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South Carolina's New Private Fund Adviser Exemption — A Boost for an Emerging Industry

By Ernie L. Cochran II, Robert M. Crea, and Lauren E. McFadden

On September 6, 2019, the Securities Division of South Carolina's Office of the Attorney General issued an order (found here) providing an exemption from the state investment adviser registration requirements for advisers that provide advice solely to certain private investment funds (the "Order"). This news should prove welcome to South Carolina's burgeoning private fund industry.

I. BACKGROUND

Until issuance of the Order, South Carolina was one of a handful of states that did not have an exemption for private fund advisers. As a consequence, under South Carolina's Uniform Securities Act of 2005, South Carolina Code Section 35-1-101 et seq. (the "Act"), a South Carolina-based adviser that advised only private funds would have to register as an investment adviser with the Securities Division of the Office of the Attorney General (the "Securities Division"). Further, the principals of the adviser would have to register as investment adviser representatives, which in turn entailed taking either the Series 65 exam or both the Series 66 and 7 exams.[1]

As a workaround from the Act's strictures, a private fund adviser could seek no-action relief from the Office of the Attorney General. When such relief was granted, a private fund adviser would still have to register with the Securities Division but would generally be exempt from some of the Act's more onerous conditions, such as posting surety bonds and the requirements that principals register as investment adviser representatives and take specified exams.

The Order provides much clearer guidance for South Carolina's emerging private fund adviser industry. Working with the industry and members of the South Carolina Bar, the Office of the Attorney General adopted a rule based on the model rule of the North American Securities Administrators Association (NASAA) (found here) with some significant enhancements that many private fund advisers should find welcome and which other states might seek to emulate.[2]

II. SOUTH CAROLINA'S PRIVATE FUND ADVISER EXEMPTION

The Order sets forth four basic requirements that a private fund adviser must meet to claim exemption from South Carolina's registration requirements. It also prescribes additional requirements for advisers to qualifying private funds that rely on the exclusion from the

[1] *See* "Frequently Asked Questions - Investment Adviser Representatives" on the South Carolina Attorney General's website, found here.

[2] NASAA is a voluntary association of state and provincial securities regulators in the United States, Canada, and Mexico. NASAA adopted its model rule on private fund adviser and registration on December 16, 2011.

definition of an "investment company" contained in Section 3(c)(1) of the Investment Company Act of 1940, as amended (the "Investment Company Act").

A. Basic Requirements

The four basic requirements for exemption under the Order are as follows:

- Advisers must solely advise "qualifying private funds";[3]
- Advisers may not be subject to disqualification by the U.S. Securities and Exchange Commission ("SEC");[4]
- Advisers must file with the state each report required to be filed by an exempt reporting adviser pursuant to Rule 204-4 under the Investment Advisers Act of 1940, as amended (the "Advisers Act") (see Section III below for a description of the Exempt Adviser Reporting Requirements); and
- Advisers must pay the standard $210 South Carolina investment adviser registration and renewal fees for each year in which the exemption is sought.

Notably, the Order also exempts private fund advisers managing funds aggregating less than $25 million from having to (i) file exempt reporting adviser reports, (ii) pay initial registration and renewal fees, and (iii) obtaining an annual audit of any Section 3(c)(1) fund that is not a venture capital fund.[5]

B. Special Requirements for Advisers to Section 3(c)(1) Funds That Are Not "Venture Capital Funds"

The Order sets forth additional requirements for advisers to qualifying private funds that rely on the exclusion from the definition of an "investment company" contained in Section 3(c)(1) of the Investment Company Act ("3(c)(1) Funds") that are not venture capital funds.[6] Advisers to these 3(c)(1) Funds will be exempt from registration with the Securities Division only if they adhere to the following requirements and restrictions:

[3] A "qualifying private fund" means a private fund that meets the federal definition of a qualifying private fund in Rule 203(m)-1 of the Investment Advisers Act of 1940, as amended.

[4] SEC "disqualification" is described in Rule 262 of Regulation A under the Securities Act of 1933, as amended (the "1933 Act"). Paragraph I of the Order authorizes the South Carolina Attorney General, acting under his or her authority as Securities Commissioner, upon a showing of good cause, to waive without prejudice such disqualification.

[5] *See* Paragraph D of the Order.

[6] *See* Paragraph C of the Order.

- Each investor in each 3(c)(1) Fund meets the "accredited investor"[7] or "qualified client"[8] standard at the time an investor purchases interests in a fund;[9]
- The private fund adviser discloses in writing at the time of purchase (a) all services, if any, to be provided to individual beneficial owners; (b) all duties, if any, the private fund adviser owes to the beneficial owners; and (c) any other material information affecting the rights or responsibilities of the beneficial owners;
- The adviser obtains, on an annual basis, audited financial statements of each 3(c)(1) Fund and delivers a copy of such statements to each beneficial owner within 120 days of fiscal year end (or 150 days for a fund of funds);[10]
- In the event the adviser seeks to receive compensation in respect of an investor that is not a qualified client on the basis of a share of capital gains or the capital appreciation of a fund, then the adviser must disclose in writing all material information concerning the proposed fee arrangement, including the following:
  - The fee arrangement may create an incentive for the private fund adviser to make investments that are riskier or more speculative than would be the case in the absence of a performance fee;
  - Where relevant, that the private fund adviser may receive increased compensation with regard to unrealized appreciation as well as realized gains in the client's account;
  - The periods that will be used to measure the investment performance throughout the contract and their significance in the computation of the fee;
  - The nature of any index that will be used as a comparative measure of investment performance, the significance of the index, and the reason the private fund adviser believes that the index is appropriate; and
  - Where the private fund adviser's compensation is based in part on the unrealized appreciation of securities for which market quotations are not readily available, how the securities will be valued and the extent to which the valuation will be independently determined.

The aforementioned requirements largely comport with the NASAA model rule with the notable exception of a private fund adviser's ability under the South Carolina Order to collect performance compensation in respect of investors that are not qualified clients. This ability

[7] The term "accredited investor" is defined in Rule 501 of regulation D under the 1933 Act. The accredited investor standard looks to an individual's financial means to determine whether such person meets a minimum threshold. For natural persons, individual net worth, or joint net worth with a person's spouse, must exceed $1,000,000, excluding the value of the primary residence of such person or persons. A natural person will also be deemed an accredited investor if such person had an individual income in excess of $200,000 in each of the two most recent years or joint income with that person's spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year.

[8] Rule 205-3 under the Advisers Act defines a "qualified client" as (i) a client with at least $1,000,000 under the management of the adviser immediately after entering into the advisory contract, or (ii) a client that the adviser reasonably believes (a) has a net worth (in the case of a natural person, together with assets owned jointly by his or her spouse) of more than $2,100,000.

[9] On this point, the Order is more flexible than the NASAA model rule, which permits only qualified clients to invest in a 3(c)(1) Fund that is not a venture capital fund.

[10] Paragraph C.(3)(b) of the Order indicates that if a fund begins operations more than 180 days into a fiscal year, the adviser need not prepare a financial audit for that fiscal year, provided that the financial audit for the fiscal year immediately succeeding is supplemented by, or includes, a financial audit of the initial fiscal year.

represents significant flexibility *vis a vis* the exemptions of many other states. A South Carolina private fund adviser that seeks to avail itself of this flexibility must be careful to include the specified disclosures in its offering materials.

C. Advisers to Venture Capital Funds

Under the Order, advisers solely to one or more venture capital funds would be exempt from registration if they meet the four basic requirements for exemption (described above in Section II.A.). The Order applies the same definition of "venture capital fund" as in SEC Rule 203(l)-1 (17 C.F.R. 275.203(l)-(1)).[11] The requirements summarized in Section II.B. above would not apply to advisers that solely advise one or more venture capital funds.

III. EXEMPT ADVISER REPORTING REQUIREMENTS

The Order requires exempt advisers (including venture capital fund advisers) to file all reports that advisers who are exempt from federal registration must file with the SEC pursuant to Rule 204-4 of the Advisers Act (17 C.F.R. 275.204-4). Rule 204-4 requires exempt advisers to complete and periodically update the relevant items required on the Form ADV Part 1A, including the following items: Item 1 (identifying information), Item 2.B (SEC reporting by exempt advisers), Item 3 (form of organization), Item 6 (other business activities), Item 7 (financial industry affiliation and private fund reporting), Item 10 (control persons), Item 11 (disciplinary history), as well as those sections of Schedules A, B, C, and D that correspond to the items listed above.[12] Exempt advisers would not be required to complete a Form ADV Part 2A, 2B, or 3.

IV. INVESTMENT ADVISER REPRESENTATIVES

The Order explicitly exempts from the registration requirements of Section 35-1-404 of the Act any person employed by or associated with a private fund adviser exempt from registration under the Order.[13]

V. TRANSITION

The Order provides that a private fund adviser currently registered with the Office of the Attorney General who wishes to rely on the exemption must comply with the Order within 60 days of relying on the exemption. Advisers that become ineligible for the exemption would be required to register within 90 days from the date the adviser's eligibility for the exemption ceases.[14]

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[11] For a complete description of the SEC's definition of a "venture capital fund," *see* K&L Gates Investment Management Alert: Advisers Act Registration Exemptions for Venture Capital Fund Advisers and Private Fund Advisers: The SEC Adopts Final Rules (July 20, 2011) ("K&L Private Fund Adviser Note").

[12] The SEC requires certain categories of advisers who are exempt from registration under the Advisers Act, including advisers to private funds, to provide it with the information listed above in notice filings. For a detailed discussion of the SEC's notice filing requirements, see K&L Private Fund Adviser Note, *supra* note 11.

[13] *See* Paragraph F of the Order.

[14] *See* Paragraph H of the Order.

VI. CONCLUSION

As professionals specializing in venture capital, private equity, and hedge funds increasingly domicile in the Southeast, and specifically South Carolina, South Carolina's Order could not have come at a better time. The flexibility of the Order should come as welcome news both to private fund advisers who already have operations in South Carolina, as well as those who seek to establish operations in the state.

Authors:

Ernie L. Cochran II
ernie.cochran@klgates.com
+1.843.579.5630

Robert M. Crea
robert.crea@klgates.com
+1.415.882.8199

Lauren E. McFadden
lauren.mcfadden@klgates.com
+1.843.579.5611