Proposed Model Rule for Exempt Reporting Advisers

Introduction

On December 10, 2010, NASAA published for comment a proposed model rule that would exempt investment advisers to certain types of private funds from state registration. NASAA received five comments in response to the proposed model rule.[1] The drafters of the proposed rule reviewed the comments, and in response, revised several provisions within the proposed rule. NASAA is now publishing for comment a revised version of the model rule.

Background

Under the new regulatory framework established by the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act" or "Act"), advisers to certain private funds who previously relied on an exemption from SEC registration pursuant to Section 203(b)(3) of the Investment Advisers Act will now be subject to registration while others, including advisers to venture capital funds, will be exempt from registration but required to submit reports to the SEC. As established by the Act, a private fund is defined as an issuer that would be an investment company under Section 3 of the Investment Company Act of 1940 but for an exception provided from that definition by either Section 3(c)(1) or 3(c)(7). Congress left to the SEC the task of promulgating a rule defining "venture capital fund."

NASAA's proposed rule was drafted in response to these new provisions governing the regulation of investment advisers to private funds. NASAA designed its model rule to follow certain provisions in the Dodd-Frank Act as implemented by the SEC. The SEC has yet to adopt final rules regarding the registration and reporting requirements for advisers to private funds. However, the agency has indicated that it will adopt final rules in advance of the July 21 anniversary date of the passage of Dodd-Frank. If necessary, NASAA may make further revisions to the model rule based on the final rules adopted by the SEC.

Revisions to the Proposed Model Rule

As originally proposed, the model rule provided an exemption from state registration for advisers who solely advise private funds structured in compliance with Section 3(c)(7). The limited scope of the exemption was the primary focus of most of the comments. Comments submitted by persons who represent advisers and funds argued that the exemption should not be limited to these funds and should include both advisers to venture capital funds and Section 3(c)(1) funds.

At least one commenter indicated opposition to inclusion of 3(c)(1) funds in the proposed exemption and expressed a concern that the rule could frustrate the goals of bringing transparency and oversight to the regulation of private fund advisers.

After evaluating the comments and considering other issues, the NASAA drafting group made revisions to the proposal. The scope of the rule was expanded to cover investment advisers to venture capital funds and, in specific circumstances, investment advisers to Section 3(c)(1) funds. Although representatives from the private fund industry advocated for the inclusion of all 3(c)(1) funds, the

[1] Copies of the comment letters are available on the NASAA website at www.nasaa.org.

drafting group was concerned that the level of investor protection was not sufficient given the standards imposed for investing in such funds. However, as pointed out in certain comment letters, there may be legitimate reasons for including 3(c)(1) funds within the exemption. Specifically, several of the comment letters asserted that 3(c)(1) funds are significant contributors to the capital formation efforts of small companies at the local level and are important to economic development.

To address investor protection concerns, the drafting group revised the proposal to include a provision that will exempt advisers to 3(c)(1) funds, but only if those funds are made up of investors who satisfy the "qualified client" standard contained in SEC Rule 205-3(d)1. Further, the rule requires that the value of the investor's primary residence be excluded in calculating an investor's net worth for purposes of determining whether the investor is a qualified client.[2]

Additional revisions to the original proposal are as follows:

1. Additional Disclosures. To qualify for the exemption, advisers to Section 3(c)(1) funds must provide, on an annual basis, audited financial statements to investors. The advisers would also be required to provide investors with additional disclosures. The disclosures, which must be provided in writing to the investors in the fund, must include: the fact that the fund, rather than the individual beneficial owners, is the client of the adviser; a description of all services, if any, to be provided to individual beneficial owners and of all duties owed, if any, by the adviser to the beneficial owners; and any other material information affecting the rights or responsibilities of the beneficial owners

2. Transition Provision. Advisers who become ineligible for the exemption will have 90 days to comply with applicable laws governing registration or notice filing.

3. Optional Grandfathering Provision. The proposal includes a new provision that would grandfather into the exemption advisers to Section 3(c)(1) funds with existing investors who would not qualify for the heightened "qualified client" standard. If a state does not currently require registration for these advisers it may, at its discretion, include this optional provision to facilitate a continuing exemption for those advisers to funds that were in existence prior to the adoption of the model rule.

Request for Comments

NASAA is seeking comments on the proposed rule. Comments should be submitted electronically to advcomments@nasaa.org and copied to Joseph Brady, NASAA Deputy General Counsel at jb@nasaa.org. The deadline for submission of comments is **July 13, 2011**. Written comments may be mailed to NASAA, Attn. Joseph Brady, 750 First Street, NE, Suite 1140, Washington, DC, 20002.

[2] The SEC recently proposed revisions to Rule 205-3. These revisions would increase the dollar amount tests in Rule 205-3 and require the exclusion of the value of a person's primary residence when calculating net worth.

Rule XXX. Registration exemption for investment advisers to private funds.

(a) ***Definitions***. For purposes of this regulation, the following definitions shall apply:

(1) "Value of primary residence" means the fair market value of a person's primary residence, subtracted by the amount of debt secured by the property up to its fair market value.

(2) "Private fund adviser" means an investment adviser who provides advice solely to one or more private funds.

(3) "Private fund" means 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.

(4) "3(c)(1) fund" means a private fund that is excluded from the definition of an investment company under section 3(c)(1) of the Investment Company Act of 1940, 15 U.S.C. 80a-3(c)(1).

(5) "Venture capital fund" means a private fund that meets the definition of a venture capital fund in SEC Rule 203(l)-1, 17 C.F.R. § 275.203(l)-1.

(b) ***Exemption for private fund advisers.*** Subject to the additional requirements of paragraph (c) below, a private fund adviser shall be exempt from the registration requirements of Section XXX [403 of USA 2002] if the private fund adviser satisfies each of the following conditions:

(1) neither the private fund adviser nor any of its advisory affiliates are subject to a disqualification as described in Rule 262 of SEC Regulation A, 17 C.F.R. § 230.262;

(2) the private fund adviser files with the state each report and amendment thereto that an exempt reporting adviser is required to file with the Securities and Exchange Commission pursuant to SEC Rule 204-4, 17 C.F.R. § 275.204-4; and

(3) the private fund adviser pays the fees specified in Section XXX [410 of USA 2002];

(c) ***Additional requirements for private fund advisers to certain 3(c)(1) funds***. In order to qualify for the exemption described in paragraph (b) of this regulation, a private fund adviser who advises at least one (3)(c)(1) fund that is not a venture capital fund shall, in addition to satisfying each of the conditions specified in paragraphs (b)(1) through (b)(3), comply with the following requirements:

(1) The private fund adviser shall advise only those 3(c)(1) funds (other than venture capital funds) whose outstanding securities (other than short-term paper) are beneficially owned entirely by persons who, after deducting the value of the primary residence from the person's net worth, would each meet the definition of a qualified client in SEC Rule 205-3, 17 C.F.R. § 275.205-3, at the time the securities are purchased from the issuer;

(2) At the time of purchase, the private fund adviser shall disclose the following in writing to each beneficial owner of a 3(c)(1) fund that is not a venture capital fund:

(A) the fund, rather than the individual beneficial owners, is the investment adviser's client;

(B) all services, if any, to be provided to individual beneficial owners;

(C) all duties, if any, the investment adviser owes to the beneficial owners; and

(D) any other material information affecting the rights or responsibilities of the beneficial owners.

(3) The private fund adviser shall obtain on an annual basis audited financial statements of each 3(c)(1) fund that is not a venture capital fund, and shall deliver a copy of such audited financial statements to each beneficial owner of the fund.

(d) ***Federal covered investment advisers***. If a private fund adviser is registered with the Securities and Exchange Commission, the adviser shall not be eligible for this exemption and shall comply with the state notice filing requirements applicable to federal covered investment advisers in Section XXX [405 of USA 2002].

(e) ***Investment adviser representatives***. A person is exempt from the registration requirements of Section XXX [404 of USA 2002] if he or she is employed by or associated with an investment adviser that is exempt from registration in this state pursuant to this regulation and does not otherwise act as an investment adviser representative.

(f) ***Electronic filing***. The report filings described in paragraph (b)(2) above shall be made electronically through the IARD. A report shall be deemed filed when the report and the fee required by Section XXX [410 of USA 2002] are filed and accepted by the IARD on the state's behalf.

(g) ***Transition***. An investment adviser who becomes ineligible for the exemption provided by this rule must comply with all applicable laws and rules requiring registration or notice filing within ninety (90) days from the date the investment adviser's eligibility for this exemption ceases.

*[(h) **Grandfathering for investment advisers to 3(c)(1) funds with non-qualified clients**. An investment adviser to a 3(c)(1) fund (other than a venture capital fund) that is beneficially owned by one or more persons who are not qualified clients as described in subparagraph (c)(1) may qualify for the exemption contained in paragraph (b) of this regulation if the following conditions are satisfied:*

(1) the subject fund existed prior to the effective date of this regulation; and,

(2) as of the effective date of this regulation, the subject fund ceases to accept beneficial owners who are not qualified clients, as described in subparagraph (c)(1) of this regulation.]