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Private Equity Alert

SEC Proposes Rules for the Registration of Hedge Fund and Other Private Fund Advisers

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On November 19, 2010, pursuant to Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), the Securities and Exchange Commission (the "SEC") proposed rules to implement expanded registration and disclosure requirements for advisers to hedge funds and other private funds under the Investment Advisers Act of 1940, as amended (the "Advisers Act"). Included in the proposed rules, among other items, are a definition of "venture capital fund" for purposes of the venture capital registration exemption, provisions for determining the amount of an adviser's private fund assets for calculating whether an adviser meets the $150 million *de minimis* registration exemption, and definitions of a number of terms related to the "foreign private adviser" registration exemption. The proposed rules also increase disclosure requirements for certain advisers to private funds.

Exemption for Advisers to Venture Capital Funds

New Section 203(l) of the Advisers Act provides that private fund managers who are advisers solely to "venture capital funds," without regard to the number of such private funds advised or the size of such private funds, are exempt from registration under the Advisers Act. Advisers relying on this exemption are required to provide the SEC with reports and keep records as the SEC deems necessary. Because the proposed definition of "venture capital fund" is fairly narrow, most private equity and hedge fund managers will not be able to utilize this exemption.

Venture Capital Fund

Proposed Rule 203(l)-1 defines "venture capital fund" as a private fund (defined as a fund that relies on the exception from the definition of "investment company" contained in Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940, as amended (the "1940 Act")), that: (i) invests in equity securities of qualified portfolio companies ("QPC") in order to provide operating and business expansion capital; (ii) directly, or indirectly through its investment advisers, offers or provides significant managerial assistance to, or controls, the QPC; (iii) does not borrow or otherwise incur leverage (other than limited short-term borrowing); (iv) does not offer its investors redemption or other similar liquidity rights except in extraordinary circumstances; (v) represents itself as a venture capital fund to investors; and (vi) is not registered under the 1940 Act and has not elected to be treated as a business development company.

Qualifying Portfolio Companies

To qualify as a QPC a company: (i) must not be publicly traded; (ii) may not incur leverage in connection with the investment by the venture capital fund; (iii) may not use the venture capital fund's investment to redeem or repurchase any of its securities or make a distribution to existing

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- Weil advised Providence Equity Partners in connection with the acquisition of vAuto, a software provider to the automotive retail industry, by its portfolio company AutoTrader.com

shareholders; and (iv) can not itself be a private fund. In addition, while at least 80 percent of each QPC's equity securities owned by the venture capital fund must be acquired directly from that QPC, a venture capital fund may purchase up to 20 percent of a QPC's securities that it holds directly from existing shareholders. A venture capital fund may only hold equity securities, cash (and cash equivalents) and U.S. Treasuries with a remaining maturity of 60 days or less.

Grandfathering Provision

A private fund would qualify as a "venture capital fund" under the grandfathering provision of the proposed rule if it: (i) represented to investors and potential investors at the time the fund offered its securities that it is a venture capital fund; (ii) has sold securities to one or more third-party investors prior to December 31, 2010; and (iii) does not sell any securities to any person after July 21, 2011 (including accepting any additional capital commitments from existing investors).

Exemption for Private Fund Advisers with Less Than $150 Million in Assets

The Dodd-Frank Act directs the SEC to exempt from registration any investment adviser solely to private funds with less than $150 million in assets under management in the United States. The proposed rules clarify interpretative matters with respect to whether an adviser qualifies for this exemption.

Advises Solely Private Funds

For purposes of this exemption, the term "private fund" is defined by the proposed rules as a fund that: (i) relies on the exception from the definition of "investment company" contained in Section 3(c)(1) or 3(c)(7) of the 1940 Act; and (ii) is not registered under Section 8 of the 1940 Act. An adviser based in the United States that acquires a different type of client (such as a managed account) would not be eligible for the exemption. The proposed rules provide that an adviser whose principal office and place of business is outside of the United States (a "non-U.S. adviser") will be eligible to use the exemption so long as all of the non-U.S. adviser's clients that are United States persons are qualifying private funds. The principal office and place of business of an adviser is the location where the adviser controls, or has ultimate responsibility for, the management of private fund assets, and as such can be different from where day-to-day management of certain assets may take place. The type and number of non-U.S. clients will not be taken into account in determining a non-U.S. adviser's eligibility for the exemption.

Calculation of Private Fund Assets

The proposed rules require an adviser to aggregate the value of all assets of private funds it manages in the United States to determine if the adviser remains below the $150 million threshold.

Assets must be valued on a quarterly basis at fair market value using methods described in a revised Form ADV (as described in more detail below). Fair market value does not have to be determined in accordance with generally accepted accounting principles (GAAP). The total value of private fund assets will also include the amount of any uncalled capital commitments.

Assets Managed in the United States

Advisers with their principal office and place of business in the United States will have all of their private fund assets counted as "assets under management in the United States" regardless of whether they have offices outside of the United States. Non-U.S. advisers will only be required to include private fund assets managed from a place of business in the United States toward the $150 million asset limit.

Exemption for Foreign Private Advisers

Section 403 of the Dodd-Frank Act added a new exemption from Advisers Act registration for a "foreign private adviser." To qualify, an adviser must meet all of the following criteria:

- have no place of business in the United States;
- have fewer than 15 U.S.-based clients and investors in private funds at any time;
- have assets under management attributable to U.S.-based clients and investors in private funds of less than $25 million or such higher amount as the SEC, by rule, deems appropriate; and
- not hold itself out to the public in the U.S. as an investment adviser

Solely with respect to the definition of a foreign private adviser, the proposed rules seek to define the following terms:

Clients

The proposal clarifies how to count clients of foreign private advisers by incorporating the safe harbor for counting clients currently in Rule 203(b)(3)-1 under the Advisers Act, as modified to eliminate the provision allowing advisers not to count those clients from which they receive no compensation. The proposed rules also provide for a provision that would avoid double-counting private funds and their investors by advisers, so that the adviser would not count any private fund as a client if the adviser counted any investor in that private fund.

In the United States

The definition of foreign private adviser uses the term "in the United States" in several contexts. The proposed rules define the phrase "in the United States" by incorporating the definition of a "U.S. person" and "United States" under Regulation S under the Securities Act of 1933, as amended. The proposed rules further clarify that a person that is "in the United States" may be treated as not being "in the United States" if such person was not in the United States at the time of becoming a client or, in the case of an investor in a private fund, at the time the investor acquired the securities issued by the private fund.

Place of Business

The proposed rules define "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.

Assets Under Management

"Assets under management" is defined by reference to the requirements of revised Form ADV. The proposed rules revise the instructions to Form ADV to require the calculation of "assets under management" to consist of the securities portfolios and value of any private fund with respect to which an adviser provides continuous and regular supervisory or management services, regardless of whether such assets are proprietary, managed without compensation, or are assets of foreign clients, each of which may be currently excluded. Further, the SEC would require: (i) outstanding indebtedness and other accrued but unpaid liabilities which remain in a client's account and are managed by the adviser; and (ii) any uncalled capital commitments of a private fund, to be included in the calculation of assets under management. Additionally, all private fund assets must be valued at fair value instead of at cost.

Additional SEC Disclosure Requirements

The proposed rules also expand the disclosures required by Form ADV, which is publicly available, to help the SEC assess compliance risks and "identify particular practices that may harm investors."

Private Funds

As proposed, the revised Form ADV will require disclosure of any private fund that the adviser advises, regardless of the legal form of the entity, and specific organizational and operational information such as the amount of assets and liabilities, the nature of its investors, service providers, type of investment strategy, and characteristics that may present conflicts of interest or risks for investors.

Advisory Business

The proposed rules seek additional information from advisers on the scope of their business, the types of services provided and the types of clients who receive such services. This information includes the number of employees who are registered investment adviser representatives or insurance agents, and expands the types of clients to include categories such as insurance companies. Also required to be disclosed is the amount of assets under management for each client type, and the types of investments for which the adviser provides advice.

Non-Advisory and Financial Industry Affiliations

The proposed rules require an adviser to disclose any services that it provides as a trust company, registered municipal adviser, registered security-based swap dealer or major security-based swap dealer, as well as relationships with accountants and law firms. Advisers that engage in other businesses under a different name are required to disclose that fact and additional details.

Incentive-Based Compensation Arrangements

To allow the SEC to adopt rules and guidelines under the Dodd-Frank Act with other federal agencies regarding incentive-based compensation arrangements, the proposed rules revise Form ADV to require each adviser to indicate whether the adviser had $1 billion or more in assets, as determined on the adviser's balance sheet for its most recent fiscal year end.

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The SEC has requested comments on many of the provisions of the proposed rules, and comments must be received within 45 days after the proposed rules are first published in the Federal Register (expected to occur on or around November 30, 2010).

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