or law firms. *See* Proposing Release, *supra* note 26, at n.293. We did not receive any comments on these cost estimates.

[583] We did not receive any comments on the dates specified in the grandfathering provision. *See also supra* note 307.

[584] *See supra* note 572.

[585] *See* Breslow & Schwartz, *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.

[586] *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). *See also* ABA Letter; Davis Polk Letter; Oak Investment Letter; SVB Letter (discussing the potential costs associated with complying with various elements of the proposed rule such as managerial assistance, venture capital fund leverage

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 plan to launch would be from $64,400 to $110,400.[590] As they launch new funds and negotiate with potential investors, these advisers would have to determine whether it is more cost effective to register or to structure the venture capital funds they manage to meet the definition. Such considerations of legal or other requirements, however, comprise a typical business and operating expense of conducting new business. New advisers that enter into the business of managing venture capital funds also would incur such ordinary costs of doing business in a regulated industry.[591]

In the Proposing Release, we stated that we believed that existing advisers to venture capital funds would meet most, if not all, of the elements of the proposed definition.[592] As discussed above, most commenters generally acknowledged that the proposed definition would generally encompass most venture capital investing activity that typically occurs.[593] Several noted, however, that they might deviate from typical investing patterns on occasion or wanted the flexibility to invest small amounts of capital in investments that would be precluded by the proposed definition.[594] Under the final rule, venture capital funds that qualify for the definition may invest in non-qualifying investments subject to availability of the non-qualifying basket, including investments specified by some commenters. As a result of these modifications, the final definition is more closely modeled on current business practices of venture capital funds and provides advisers with flexibility to take advantage of investment opportunities. As a result, we do not anticipate that many venture capital fund advisers would have to change significantly the structure of new funds they launch.

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

The final rule may have effects on competition and capital formation. To the extent that advisers choose to structure new venture capital funds to conform to the definition, or choose not to form new funds in order to avoid registration, these choices could result in fewer investment choices for investors, less competition and less capital formation.[595] For example, to the extent that new venture capital funds do not invest in non-qualifying investments in excess of the 20 percent basket in order to meet the definition, the final rule could decrease competition and capital formation. If venture capital funds invest less in non-qualifying investments or more in qualifying portfolio company securities that are qualifying investments, this could increase competition among qualifying portfolio companies or private funds that invest in such companies. To the extent that funds invest more in less risky but lower yielding non-qualifying investments, this could decrease competition among investors that seek to invest in qualifying investments. To the extent that advisers choose to register in order to structure new venture capital funds without regard to the definitional criteria or in order to expand their businesses (*e.g.,* pursue additional investment strategies beyond venture capital investing or expand the potential investor base to include investors that are required to invest with registered advisers), these choices may result in greater investment choices for investors, greater competition and greater capital formation.[596]

Investment advisers to new venture capital funds that would not meet the definition would have to register and

and solely investing in qualifying portfolio companies).

[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 experience 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] *See, e.g.,* Lowenstein Letter; NVCA Letter; Venrock Letter.

[596] *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).

incur 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,[597] excluding the initial filing fees and annual filing fees to the Investment Adviser Registration Depository (''IARD'') system operator.[598] These registration costs include the costs attributable to completing and periodically amending Form ADV, preparing brochure supplements, and delivering codes of ethics to clients.[599] 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.[600]

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.[601] 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.[602] 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.[603]

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 cost estimates compensation costs for hiring a dedicated chief compliance officer (''CCO'').[604] 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.[605]

[597] This estimate is based upon the following calculations: $15,077 = ($9,627,871 aggregate costs to complete Form ADV ÷ 750 advisers expected to register with the Commission) + ($8,509,000 aggregate costs to complete private fund reporting requirements ÷ 3,800 advisers expected to provide private fund reports). *See* Implementing Adopting Release, *supra* note 32, at nn.612–618 and accompanying text for a more detailed discussion of these costs. This also assumes that the performance of this function would most likely be equally allocated between a senior compliance examiner and a compliance manager. *See id.,* at n.608. Data from SIFMA's Management & Professional Earnings in the Securities Industry 2010, modified to account for an 1,800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead, suggest that costs for these positions are $235 and $273 per hour, respectively.

[598] Filing fees paid for submitting initial and annual filings through the IARD currently range from $40 to $225 based on the amount of assets an adviser has under management. The current fee schedule for registered advisers may be found on our Web site at *http://www.sec.gov/divisions/investment/iard/iardfee.shtml. See* Implementing Adopting Release, *supra* note 32, at n.566–567 and accompanying text (assuming for purposes of the analysis that exempt reporting advisers will pay a fee of $225 per initial or annual report).

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

[600] *See* Implementing Adopting Release, *supra* note 32, at n.729.

[601] *See* Proposing Release, *supra* note 26, at n.303 and accompanying text. Our estimate was based on the expectation that most advisers that might choose to register for business reasons have already built compliance infrastructures as a matter of good business practice. Nevertheless, we expect advisers will incur costs for outside legal counsel to evaluate their compliance procedures initially and on an ongoing basis. We estimate that the costs to advisers to establish the required compliance infrastructure will be, on average, $20,000 in professional fees and $25,000 in internal costs including staff time. These estimates were prepared in consultation with attorneys who, as part of their private practice, have counseled private fund advisers establishing their registrations with the Commission. We included a range because we believe there are a number of unregistered advisers of private funds whose compliance operations are already substantially in compliance with the Advisers Act and that would therefore experience only minimal incremental ongoing costs as a result of registration. In connection with previous estimates we have made regarding compliance costs for registered advisers, we received comments from small advisers estimating that their annual compliance costs would be $25,000 and could be as high as $50,000. *See, e.g.,* Comment Letter of Joseph L. Vidich (Aug. 7, 2004). *Cf.* Comment Letter of Venkat Swarna (Sept. 14, 2004) (estimating costs of $20,000 to $25,000). These comment letters were submitted in connection with the Hedge Fund Adviser Registration Release, *supra* note 14, and are available on the Commission's Internet Web site at *http://www.sec.gov/rules/proposed/s73004.shtml.*

[602] *See, e.g.,* Comment Letter of Atlas Holdings (Jan. 21, 2011) (''Atlas Letter'') (estimating $500,000 in 2011 and $350,000 per year thereafter for compliance manuals and oversight, employee trading records, legal documentation, and the hiring of additional compliance employees); Comment Letter of Sentinel Capital Partners (Jan. 16, 2011) (''Sentinel Letter'') (estimating between $500,000–$600,000 in 2011 and more than $375,000 per year thereafter for compliance manuals and oversight, employee trading records, legal documentation, and the hiring of additional compliance employees); Comment Letter of Charlesbank Capital Partners (Jan. 21, 2011) (''Charlesbank Letter'') (''[A]lthough impossible to quantify at this point given the absence of regulations, we anticipate a substantial cost associated with ongoing compliance.''); Comment Letter of Crestview Advisors, LLC (Jan. 19, 2011) (''Crestview Letter'') (estimating annual costs of $300,000–$500,000); Comment Letter of Azalea Capital (Feb. 17, 2011) (''Azalea 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). *See also* Memorandum to File No. S7–37–10, dated March 17, 2011, concerning a meeting with certain private fund representatives, avail. at *http://www.sec.gov/comments/s7-37-10/s73710-124.pdf* (''File Memorandum'') (estimating that costs for small firms range from $100,000–$200,000 (exclusive of salary costs for a CCO)).

[603] *See* VIA Letter (estimating an initial cost of $75,000 or more and ongoing costs of $50,000 to $150,000 per year); Pine Brook Letter (estimating initial costs of $125,000 to $200,000 and ongoing compliance costs of $100,000–150,000 per year).

[604] *See, e.g.,* Katten Foreign Insurance Letter (''In addition, there are added salary costs for hiring a chief compliance officer. In all, costs could be expected to total hundreds of thousands of dollars and hundreds of hours of personnel time for each new registrant.''); Comment Letter of Cortec Group (Jan. 14, 2011) (''Cortec Letter'') (''Furthermore, the Act requires we add a compliance officer (who has to be a senior-level executive), at a minimum annual compensation of $200,000, yet we do not engage in any activity the Act wishes to monitor.''). Other commenters may have included such costs in their estimates although they did not provide details on individual components. *See, e.g.,* Crestview Letter (''As part of these new regulations, we are required to develop a compliance program; hire a compliance officer; custody our private company stock certificates, which are worthless to any party not part of the original purchase agreement; and register with the SEC.'')

[605] *See* Advisers Act rule 206(4)–(7) (requiring, among other things, an adviser registered or

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 duties 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.[606]

Some commenters asserted that the costs of ongoing compliance would be substantial.[607] 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.[608]

Some commenters expressed concern that compliance costs would be prohibitive in comparison to their revenues or in relation to their size or activities.[609] We note, however, that an adviser is required to adopt policies and procedures that take into consideration the nature of that adviser's operations.[610] 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.[611] The preparation of these simpler policies and procedures and their administration should be much less burdensome.[612]

We also note that approximately 570 smaller advisers currently are registered with us.[613] 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[614]) 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.[615] 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.[616]

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.[617] As a result, we expect that the definition is not likely to significantly affect the way in which investment advisers to these funds do

required to be registered under the Advisers Act to designate an individual (who is a supervised person) responsible for administering the policies and procedures). In determining whether existing staff can fulfill the CCO requirement, advisers may consider factors such as the size of the firm, the complexity of its compliance environment, and the qualifications of current staff.

606 Although some commenters noted that requiring existing employees to assume compliance-related responsibilities would involve costs, they did not provide sufficient information on which we could estimate these costs.

607 *See supra* note 602.

608 *Compare* Azalea Letter (estimated ongoing compliance costs of $50,000 to $100,000 per year) *with* Crestview Letter (estimated ongoing compliance costs of $300,000 to $500,000 per year). *See also* Charlesbank Letter (stating that costs associated with ongoing compliance are impossible to quantify at this point).

609 *See, e.g.,* Crestview Letter (''The cost of complying with these new regulations is estimated to be $300,000–$500,000 per year, which is a significant sum for a firm that invests in two to three private companies each year in relation to the benefit it provides.''); Azalea Letter (''The cost of complying with these new regulations is estimated to be $50,000 to $100,000 per year, which is a significant sum for a firm that invests in two to three private companies each year.''); Gen Cap Letter (''The cost of complying with these new regulations is estimated to be $150,000–$250,000 per year, which is a significant sum for a firm that invests in two to three private companies each year in relation to the benefit it provides.'').

610 *See Compliance Programs of Investment Companies and Investment Advisers,* Investment Advisers Act Release No. 2204 (Dec. 17, 2003) [68 FR 74714 (Dec. 24, 2003)], discussion at section II.A.1.

611 *Id. See also id.* at n.13 (noting that even small advisers may have arrangements, such as soft dollar agreements, that create conflicts; advisers of all sizes, in designing and updating their compliance programs, must identify these arrangements and provide for the effective control of the resulting conflicts).

612 *Id.,* discussion at section II.A.1.

613 *See* Implementing Adopting Release, *supra* note 32, at n.823 and accompanying text (noting that, based on data from the Investment Adviser Registration Depository as of April 7, 2011, 572 advisers registered with the Commission were small advisers).

614 *See* NVCA Yearbook 2011, *supra* note 152, at 9, Fig. 1.0.

615 *See* Proposing Release, *supra* note 26, at n.303. *See also supra* note 601.

616 *See supra* text following note 575.

617 *See supra* notes 548, 586 and accompanying text.

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 also could 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 publicly 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 adviser to a fund of venture capital funds ceases business or ceases to offer new funds in order to avoid registration with the Commission, this could reduce the pool of potential investors investing in venture capital funds,[626] and potentially reduce capital formation for potential qualifying portfolio companies.

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

As discussed in Section II.B, rule 203(m)–1 exempts from registration under the Advisers Act any investment adviser solely to private funds that has less than $150 million in assets under management in the United States. The rule implements the private fund adviser exemption, as directed by Congress, in section 203(m) of the Advisers Act and includes provisions for determining the amount of an adviser's private fund assets for purposes of the exemption and when those assets are deemed managed in the United States.[627]

1. Benefits

*Method of Calculating Private Fund Assets.* As discussed in Section II.B.2 above and in the Implementing Adopting Release, we are revising the instructions to Form ADV to provide a uniform method for calculating assets under management that can be used 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 the private fund adviser exemption under section 203(m) of the Advisers Act and rule 203(m)–1 thereunder and the foreign private adviser exemption under section 203(b)(3) of the Advisers Act.[628] We believe that this uniform approach will benefit regulators (both state and Federal) as well as advisers, because only a single determination of assets under management is required for purposes of registration and exemption from Federal registration.

The instructions to Form ADV previously permitted, but did not require, advisers to exclude certain types of managed assets.[629] As a result, it was not possible to conclude that two advisers reporting the same amount of assets under management were necessarily 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.[630] 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; AFL–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.

[627] *See supra* Sections II.B.2–3.

[628] *See supra* notes 332–336 and accompanying text.

[629] *See* Form ADV: Instructions to Part 1A, instr. 5.b(1), as in effect before the amendments adopted in the Implementing Adopting Release, *supra* note 32.

[630] *See supra* Section II.B.2. As discussed below, we are permitting advisers to calculate their private fund assets annually in connection with their annual updating amendments to their Forms ADV, rather than quarterly as proposed. Requiring annual, rather than quarterly, calculations will be less costly for advisers.

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.[631] 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 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.[637] Requiring annual, rather than quarterly, calculations thus responds to concerns expressed by commenters who argued that quarterly calculations would (i) impose unnecessary costs and burdens on advisers, some of whom might not otherwise perform quarterly valuations; and (ii) inappropriately permit shorter-term fluctuations in assets under management to require advisers to register.[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.[639]

[631] *See supra* note 339.

[632] *See, e.g.,* AIMA Letter (suggested modifications to the method of calculating regulatory assets under management but also stated ''[w]e 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 staff's risk assessment program''').

[633] *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 ''regulatory assets under management'' in item 5.F of Form ADV, Part 1A); 203(m)–1(d)(4) (defining ''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.

[634] *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)(2)); 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).

[635] *See* Proposing Release, *supra* note 26, discussion at section V.B. *See also infra* Section V.B.2.

[636] *See, e.g.,* ABA Letter (''[A] semi-annual or annual measuring 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 Exemption assistance in avoiding issues arising from temporary increases in asset values.''); AIMA 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.'').

[637] *See, e.g.,* Dechert Foreign Adviser Letter (''[T]he Foreign Asset Manager submits that a yearly calculation (rather than a quarterly calculation) would be more appropriate, as some private funds may not provide for quarterly calculations of their NAV.''); Katten Foreign Advisers Letter (argued for annual calculations, noting that ''[m]any advisers only determine their aggregate assets under management on an annual basis''); NASBIC/SBIA Letter (''Unless sought by the adviser, evaluations on whether to register should be made no more often than an annual basis.''); Seward Letter (''We believe that annual measurement of assets for purposes of determining an adviser's ability to rely on the private fund adviser exemption would be consistent with the approach established under NSMIA.'').

[638] *See* AIMA Letter; Dechert Foreign Adviser Letter; Dechert General Letter; EFAMA Letter; Katten Foreign Advisers Letter; Merkl Letter; Seward Letter.

[639] *See supra* Section II.B.2.b; rule 203(m)-1(c) (requiring advisers to calculate their private fund assets annually, in accordance with General

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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.[640] 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.[641] 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.[642]

*Assets under Management in the United States.* Under rule 203(m)–1(a), all of the private fund assets of an adviser with a principal office and place of business in the United States are considered to be ''assets under management in the United States,'' even if the adviser has offices outside of the United States.[643] 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.[644] 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.[645]

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.[646]

*Territorial Approach.* Under rule 203(m)–1(b), a non-U.S. adviser with no U.S. place of business may avail itself of the exemption even if it advises non-U.S. clients that are not private funds, provided that it does not advise any U.S. clients other than private funds.[647] We believe that this aspect of the rule, which looks primarily to the principal office and place of business of an adviser to determine eligibility for the exemption, will increase the number of non-U.S. advisers that may be eligible for the exemption. As with other Commission rules that adopt a territorial approach, the private fund adviser exemption is available to a non-U.S. adviser (regardless of its non-U.S. advisory or other business activities) in recognition that non-U.S. activities of non-U.S. advisers are less likely to implicate U.S. regulatory interests and in consideration of general principles of international comity. This aspect of the rule 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.[648]

We believe that our interpretation of the availability of the private fund adviser exemption for non-U.S. advisers, as reflected in the rule, will benefit those advisers by facilitating their continued participation in the U.S. market with limited disruption to their non-U.S. advisory or other business practices.[649] This approach also should benefit U.S. investors and facilitate competition in the market for advisory services to the extent that it maintains or increases U.S. investors' access to potential advisers. Furthermore, because non-U.S. advisers that elect to avail themselves of the exemption would be subject to certain reporting requirements,[650] we believe that our approach will increase the availability of information publicly available to U.S. investors who invest in the private funds advised by such exempt but reporting non-U.S. advisers.

Most of the commenters who considered this aspect of the rule supported it, citing, among other benefits, that this interpretation would effectively protect U.S. markets and investors and is consistent with the Commission's overall territorial

Instruction 15 to Form ADV); General Instruction 15 to Form ADV; rule 204–4.

[640] *See supra* note 378 (explaining that the transition period is available to an adviser that has complied with ''all [Commission] reporting requirements applicable to an exempt reporting adviser as such,'' rather than ''all applicable Commission reporting requirements,'' as proposed).

[641] An adviser must file its annual Form ADV updating amendment within 90 days after the end of its fiscal year and, if the transition period is available, may apply for registration up to 90 days after filing the amendment. We proposed, in contrast, to give advisers three months to register with us after becoming ineligible to rely on the exemption due to an increase in the value of their private fund assets as reflected in the proposed quarterly calculations.

[642] *See, e.g.,* Sadis & Goldberg Implementing Release Letter (''Three (3) months provides an insufficient amount of time for an investment adviser to (i) complete its ADV Parts 1, 2A and 2B, including the newly required narrative brochure and brochure supplement; (ii) submit its completed application to the Commission through IARD; and (iii) receive its approval from the Commission, which may take up to forty-five (45) days.''); Shearman Letter (''Our experience is that registering an investment adviser firm in a thoughtful and deliberate manner is often closer to a six-month task (that can sometimes take even longer depending on the need to engage new or additional service providers to the firm or its funds), so that an at least 180-day transition period would be more appropriate.'').

[643] As discussed above, the rule looks to an adviser's principal office and place of business as the location where it directs, controls and coordinates its advisory activities. Rule 203(m)-1(d)(3).

[644] *See, e.g.,* Merkl 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).

[645] *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.''); MAp Airports 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 of non-U.S. advisers 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.

[646] *See supra* text preceding, accompanying, and following note 575.

[647] 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).

[648] *See supra* note 393 and accompanying text.

[649] *See supra* Section II.B.3.

[650] *See* Implementing Adopting Release, *supra* note 32, discussion at section II.B.

approach to Advisers Act regulation.[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.'' [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.[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.'' [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.[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.[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.[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.[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).'' [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.[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.[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.[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 incur 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.[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.[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,[665] and we believe it is the way in which most advisers would have interpreted the exemption without our rule.[666]

[651] ABA Letter; Debevoise Letter; Dechert Foreign Adviser Letter; Gunderson Dettmer Letter; Katten Foreign Advisers Letter; MAp Airports Letter; Merkl Letter; Wellington Letter.

[652] Wellington Letter.

[653] Debevoise Letter. *See also* ABA Letter (''When, in the private fund context, United States investors invest with a non-United States-based investment manager, they understand they are not being afforded the investor protection safeguards of the United States Investment Advisers Act.''); 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.'').

[654] ABA Letter.

[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 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 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 incorporation of the definition 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.

[656] AIMA Letter; CompliGlobe Letter; Debevoise Letter; Dechert General Letter; Gunderson Dettmer Letter; Katten Foreign Advisers Letter; O'Melveny Letter.

[657] *See supra* Section II.B.4.

[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' ''); IFIC 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.'').

[659] *See* proposed rule 203(m)–1(e)(5).

[660] Rule 203(m)–1(d)(5). 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.*

[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.

[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).

[663] *See supra* note 385 and accompanying text.

[664] *See supra* note 384 and accompanying text.

[665] *See supra* note 385 and accompanying text.

[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

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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

are now centrally held by securities depositories, which perform electronic ''book-entry'' changes in their records to document ownership of securities. This arrangement reduces transmittal costs and increases efficiencies for securities settlements. *See generally* Bank for International Settlements, The Depository Trust Company: Response to the Disclosure Framework for Securities Settlement Systems (2002), *http://www.bis.org/publ/cpss20r3.pdf.* An account also has no physical location even if the prime broker, custodian or other service that holds assets on behalf of the customer does. Each of these approaches would be confusing and extremely difficult to apply on a consistent basis.

[667] We estimated in the Proposing Release that a non-U.S. adviser would need no more than 10 hours of external legal advice (at $400 per hour) and 10 hours of internal review by a senior compliance officer (at $294 per hour) to evaluate whether the adviser would qualify for the exemption provided by rule 203(m)–1, for a total estimated cost of $6,940. We did not receive any comments on these estimates. We are, however, decreasing this estimate slightly, to $6,730, to account for more recent salary data reflecting a $273 per hour wage for senior compliance officers. *See supra* note 597. One commenter suggested that we presume for non-U.S. advisers, like U.S. advisers, that all of their private fund assets are managed at their principal office and place of business. Katten Foreign Advisers Letter. We decline to adopt this suggestion for the reasons discussed above. *See supra* notes 388–389 and accompanying text. In addition, the commenter did not convince us that the costs we estimate a non-U.S. adviser would incur in determining if it has assets under management in the United States justify foregoing our approach and its attendant benefits. To the extent the commenter suggests that we adopt an alternative interpretation to conserve our resources, we note that any interpretation that requires additional advisers to register will contribute to our workload, and registration provides benefits of its own, as discussed above.

[668] Portfolio Manager Letter. *See also* Tuttle Implementing Release Letter (argued that businesses may move offshore if they become too highly regulated in the United States).

[669] *See supra* note 392 and accompanying text.

[670] *See supra* note 393 and accompanying text.

[671] *See also supra* Section II.B.3. We also decline to accept a separate commenter's suggestion to permit U.S. advisers to exclude assets managed at non-U.S. offices. *See supra* notes 395–396 and accompanying and following text.

[672] *See* Proposing Release, *supra* note 26, discussion at section V.B.2.

[673] We note that the two commenters that suggested U.S. advisers might relocate to rely on the rule provided no data as to the likelihood that this would occur or the number or types of advisers who might relocate, and neither refuted our contention that the primary reasons for advisers to locate in a particular jurisdiction involve tax and other business considerations. *See* Portfolio Manager Letter; Tuttle Implementing Release Letter.

[674] Portfolio Manager Letter (''If you raise significant money here you should be on the same level playing field as the fund managers located here so that we can compete fairly.''). *See also* 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). Another commenter suggested that we determine the ''assets under management in the United States'' for U.S. advisers by reference to the amount of assets invested, or ''in play,'' in the United States. Dougherty Letter. 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 would be confusing and extremely difficult to apply on a consistent basis. *See supra* note 394 and accompanying and following text.

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 advisers previously were permitted to exclude. 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 valuation 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 may 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 that they manage 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 does not have an internal capability for valuing specific illiquid assets, we expect that it could obtain pricing or valuation services from an outside administrator or other service provider. Staff estimated that the cost of such a service would range from $1,000 to $120,000 annually, which could be borne by several funds that invest in similar assets or have similar investment strategies.[680] 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 funds 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.[681]

In addition, as discussed above, we have taken several steps to mitigate these costs.[682] While many advisers will calculate fair value in accordance with GAAP or another international accounting standard,[683] other advisers acting consistently and in good faith may utilize another fair valuation standard.[684] While these other standards may not provide the quality of information in financial reporting (for

[675] *See supra* note 634 and accompanying and following text. In addition, we estimate in the Implementing Adopting Release, based on registered advisers' responses to Items 5.D, 7.B, and 9.C of Form ADV, that approximately 3% of registered advisers have at least one private fund client that is not audited, and that these advisers therefore may incur costs to fair value their private fund assets. *See* Implementing Adopting Release, *supra* note 32, at nn.634–641 and accompanying text. We also estimate in that release that each of these registered advisers that potentially would incur costs as a result of the fair value requirement would incur costs of $37,625 on an annual basis. *Id.,* at n.641 and accompanying text. This is the middle of the range of the estimated fair value costs, which range from $250 to $75,000 annually. *Id. See also infra* notes 680–681 and accompanying text.

[676] *See* Proposing Release, *supra* note 26, at n.323 and accompanying text.

[677] For example, a hedge fund adviser may value fund assets for purposes of allowing new investments in the fund or redemptions by existing investors, which may be permitted on a regular basis after an initial lock-up period. An adviser to private equity funds may obtain 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.

[678] *See, e.g.,* Gunderson Dettmer Letter; Merkl Letter; O'Melveny Letter; Seward Letter; Wellington Letter.

[679] We estimated in 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. This revised estimate is based upon 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.

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

[681] The staff's revised estimate is based on the following calculations: (50 × $5.00 = $250; 15 × $5,000 = $75,000). *See also supra* note 680.

[682] *See supra* notes 363–366 and accompanying text.

[683] *See supra* note 364 and accompanying text.

[684] *See supra* note 365 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 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-investments 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

[685] *See supra* note 366 and accompanying text.

[686] *See, e.g.,* ABA Letter; Katten Foreign Advisers Letter; Seward Letter.

[687] *See supra* note 347 and accompanying text.

[688] Katten Foreign Advisers Letter.

[689] Dechert General Letter. *See also* Implementing Adopting Release, *supra* note 32, at n.80 and accompanying text.

[690] MFA Letter.

[691] *See, e.g.,* Merkl Letter; Shearman Letter. *See also supra* note 351.

[692] *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.A.3.

[693] *See id.*

[694] *See id.,* at n.82 and preceding and accompanying text.

[695] ABA Letter.

[696] *See, e.g.,* Dechert General Letter. *See also* Implementing Adopting Release, *supra* note 32, at n.80 and accompanying text.

[697] *See supra* note 357.

[698] NASBIC/SBIA Letter; Seward Letter.

[699] NASBIC/SBIA Letter.

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.

*Assessing Whether the Exemption Is Available and Costs of Registration and Compliance.* We estimate each adviser may incur between $800 to $4,800 in legal advice to learn whether it may rely on the exemption.[700] We did not receive any comments concerning these estimates. We also estimate that each adviser that registers would incur registration costs, which we estimate would be $15,077,[701] initial compliance costs ranging from $10,000 to $45,000, and ongoing annual compliance costs ranging from $10,000 to $50,000.[702] 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.[703] Although some advisers may incur these costs, we do not believe they are representative, as discussed above.[704] 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 private fund adviser exemption we are required to provide under section 203(m).[705] We also note that the costs of registration for advisers that do not qualify for the private fund adviser exemption flow from the Dodd-Frank Act, which removed the private adviser exemption on which they currently rely.

*C. Foreign Private Adviser Exemption*

Section 403 of the Dodd-Frank Act replaces the current private adviser exemption from registration under the Advisers Act with a new exemption for any ''foreign private adviser,'' as defined in new section 202(a)(30) of the Advisers Act.[706] 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.'' [707] 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.[708]

Rule 202(a)(30)–1 clarifies several provisions used in the statutory definition of ''foreign private adviser.'' First, the rule includes a safe harbor for counting clients, which previously appeared in rule 203(b)(3)–1, and which we have modified to account for its use in the foreign private adviser context. Under the safe harbor, an adviser would count certain natural persons as a single client under certain circumstances.[709] Rule 202(a)(30)–1 also includes another provision of rule 203(b)(3)–1 that permits an adviser to treat as a single ''client'' an entity that receives investment advice based on the entity's investment objectives and two or more entities that have identical owners.[710] 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

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

[701] *See supra* note 597 and accompanying text.

[702] *See supra* note 601 and accompanying text.

[703] *See supra* notes 602–603 and accompanying text.

[704] *See supra* Section V.A.2.

[705] 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 they 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, or a ''middle market'' private equity adviser). *See, e.g.,* Atlas Letter (middle market private equity adviser with $365 million of assets under management); Cortec Letter (middle market private equity adviser with less than $750 million of assets under management). *See also supra* note 614 and accompanying text.

[706] *See supra* notes 415–418 and accompanying text. The new exemption is codified as amended section 203(b)(3). *See supra* Section II.C.

[707] Rule 202(a)(30)–1(c).

[708] *See supra* Section II.C. Rule 203(b)(3)–1, which we are rescinding with the Implementing Adopting Release, provides 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 rules 203(b)(3)–1(b)(4), (5), or (7). *See supra* notes 316, 420 and 425 and accompanying text.

[709] Rule 202(a)(30)–1(a)(1).

[710] Rule 202(a)(30)–1(a)(2)(i)–(ii). 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 partnership, limited partnership, limited liability company, trust, or other legal organization, as a client if the adviser provides investment advisory services to the owner separate and apart from the investment advisory services provided to the legal organization; (2) an adviser is not required to count an owner as a client solely because the adviser, on behalf of the legal organization, offers, promotes, or sells interests in the legal organization to the owner, or reports periodically to the owners as a group solely with respect to the performance of or plans for the legal organization's assets or similar matters; and (3) any general partner, managing member or other person acting as an investment adviser to a limited partnership or limited liability company must treat the partnership or limited liability company as a client.

[711] *See* rule 203(b)(3)–1(b)(4); *supra* notes 425–427 and accompanying text.

[712] *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 a person as an investor if the adviser counts such person as a client in the United States). *See also supra* note 429.

[713] *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, at note to paragraph (c)(2).

[714] *See* rule 202(a)(30)–1(c)(2)(ii); *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).

[715] Rule 202(a)(30)–1(c)(3). *See supra* Section II.C.3.

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 references to other rules will 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 counting or qualification requirements under section 3(c)(1) or 3(c)(7) of the Investment Company Act.[725] In determining whether a client, an investor, or a place of business is ''in the United States,'' or whether it holds itself out as an investment adviser to the public ''in the United States,'' an adviser 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]

As noted 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

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

[717] *See* 17 CFR 230.902(k). We are allowing foreign advisers to determine whether a client or investor is ''in the United States'' by reference to the time the person became a client or acquires securities issued by the private fund. *See* rule 202(a)(30)–1, at note to paragraph (c)(3)(i).

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

[719] *See* rule 202(a)(30)–1(c)(4); rule 222–1(a) (defining ''place of business'' of an investment adviser as: ''(1) An office at which the investment adviser regularly provides investment advisory services, solicits, meets with, or otherwise communicates with clients; and (2) Any other location that is held out to the general public as a location at which the investment adviser provides investment advisory services, solicits, meets with, or otherwise communicates with clients.''). *See supra* Section II.C.4.

[720] Rule 202(a)(30)–1(c)(1); Form ADV: Instructions to Part 1A, instr. 5.b(4). *See also supra* Section II.C.5.

[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 432 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 and following 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.

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 48(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 investors for 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 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.[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 count 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.,* Goodwin 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 Tax-Deferred 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

Continued

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,[758] 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.[759] 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

cost of enhanced regulatory compliance [resulting from advisers registering or filing reports required of advisers relying on rule 203(m)–1] may, as a commercial matter, have to be borne solely by U.S. investors, which would affect their net returns''; the commenter also stated that, alternatively, ''many non-U.S. advisers with less significant amounts of U.S. assets invested in their funds may choose to restrict the participation by U.S. investors rather than attempt to comply with the Proposed Rules and, thereby, decrease the availability of potentially attractive investment opportunities to U.S. investors''). We note, however, that the benefits and costs associated with the elimination of the private adviser exemption are attributable to the Dodd-Frank Act, including the costs of registration incurred by advisers that previously relied on that exemption but that will have to register because they do not qualify for another exemption. In addition, the benefits and costs associated with the reporting requirements applicable to advisers relying on the private fund adviser exemption are associated with the separate rules that impose those requirements. *See* Implementing Adopting Release, *supra* note 32, at section II.B.

[744] *See supra* note 597 and accompanying text.

[745] *See supra* note 601 and accompanying text.

[746] *See supra* notes 602–603 and accompanying text.

[747] *See supra* Section V.A.2.

[748] *See* Shearman Letter.

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

[750] *See supra* Section II.C.5.

[751] *See supra* Section II.B.2.a.

[752] *See* Implementing Adopting Release, *supra* note 32, discussion at section II.A.3; *supra* Section II.B.2.a. 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.'' *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* note 676 and accompanying text.

[755] *See supra* text following note 676.

[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'').[760]

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.[761] 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.

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

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

## 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:

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

* * * * *

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

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

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

(1) A natural person, and:

(i) Any minor child of the natural person;

(ii) Any relative, spouse, 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)(2)(i) of this section that have identical owners.

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

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

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

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

(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).

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

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

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

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

(1) Represents to investors and potential investors that it 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:

(1) 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;

(2) 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

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

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

(1) *Committed capital* means any commitment pursuant to which a person is obligated to:

(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)(3)(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 the investment adviser:

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

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

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

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

(2) All assets managed by the investment adviser 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.

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

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

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

**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.*

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