Proposed NASAA Model Rule on Private Fund Adviser Registration and Exemption

Introduction

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") made significant changes to the provisions governing the regulation of investment advisers under the Investment Advisers Act of 1940 ("IAA"). In addition to expanding the states' oversight of investment advisers by increasing the assets under management threshold for registration with the Securities and Exchange Commission ("SEC"), the Act made substantial changes to the regulation of investment advisers to hedge funds and other private funds. The implementation of these provisions and others is the subject of two releases recently issued by the SEC for comment.

In Release No. IA-3110 and Release No. IA-3111 the SEC explains how the agency intends to implement the new registration and reporting requirements for investment advisers as well as other changes required under the Dodd-Frank Act. As more fully discussed below, NASAA is considering adopting a model rule governing the registration and reporting requirements for advisers to private funds. NASAA's proposal is designed to follow certain provisions in the Dodd-Frank Act as implemented by the SEC, and, therefore, is contingent in many respects on how the SEC moves forward on implementation in this area. Consequently, if the SEC makes significant alterations to its proposals NASAA may be required to reevaluate the provisions in any proposed model rule or rules.

Background

Title IV of the Dodd-Frank Act, known as the "Private Fund Investment Advisers Registration Act of 2010," eliminated the "private adviser exemption" previously found in Section 203(b)(3) of the IAA. The "private adviser exemption" allowed investment advisers to private funds to operate without federal regulatory oversight. The elimination of this provision was accompanied by the creation of a new registration and reporting regime designed to bring transparency and oversight to private fund advisers.

Under this new regulatory framework, advisers to certain private funds will be subject to registration while others will be exempt from registration but required to submit reports to the SEC. Specifically, the Dodd-Frank Act amended the IAA and added Section 202(a)(29) to include a definition of "private fund." Under this provision, a private fund is defined as an issuer that would be an investment company under Section 3 of the Investment Company Act of 1940 (ICA) but for an exclusion provided from that definition by either Section 3(c)(1) or 3(c)(7) of the ICA.

Section 3(c)(1) of the ICA provides an exclusion from the definition of "investment company" for a fund whose securities are owned by not more than 100 persons and are not publicly offered. Interests in the fund are typically offered to prospective investors pursuant to Regulation D, Rule 506. Securities offered under Rule 506 may be sold solely to "accredited investors" and up to 35 "sophisticated investors."

Section 3(c)(7) of the ICA provides another exclusion from the definition of "investment company" for a fund whose securities are owned only by qualified purchasers and are not publicly offered. Generally, a qualified purchaser includes an individual with investible assets of $5 million or an institution with $25 million.

Prior to the passage of the Dodd-Frank Act, advisers to these private funds generally were exempt from registration with the SEC by virtue of the number of clients they served and the wealth/sophistication of these clients. As noted above, former Section 203(b)(3) of the IAA excluded from registration those advisers with fewer than 15 clients who also did not generally hold themselves out to the public as investment advisers.

Private Fund Advisers Under the Dodd-Frank Act

Contemporaneous with deleting the "private fund exemption," the Dodd-Frank Act established new exemptions from SEC registration for advisers to private funds including advisers to venture capital funds and advisers to private funds with less than $150 million in assets under management.

Advisers to Private Funds

The Dodd-Frank Act provides exemptions from registration for advisers to private funds and advisers to "venture capital funds."[1] In general, advisers to private funds with less than $150 million in assets under management will be exempt from registering with the SEC. However, these advisers must submit reports to the SEC and also must maintain certain books and records. These advisers, referred to as "exempt reporting advisers" are neither excluded from the definition of "investment adviser" nor required to register under the IAA. Therefore, states are not preempted from requiring "exempt reporting advisers" to register.

Advisers to private funds with AUM of $150 million or more will be required to register with the SEC. These advisers will, therefore, be federal covered advisers and, as such, be required to notice file in the states in which they maintain a place of business. Presumably the investment adviser representatives for these firms would be required to register with the states if they meet the definition of investment adviser representative under SEC Rule 203A-3.

Proposed Model Rule

Purpose

Given the changes to the regulatory requirements of these advisers at the federal level, NASAA is considering whether to adopt a model rule that would, in many respects, mirror at the state level the treatment of private fund advisers at the federal level. The attached model rule would provide the basis for an exemption from state registration for advisers only to 3(c)(7) funds, including venture capital funds formed under 3(c)(7). The model rule is limited to this category given the level of wealth required to invest in these funds. However, as noted below, NASAA is interested in divergent opinions, if any, as to the scope of the exemption.

[1] The Act delegated to the SEC the responsibility for promulgating a definition of "venture capital fund." SEC Release No. IA-3111 contains a proposed definition of "venture capital fund."

Explanation of Model Rule Provisions

As explained in paragraph (a) an investment adviser solely to one or more private funds, will be exempt from state registration requirements if the adviser satisfies the conditions as specified in the rule. The first condition is that the adviser cannot be subject to a disqualification. Second, the adviser's clients must be limited to private funds that are subject to the exclusion under 3(c)(7) of the ICA. Advisers to 3(c)(1) funds will not qualify for the exemption. Third, the exempt reporting adviser must file with the state the report required by the SEC for exempt reporting advisers..[2] Finally, the exempt reporting adviser must pay the fees specified by the state.[3]

Paragraph (b) provides that the exemption does not apply to an investment adviser that is registered with the SEC. Such advisers must comply with state notice filing requirements that are applicable to all SEC-registered investment advisers.

Paragraph (c) specifies that the investment adviser representatives associated with the exempt reporting advisers would be exempt from state registration.

The paragraph also defines "private fund" as an issuer that would be an investment company as defined in section 3 of the ICA but for sections 3(c)(1) or 3(c)(7) of the Act.

Last, paragraph (e) requires the reports necessary to satisfy the exemption be filed electronically through the IARD. A report shall be deemed filed when the report and the fee required by the administrator are filed and accepted by the IARD on the state's behalf.

Request for Comments

NASAA is seeking comments on the proposed rule in general and is particularly interested in comments as to the scope of the rule. Should other categories of advisers to private funds be included or excluded from the exemption? For instance, should advisers to 3(c)(1) funds be exempted from registration? Should all advisers to venture capital funds as defined by the SEC be excluded from registration?

Comments should be submitted electronically to advcomments@nasaa.org. The deadline for submission of comments is **January 24, 2011**. Written comments may be mailed to NASAA, Attn. Joseph Brady, 750 First Street, NE, Suite 1140, Washington, DC, 20002.

[2] Part 1A of the ADV, as proposed by the SEC in SEC Release IA. No. 3110, includes changes that would enable advisers to file these reports with state securities regulators.

[3] In order to requirement the payment of the fee for this exemption, states may have to amend the fee provision in their statutes.

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Rule XXX. Registration exemption for exempt reporting advisers

a. Subject to the provisions of paragraph (b) herein, an investment adviser solely to one or more private funds, shall be exempt from the registration requirements of Section XXX [identify authority] and shall be considered an exempt reporting adviser in this state if the adviser satisfies the following conditions:

(1) neither the adviser nor any of its advisory affiliates are subject to a disqualification as described in Section 230.262 of title 17, Code of Federal Regulations, or any successor thereto;

(2) the adviser acts as an adviser solely to private funds that qualify for the exclusion from the definition of "investment company" under Section 3(c)(7) of the Investment Company Act of 1940;

(3) the adviser files with the state a copy of each report and amendment thereto that an exempt reporting adviser under the Investment Advisers Act of 1940 would be required to file with the Securities and Exchange Commission pursuant to SEC Rule 275.204-4, along with a consent to service of process complying with Section XXX [identify authority]; and

(4) the adviser pays the fees specified in Section XXX [identify authority].

b. A federal covered investment adviser shall not be eligible for this exemption and shall comply with the state notice filing requirements applicable to such advisers.

c. An investment adviser representative is exempt from the registration requirements of Section XXX [identify authority] if he or she is employed by or associated with an adviser that is exempt from registration in this state pursuant to paragraph (a.) above.

d. As used in this rule a private fund means an issuer that would be an investment company as defined in section 3 of the Investment Company Act of 1940 but for sections 3(c)(1) or 3(c)(7) of the Act.

e. The report filings described in paragraph (a.)(3) above shall be made electronically through the IARD. A report shall be deemed filed when the report and the fee required by Section XXX [identify authority] are filed and accepted by the IARD on the state's behalf.