



## Adoption of NASAA's Model "Private Fund Manager" Exemption to State Investment Adviser Registration

### SEC Registration

Investment advisers are required to register with the SEC under the Investment Advisers Act of 1940 ("Advisers Act") when certain assets under management thresholds are met. Passed on July 21, 2010, the Dodd Frank Act (Dodd-Frank) modified the exemptions for investment advisers to private funds as part of an effort have the SEC focus its regulatory scrutiny on large fund managers while state regulatory agencies given primary responsibility for oversight of small and midsize fund managers within their states.

Dodd-Frank eliminated the longstanding "Private Adviser Exemption" under the Advisers Act, which exempted from registration advisers with fewer than 15 clients and replaced it with a "regulatory assets under management" ("RAUM") test. Specifically, private fund investment advisers are exempted from registration with the SEC under 203(l) when advising only venture capital funds, and under 203(m) when they advise funds with RAUM of less than \$150 million.

Thus, investment advisers to funds with less than \$150 million RAUM, or that meet another exemption, are generally precluded from SEC registration but may *still* be subject to state registration.

### State Regulation - NASAA Model Rule

Along with potential SEC regulatory oversight, every investment adviser is subject, absent an exemption, to registration in the state(s) where they provide investment advice. Since the adoption of Dodd-Frank, states have sought to realign their regulatory regimes with the federal rules. In an effort to encourage state regulators to harmonize their rules the North American Securities Administrators Association (NASAA) adopted a private fund adviser exemption *model rule* meant to serve as a guideline for states (the "Model Rule").

Under the Model Rule, a private fund adviser is exempt from registration if each of the following conditions is satisfied:

1. Neither the adviser nor any of its affiliates are subject to certain **disqualifications**<sup>1</sup>;
2. The adviser **files** form ADV with the state pursuant to SEC Rule 204-4<sup>2</sup>; and
3. The adviser pays the relevant state **fees**.

### Additional Requirements for 3(c)(1) funds

<sup>1</sup> Also known as "bad boy" disqualifications, the relevant provisions are described in Rule 262 of SEC Regulation A. These disqualifications include the conviction of any felony or misdemeanor in connection with the purchase or sale of any security within 5 years and the filing of a registration statement, which has been the subject of any refusal or stop order.

<sup>2</sup> Section 204-4 requires that an adviser relying on the exemption under either 203(l) or (m) must file reports on Form ADV electronically with the Investment Adviser Registration Depository (IARD).



A fund owned by less than 100 people qualifies for the exclusion from the definition of an investment company under section 3(c)(1) of the Investment Company Act. The Model Rule imposes the following additional conditions for 3(c)(1) funds:

1. The fund's outstanding securities must be owned entirely by persons who meet the definition of a "**qualified client**" in SEC Rule 205-3<sup>3</sup>
2. The adviser shall **disclose** the following in writing to each owner of the fund:
  - a. all *services* provided to the owners;
  - b. all *duties* the adviser owes to the owners; and
  - c. any other *material information* affecting the owners.
3. The adviser shall deliver annual **audited financial statements** to each fund owner

#### Transition

When an exempt reporting adviser loses the private fund exemption by, for instance, adding a client that does not meet the definition of a "qualified client", the adviser is required to register within 90 days.

#### Grandfathering Provision

The Model Rule provides that an adviser to a 3(c)(1) fund that has one or more beneficial owner(s) who are *not* qualified clients is still eligible for the exemption if the following conditions are satisfied:

1. The Fund **existed prior** to the effective date of the state's regulation;
2. As of the date of the regulation, the fund **ceases to accept** non-qualified clients
3. The adviser **discloses** in writing the information described in Section (2) above; and
4. As of the date of the regulation the investment adviser **delivers audited financial statements**.

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<sup>3</sup> Under Rule 205-3 a "qualified client" has at least \$1 million under management with the adviser OR the adviser reasonably believes that the client has a net worth of more than \$2 million (excluding the value of such investor's primary residence) at the time the contract is entered into. When calculating such person's net worth, the value of that person's primary residence is excluded from the net worth test.

## State Adoption of NASAA's Model Rule

As of this writing, 12 states have adopted (and Washington has proposed) a private fund adviser exemption based on the NASAA model rule. It is likely that other states will continue the trend and adopt some version of the model rule. Given that some states have modified it slightly, the chart below details the major differences, if any, between rules adopted by the state in question and Model Rule.

| State             | Web Version   | Date Adopted  | Differences from NASAA  |
|-------------------|---|---|---|
| <b>California</b> | <a href="http://www.corp.ca.gov/Regulations/CSL/0211O_Rev082712.pdf">http://www.corp.ca.gov/Regulations/CSL/0211O_Rev082712.pdf</a>   | Administrative order effective August 27 <sup>th</sup> , 2012   | <ul style="list-style-type: none"> <li>• Substitutes the definition of “accredited investor” under Rule 501(a) of Reg. D for “qualified client”; and does not deduct value of primary residence from person’s net worth</li> </ul>  |
| <b>Colorado</b>   | <a href="http://webcache.googleusercontent.com/search?q=cache:mgPZwko3kFsJ:www.sos.state.co.us/CCR/Upload/AGORequest/AdoptedRules0201000728.RTF+Colorado+Investment+Adviser+registration+exemption&amp;cd=10&amp;hl=en&amp;ct=clnk&amp;gl=us&amp;client=safari">http://webcache.googleusercontent.com/search?q=cache:mgPZwko3kFsJ:www.sos.state.co.us/CCR/Upload/AGORequest/AdoptedRules0201000728.RTF+Colorado+Investment+Adviser+registration+exemption&amp;cd=10&amp;hl=en&amp;ct=clnk&amp;gl=us&amp;client=safari</a> | Administrative order effective March 30, 2012                   |   |
| <b>Indiana</b>    | <a href="http://www.in.gov/sos/securities/files/Private_Adviser_AO.pdf">http://www.in.gov/sos/securities/files/Private_Adviser_AO.pdf</a>   | Administrative order effective January 9, 2012                  | <ul style="list-style-type: none"> <li>• Allows for fund advisers already registered with the SEC to be eligible for state exemption</li> <li>• Doesn’t require reporting under SEC Rule 204-4 as required by Section (b)(2) of the model rule</li> </ul> <p>Other conditions <b>not</b> in NASAA:</p> <ul style="list-style-type: none"> <li>• During the previous 12 months did not have more than 5 clients</li> </ul> |
| <b>Maine</b>      | <a href="http://www.maine.gov/tools/whatsnew/attach.php?id=353870&amp;an=1">http://www.maine.gov/tools/whatsnew/attach.php?id=353870&amp;an=1</a>   | Administrative order effective February 16 <sup>th</sup> , 2012 | <ul style="list-style-type: none"> <li>• Substitutes the definition of “accredited investor” under Rule 501(a) of Reg. D for “qualified client”; and does not deduct the value of primary residence from net worth</li> <li>• Only applies “private fund” definition to 3(c)(1) funds and not 3(c)(7) funds (those owned solely by qualified purchasers)</li> </ul>   |



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| <b>Massachusetts</b> | <a href="http://www.sec.state.ma.us/sct/sctnewregs_11_11/950%20CMR%2012_205.pdf">http://www.sec.state.ma.us/sct/sctnewregs_11_11/950%20CMR%2012_205.pdf</a>  | Adopted rule effective February 3, 2012          |  |
| <b>Maryland</b>      | <a href="http://www.oag.state.md.us/Securities/MD_ERA_Order_6_15.pdf">http://www.oag.state.md.us/Securities/MD_ERA_Order_6_15.pdf</a>  | Administrative order effective June 15, 2012     |  |
| <b>Michigan</b>      | <a href="http://www.michigan.gov/documents/dleg/11-009-M_347536_7.pdf">http://www.michigan.gov/documents/dleg/11-009-M_347536_7.pdf</a>  | Administrative order effective March 3, 2011     | <ul style="list-style-type: none"> <li>• Doesn't include the "bad boy" provisions as a disqualification from exemption under Section (b)(1) of the model rule.</li> <li>• Allows for advisers already registered with the SEC to be eligible for the state exemption</li> <li>• Allows for "qualified clients" under Rule 205-3(d)(1) OR "accredited investors" under Rule 501(a) of Reg. D</li> <li>• Does not require the certain disclosures or audited financial statements to owners as under Section (2) or (3) of the model rule</li> <li>• Doesn't require reporting under SEC Rule 204-4 as required by Section (b)(2) of the model rule</li> </ul> |
| <b>Minnesota</b>     |  |  |  |
| <b>Missouri</b>      | <a href="http://www.sos.mo.gov/securities/AR-12-03.asp">http://www.sos.mo.gov/securities/AR-12-03.asp</a><br>Performance based compensation can only be paid to "qualified clients" as defined under federal law.<br>"Accredited investors" excludes the income test.<br>Exempt reporting adviser filing required. | Adopted rule effective October 31, 2012          |  |
| <b>Vermont</b>       | <a href="http://www.dfr.vermont.gov/sites/default/files/Registration%20Exemption%20for%20IAs%20to%20Private%20Funds.pdf">http://www.dfr.vermont.gov/sites/default/files/Registration%20Exemption%20for%20IAs%20to%20Private%20Funds.pdf</a>  | Administrative order effective November 12, 2012 |  |
| <b>Virginia</b>      | <a href="http://www.scc.virginia.gov/srf/s_12_09.pdf">http://www.scc.virginia.gov/srf/s_12_09.pdf</a>  | Administrative order effective May 7, 2012       |  |
| <b>Rhode Island</b>  | <a href="http://www.eastprovchamber.com/">http://www.eastprovchamber.com/</a>  | May 17, 2012                                     |  |



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|-------------------|---|---|--|
|                   | documents/Budgetbill.pdf  |   |  |
| <b>Washington</b> | <a href="http://www.dfi.wa.gov/sd/rulemaking/pdf/2012/investment-adviser-rule-update.pdf">http://www.dfi.wa.gov/sd/rulemaking/pdf/2012/investment-adviser-rule-update.pdf</a>                             | Proposed rule, August 13, 2012          |  |
| <b>Wisconsin</b>  | <a href="http://www.wdfi.org/resources/indexed/site/fi/securities/PrivateFundAdviserExemptionOrder.pdf">http://www.wdfi.org/resources/indexed/site/fi/securities/PrivateFundAdviserExemptionOrder.pdf</a> | Administrative order, February 17, 2012 | <ul style="list-style-type: none"><li>• Substitutes the definition of “accredited investor” under Rule 501(a) of Reg. D for “qualified client”</li></ul> |