NOTICE OF REQUEST FOR PUBLIC COMMENT:
PROPOSED CHANGES TO THE NASAA REGISTRATION EXEMPTION
FOR INVESTMENT ADVISERS TO PRIVATE FUNDS MODEL RULE UNDER THE UNIFORM SECURITIES ACTS OF 1956 AND 2002

The Board of Directors of the North American Securities Administrators Association, Inc. ("NASAA") has authorized release for public comment the following proposed changes to the NASAA Registration Exemption for Investment Advisers to Private Funds Model Rule under the Uniform Securities Act of 1956 and under the Uniform Securities Act of 2002 ("the NASAA Model Rule" or "the Model Rule").

Public Comment Period

The public comment period will remain open until September 5, 2013. To facilitate considerations of comments, please send comments to Andrea Seidt (Andrea.Seidt@com.state.oh.us), Chair of the Investment Adviser Section, and Joseph Brady (jb@nasaa.org) and A.Valerie Mirko (vm@nasaa.org), NASAA Legal Department. We encourage, but do not require, comments to be submitted by e-mail. Hard copy comments can be submitted at the address below. We also welcome any general comments on the NASAA Registration Exemption for Investment Advisers to Private Funds Model Rule.

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Background on Proposed Amendments

On December 16, 2011, NASAA adopted the NASAA Registration Exemption for Investment Advisers to Private Funds Model Rule ("the NASAA Model Rule" or "the Model Rule"). The Model Rule is designed to provide a model exemption framework from investment adviser registration for advisers that advise solely one or more "qualifying private funds."[1] States that do not register private fund advisers can draw from the exemption framework of the Model Rule, which is similar to the provisions to exempt such funds in the Dodd-Frank Wall Street Reform and Consumer Protection Act as implemented by the Securities and Exchange Commission. While the reporting framework of the NASAA Model Rule is identical to the SEC exempt reporting adviser framework, the NASAA Model Rule places additional requirements absent from the SEC framework. The current version of the Model Rule incorporates the statutory disqualifications found in Rule 262 of SEC Regulation A (17 C.F.R. § 230.506(d)(1)) which, when triggered, prohibit a private fund adviser from utilizing the exemption. The general rules relating to registration would then apply.

[1] A *qualifying private fund* means any private fund that is not registered under Section 8 of the Investment Company Act of 1940 and has not elected to be treated as a business development company pursuant to Section 54 of that Act. 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 in addition to those provided by section 3(c)(1) or 3(c)(7) of that Act provided that the investment adviser treats the issuer as a private fund under the Act and the rules thereunder for all purposes.

On July 10, 2013, the Securities and Exchange Commission issued Release No. 33-9414 in which it adopted a final rule disqualifying felons and other "bad actors" from Rule 506 offerings.[2] The final rule, in compliance with Dodd-Frank Section 926, adopted statutory disqualification provisions under Rule 506 that were "substantially similar" to those found in Rule 262. Furthermore, the final rule changes to Rule 506 adopted additional disqualifying events required by Dodd-Frank, including certain state administrative actions.[3] The newly adopted Rule 506 statutory disqualification language is similar to proposed amendments to the Model Rule that the Investment Adviser Regulatory and Policy Project Group ("the Project Group") had independently considered earlier in 2013. As of the time of the Project Group's initial proposed revisions, the SEC had not issued a final rule as required by Section 926. The proposal outlined in this Request for Public Comment is the product of the Project Group's work in conjunction with an extensive internal comment process, which included revisions to the initial proposal as a result of SEC Release No. 33-9414.

Proposed Reference to Rule 506 to Replace Reference to Rule 262

The Commission did not amend Rule 262 to reflect the new Rule 506 "bad actor" provisions. NASAA therefore proposes to amend the Model Rule to disqualify advisers from use of the private fund exemption if the adviser or its advisory affiliates are subject to an event that would disqualify an issuer under Rule 506(d)(1) of SEC Regulation D.[4] Incorporating the disqualifications listed in Rule 506 rather than those in Rule 262 enhances investor protection and serve as a better set of disclosures for use in the Model Rule. We seek comment regarding the transition from referring to Rule 262 to Rule 506 disqualification language in the Model Rule.

The Rule 506 "bad actor" disqualifications are, with limited exceptions,[5] generally more comprehensive than Rule 262's disqualification provisions. Additionally, most private fund advisers advise funds that are exempt from securities registration under Rule 506, such that using the same list of disqualifying events for both the private fund advisers and the funds they advise provides a level of uniformity.

[2] SEC Rel. No. 33-9414, 2013 WL 3817311 (July 10, 2013); 78 Fed. Reg. 44730 (July 24, 2013).

[3] There are two types of state administrative orders that can trigger disqualification under Rule 506. First, orders that, at the time of sale, bar the person from association with an entity regulated by the commission, authority, agency or officer entering the order, or engaging in the business of securities, insurance or banking, or engaging in savings association or credit union activities. These orders act as a disqualification during the period in which the bar is operative. Second, orders that constitute a final order based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct. These orders act as a disqualifying event for ten years from entry of the order, subject to an SEC grandfathering provision.

[4] The Project Group proposed modifying the language of paragraph (b)(1) in order to clarify that an adviser would be disqualified if they are the subject of an event that would disqualify an issuer under Rule 506(d)(1). This change was made because Rule 506(d)(1) refers to the disqualifications in terms of issuers of securities, not advisers. The proposed language is not intended to suggest that the rule is subject to the waiver provisions in Rule 506 except to the extent explicitly referenced. This language change is intended to be a simple clarification and a non-substantive change.

[5] Unlike Rule 262, which applies to disqualifying events by *any* officer, new Rule 506(d)(1) is limited to officers who participate in the offering or executive officers; similarly Rule 262 applies to beneficial owners of 10 percent or more of the issuer's outstanding shares, but Rule 506(d)(1) changes the ownership threshold to 20 percent of the voting shares.

General Waiver Provision

The proposal inserts a waiver provision as paragraph (h) of the Model Rule, and moves the now-existing but optional paragraph (h) grandfathering provision to a new paragraph (i). The waiver provision is modeled upon Rule 506(d)(2)(ii), which grants the SEC similar waiver authority with respect to disqualifying events in Rule 506. The proposed amendment would allow the state Administrator, upon a showing of good cause and without prejudice to any other action of the state securities regulator, to determine that it is not necessary under the circumstances that the exemption be denied.

No Automatic Waiver Provision

Including an automatic waiver provision akin to SEC Rule 506(d)(2)(iii) presents investor protection concerns within the context of the exempt reporting adviser model rule. Under Rule 506(d)(2)(iii), an otherwise disqualifying event does not trigger disqualification if, before the relevant sale, the court or regulatory authority that entered the relevant order, judgment or decree, advises in writing that disqualification should not arise as a consequence of such order, judgment or decree. Such automatic waivers with no review by the securities administrator do not serve investor protection concerns and that the waiver authority of proposed paragraph (h) grants sufficient waiver authority to evaluate such circumstances as they arise. Furthermore, in the investment adviser registration context, such events would be subject to review as part of the registration process, and it would be inconsistent with investor protection interests for a state to not have an opportunity to inquire as to such events solely because the adviser is a private fund adviser. We seek comment upon the waiver provisions.

Events Occurring Prior to the Effective Date of the Model Rule May Cause Disqualification

The proposed amendments do not include a section similar to Rule 506(d)(2)(i), as in the context of an investment adviser registration exemption, a "bad actor" provision should not be subject to an effective date for application. In the private placement issuer context, Rule 506(d)(2)(i) requires that in order to trigger disqualification for purposes of Rule 506, the conviction, order, judgment, decree, suspension, expulsion or bar must have occurred or been issued on or after the effective date of the Rule 506 "bad actor" provision. The enumerated disqualifying events listed in Rule 506(d)(1) are appropriate and should be incorporated by reference in the Model Rule. However, consistent with NASAA's stated position on the matter, disqualifying events that predate the effective date of "bad actor" rules should remain a basis for disqualification.

While Rule 506 speaks to a registration exemption for issuers of securities, the proposed amendment to the Model Rule would draw from the 506 "bad actor" provisions for use in the investment adviser registration context. States' processes for investment adviser registration include review of past convictions, orders judgments, decrees, suspensions, expulsions or bars to determine whether a registration for the adviser is appropriate in light of those disclosures. In that context, an adviser subject to a "bad actor" disqualification that pre-dates the effective date of the Model Rule generally would be disqualified (subject to the general waiver provision in paragraph (h)) from using the exemption and be required to go through the typical registration process before conducting investment advisory activity. The existing NASAA Model Rule does not include a lookback provision akin to Rule 506(d)(2)(i). The Project Group is not aware of any instances in those states that have adopted the Model Rule where the lack of a lookback provision has been problematic. We welcome comments on such instances.

We seek comment regarding the following:

1. Should the Model Rule use the "bad actor" provisions found in Rule 506, rather than those in Rule 262? What are the potential consequences of transitioning to the Rule 506 list of disqualifying events?

2. Should there be additional grounds for disqualification included in (b)(1), beyond the language drawn from Section 506?

3. Should the Model Rule include a waiver provision akin to paragraph (h) of the proposal?

4. Should the Model Rule include an automatic waiver akin to Rule 506(d)(2)(iii) of Rule 506?

5. The proposed amendments to the Model Rule would consider bars from the industry disqualifying events for purposes of qualifying for the Model Rule's exemption. In the context of the Rule 506 "bad actors" provisions, the SEC solicited comment on whether additional guidance describing a bar was necessary. The SEC chose not to provide such guidance in the rule itself. The SEC did however describe what constituted a bar in the final rule release.[6] For the purposes of the Model Rule disqualification provisions, is a general reference to a "bar" sufficient, or is additional guidance through Model Rule commentary necessary?

6. Should the Model Rule provide any provisions relating to the grandfathering of disqualifying orders that were entered prior to adoption of the private fund exemption?

[6] See SEC Release No. 33-9414 at 44 ("We believe the statutory language is clear: bars are orders issued by one of the specified regulators that have the effect of barring a person from association with certain regulated entities; from engaging in the business of securities, insurance or banking; or from engaging in savings association or credit union activities. Any such order that has one of those effects is a bar, regardless of whether it uses the term "bar." Orders that do not have any of those effects are not bars, although they may be disqualifying "final orders" . . .)

Proposed Changes to NASAA Registration Exemption for Investment Advisers to Private Funds Model Rule

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 qualifying private funds.

(3) "Qualifying private fund" means a private fund that meets the definition of a qualifying private fund in SEC Rule 203(m)-1, 17 C.F.R. 275.203(m)-1.

(4) "3(c)(1) fund" means a qualifying private fund that is eligible for the exclusion 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 an event that would ~~disqualification~~ disqualify ans ~~described~~ issuer under~~in~~ Rule ~~262~~ 506(d)(1) of SEC ~~Regulation A~~Regulation D, ~~17 C.F.R. § 230.262~~ 17 C.F.R. § 230.506(d)(1);

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

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

(C) 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) Waiver Authority with Respect to Statutory Disqualification.*Paragraph (b)(1) shall not apply upon a showing of good cause and without prejudice to any other action of the [state securities regulator], if the [Administrator] determines that it is not necessary under the circumstances that an exemption be denied.

*[(~~h~~i) **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 has one or more beneficial owners who are not qualified clients as described in subparagraph (c)(1) is eligible 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;

(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;

(3) the investment adviser discloses in writing the information described in paragraph (c)(2) to all beneficial owners of the fund; and

(4) as of the effective date of this regulation, the investment adviser delivers audited financial statements as required by paragraph (c)(3).]