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# **Dodd-Frank One-Year Anniversary: Impact on Private Equity/Hedge Funds**

Presented by  
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# Presenters



## **Yukako Kawata**

Yukako is co-head of Davis Polk's Investment Management/Private Funds Group. She advises clients on the formation and operation of private investment funds and other investment vehicles exempt under the U.S. Investment Company Act, including private equity funds, hedge funds, venture capital funds, fund of funds and funds investing in particular sectors or countries. She also advises clients on the establishment and operations of private fund managers, including private equity and hedge fund firms.



## **Leor Landa**

Leor is a partner in Davis Polk's Investment Management/Private Funds Group. He advises a wide range of clients on the development, formation, marketing and operation of private investment fund complexes, including private equity funds, hedge funds, hybrid funds, real estate funds, funds of funds and asset allocation products. Leor also advises clients in connection with structuring and executing private equity, structured equity and public market transactions as well as acquisitions of investment advisers.



## **Danforth Townley**

Dan is a partner in Davis Polk's Investment Management/Private Funds Group. He advises clients on investment funds and related corporate finance transactions, including the structuring and offering of hedge funds, private equity funds and other investment vehicles. Dan advises clients on the establishment and operation of hedge fund managers and private equity sponsors, including the structuring of carried interest plans and other profit sharing arrangements, as well as on mergers and acquisitions of fund managers.

# New Registration Requirements for Private Fund Managers

## *Elimination of the Private Investment Adviser Exemption*

- Effective July 2011, the Dodd-Frank Act eliminated the “private adviser exemption” under Section 203(b)(3).
  - Generally, investment advisers were exempt from registration if they: (i) had fewer than 15 clients during the preceding 12 months and (ii) did not hold themselves out to the public as investment advisers (the “**private adviser exemption**”)
  - One hedge fund or private equity fund was generally considered one client for purposes of the registration exemption, thus most private fund advisers were exempt from registering because they had less than 15 clients

## *Transition Rule*

- Although the private adviser exemption was statutorily rescinded on July 21, 2011, in order to give advisers who had been relying on the exemption additional time to register and comply with the requirements for registered investment advisers, the SEC extended until March 30, 2012 the date by which these advisers must register.

# New Registration Requirements for Private Fund Managers *(cont.)*

## ***Impact of SEC Registration***

- All investment advisers are subject to anti-fraud provisions of the Advisers Act, but registered advisers are subject to additional compliance obligations:
  - Appoint a chief compliance officer
  - Establish a compliance program and a code of ethics
  - Comply with custody and recordkeeping requirements
  - Subject to periodic SEC inspection
  - Reporting requirements

# New Exemptions from Advisers Act Registration

## *New Exemptions from Advisers Act Registration*

- **Private Fund Advisers (w/ less than \$150 million AUM)**
  - Exempt reporting adviser (limited amount of Form ADV reporting; no Form PF reporting)
- **Foreign Private Advisers**
  - Full 203(b) exemption from the Advisers Act
- **CFTC Registered Advisers that Advise Private Funds**
  - Full 203(b) exemption from the Advisers Act
- **Venture Capital Fund Advisers**
  - Exempt reporting adviser (limited amount of Form ADV reporting; no Form PF reporting)

# New Exemptions from Registration *(cont.)*

## Application of Advisers Act to Different Types of Advisers

	Form ADV Part 1A	Full Form ADV and Schedules	Brochure	Form PF	Subject to Entire Advisers Act	Subject to Certain Portions of Advisers Act
Registered Advisers	✓	✓	✓	✓	✓	✓
Venture Capital Fund Advisers (Exempt Reporting Adviser)	✓					✓
Private Fund Advisers with less than \$150 million AUM (Exempt Reporting Adviser)	✓					✓
Foreign Private Advisers						✓
CFTC Registered Advisers						✓

# New Exemptions from Advisers Act Registration

(cont.)

## ***Private Fund Adviser Exemption***

- The Dodd-Frank Act directed the SEC to provide an exemption to an investment adviser that:
  - Acts **solely** as an adviser to private funds; and
  - Has assets under management in the U.S. of less than \$150 million.
- On June 22, 2011, the SEC issued rules implementing this exemption

## ***SEC: Private Fund Adviser Exemption***

- ***U.S. Advisers*** (those with a “principal office and place of business” in the U.S.)
  - Acts solely as an investment adviser to one or more “qualifying private funds”; and
    - “Qualifying private fund” means any private fund (i.e., 3(c)(1) or 3(c)(7) fund) that is not a registered investment company or a business development company.
  - Manages private fund assets of less than \$150 million.
    - “Principal office and place of business” means the executive office of the investment adviser from which the officers, partners, or managers of the investment adviser direct, control, and coordinate the activities of the investment adviser.

# New Exemptions from Advisers Act Registration

(cont.)

## **SEC: Private Fund Adviser Exemption** (cont.)

- **Non-U.S. Advisers** (those with a “principal office and place of business” outside the U.S.)
  - Adviser has no client that is a U.S. Person (as defined in Regulation S) except for qualifying private funds; and
  - All assets managed at a “place of business” in the United States are solely attributable to private fund assets, the value of which is less than \$150 million.
    - “Place of business” means any office where the investment adviser regularly provides investment advisory services, solicits, meets with, or otherwise communicates with clients, and any other location that is held out to the general public as a location at which the adviser conducts any such activities.



# New Exemptions from Advisers Act Registration

(cont.)

## ***Foreign Private Advisers Exemption***

- The Dodd-Frank Act includes a narrow registration exemption for any “foreign private adviser” who:
  - Has no “place of business” in the United States;
  - Has, in total, ***fewer than 15 U.S. clients and U.S. investors in private funds*** advised by the adviser;
  - Has aggregate assets under management attributable to U.S. clients and U.S. investors in private funds of ***less than \$25M***; and
  - Does not (i) hold itself out generally to the U.S. public as an investment adviser, (ii) act as an investment adviser to a RIC or (iii) act as a business development company.

# New Exemptions from Advisers Act Registration

(cont.)

## ***Foreign Private Advisers***

- The SEC issued rules to clarify the meanings of certain undefined terms in the foreign private adviser exemption.
  - “Place of business” has the same meaning as in the private fund advisers rule (see prior slide).
  - “In the United States” is defined by reference to the definitions of “U.S. person” and “United States” in Regulation S under the Securities Act.
    - An adviser would generally only be required to look to the point in time when the person either became a client or an investor for determining whether the person was “in the United States.”

# CPO/CTA Registration Issues Under the Commodity Exchange Act (“CEA”)

## ***Proposed Rescission of CFTC Rules 4.13(a)(3) and (4)***

- On January 26, 2011, the CFTC proposed rescinding the CPO registration exemptions for commodity pools that meet sophisticated investor requirements under CFTC Rules 4.13(a)(3) and (4).
- Rescission of CFTC Rules 4.13(a)(3) and (4) was not mandated by the Dodd-Frank Act; CFTC stated that purpose is to “promote transparency” with respect to market participants and to impose additional registration requirements so that pool operators currently relying upon such exemptions cannot engage in regulatory arbitrage and avoid oversight by either the CFTC or the SEC.

## ***Potential Alternative Exemptions***

- CFTC Rule 4.7 is not an exemption from registration, but provides relief from certain recordkeeping / reporting and disclosure requirements for CPOs of pools limited to qualified eligible persons (“QEPs”) and CTAs whose clients are QEPs.
- Note: New Section 4m(3) under the CEA provides a statutory exemption for SEC-registered advisers whose business does not consist “primarily” of acting as a CTA and who do not act as a CTA to any commodity pool that engages “primarily” in trading commodity interests. Exemption covers only CTA registration, however; CPO registration remains potential issue for advisers to pools.

**Note that these CFTC proposals were not mandated by the Dodd-Frank Act.**

# New Exemptions from Advisers Act Registration

(cont.)

## ***Dodd-Frank: Venture Capital Fund Advisers***

- The Dodd-Frank Act directed the SEC to provide an exemption from registration for any investment adviser who ***solely*** acts as an adviser to one or more venture capital funds.

## ***SEC: Definition of Venture Capital Fund***

- A private fund that holds no more than 20% of the amount of the fund's aggregate capital commitments in "non-qualifying investments" (other than short-term holdings);
- Does not borrow, issue debt obligations, provide guarantees or otherwise incur leverage in excess of 15% of the fund's contributed capital and uncalled capital commitments and any such borrowing is for a non-renewable term of no longer than 120 calendar days (except for any guarantee of "qualifying portfolio company" (QPC) obligations by the fund, which is not subject to the 120-day term limit);
- Generally does not offer investors redemption rights except in exceptional circumstances; and
- Represents itself to investors as pursuing a venture capital strategy.

# New Exemptions from Advisers Act Registration

(cont.)

## **SEC: Definition of Venture Capital Fund** (cont.)

- “Qualifying Investments”
  - “Equity securities” issued by a QPC directly acquired by the VC fund (“directly acquired equity”).
    - Equity securities include common stock, preferred stock, warrants and other securities convertible into equity.
  - Equity securities issued by a QPC in exchange for directly acquired equity issued by the same QPC.
  - Equity securities issued by a company of which a QPC is a majority-owned subsidiary (or a predecessor) and that are acquired by the fund in exchange for directly acquired equity.
- “Qualifying Portfolio Company” (QPC)
  - Is not a reporting or foreign traded company (and does not have a control relationship with a reporting or foreign traded company) at the time of investment;
  - Does not incur leverage in connection with investment by the VC fund and distribute the proceeds of any such borrowing to the VC fund in exchange for the VC fund investment; and
  - Is not a fund (i.e., is an operating company).
- Grandfathering Provision for any private fund that sold securities to one or more investors prior to December 31, 2010 and represented to investors that it pursues a venture capital strategy.

# New SEC Registration Criteria

## ***Increased AUM Threshold for SEC Registration***

- Previously, advisers having less than \$25 million assets under management (“AUM”) were prohibited from SEC registration.
- Effective July 21, 2011, the minimum AUM for SEC registration for most U.S. investment advisers (that do not manage registered investment companies) is:
  - \$100 million in general; but
  - \$25 million for advisers that would either (i) not be subject to registration and examination in the state in which they maintain their respective principal offices and places of business or (ii) otherwise be required to register with 15 or more states.
- AUM calculated in the same manner as for Form ADV reporting purposes.
- “Mid-sized advisers” (*i.e.*, those that have between \$25 million and \$100 million of AUM) having their principal office and place of business in New York or Wyoming must continue to register with the SEC; such states treated as states where state-registered mid-sized advisers would not be subject to examination.

# New SEC Registration Criteria *(cont.)*

- \$10 Million Registration Buffer:
  - Advisers with greater than \$100 million in assets under management but less than \$110 million are permitted, but not required, to register with the SEC.
  - Advisers that are registered with the SEC and have at least \$90 million in assets under management need not withdraw their SEC registrations.
- Transition Period:
  - If an adviser is no longer eligible for SEC registration at the end of its fiscal year, it must withdraw SEC registration within 180 days of its fiscal year end.
- Compliance Dates:
  - Every SEC-registered adviser must file a one-time Form ADV amendment by March 30, 2012 to report its eligibility for SEC registration.
  - An SEC-registered mid-sized adviser that does not meet the new eligibility criteria rules for registration with the SEC must withdraw its SEC registration and become registered in one or more states no later than June 28, 2012.

# New Reporting and Recordkeeping Requirements

## ***New Reporting Requirements for Managers***

- The Dodd-Frank Act requires the SEC to issue rules requiring registered investment advisers (and certain “Exempt Reporting Advisers”) to private funds to file reports containing certain information as the SEC deems necessary.

## ***Two Types of New Dodd-Frank Reporting Requirements***

- Revised reporting requirements on Form ADV
- Proposed reporting requirements on new Form PF



# New Reporting and Recordkeeping Requirements

(cont.)

## ***Revised Form ADV Reporting Requirements***

- Applicable to all registered investment advisers that file Form ADV
- “Exempt Reporting Advisers” are be required to complete only a subset of the information required for registered investment advisers on Form ADV.
  - 7 Items under Part 1A, and corresponding schedules
  - Includes new private fund reporting obligations

# New Reporting and Recordkeeping Requirements

(cont.)

## ***Form ADV Reporting Requirements (all registered advisers)***

- Additional disclosures about the adviser and its advisory business:
  - Information about the adviser's clients and employees
  - Business practices that may present conflicts of interest (e.g., use of affiliated brokers, soft dollar arrangement, payments for client referrals)
  - Information about the adviser's related persons and certain non-advisory financial activities
- New disclosures about private funds
  - Substantial reporting requirements about private funds
    - Census data, approximate number of beneficial owners, investment strategy, gross asset value, etc.
  - Reporting of private fund service providers
    - Auditors, prime brokers, custodians, administrators and marketers
  - Fair value reporting of private fund assets (including illiquid securities)

# New Reporting and Recordkeeping Requirements

(cont.)

## ***Exempt Reporting Advisers –Reporting Requirements***

- Must complete 7 items on Part 1A of Form ADV and corresponding schedules
  - Item 1 – Identifying Information
  - Item 2.B – SEC Reporting by Exempt Reporting Advisers
  - Item 3 – Form of Organization
  - Item 6 – Other Business Activities
  - Item 7 – Financial Industry Affiliations and Private Fund Reporting
  - Item 10 – Control Persons (including disclosure of the owners of the adviser); and
  - Item 11 – Disclosure Information (including the disciplinary history for the adviser and its employees).
- Not required to complete remaining items of Part 1A or prepare a brochure (Part 2)
- **Timing:** An Exempt Reporting Adviser must file its initial report on Form ADV by March 30, 2012.

# New Reporting and Recordkeeping Requirements

(cont.)

## ***Form PF Reporting (registered advisers that advise 3(c)(1) or 3(c)(7) funds)***

- Joint rule proposed by the SEC and CFTC in January 2011
- Required to be filed by registered investment advisers that advise one or more “private funds” (i.e., 3(c)(1) and 3(c)(7) funds)
  - “Exempt Reporting Advisers” do not have to complete Form PF
- Reporting requirements about adviser’s various private funds
  - Hedge Funds
  - “Liquidity Funds” (i.e., unregistered money market funds)
  - Private Equity Funds
- Advisers with >\$1B AUM for any of the above private funds:
  - Subject to greater reporting frequency (quarterly vs. annually)
  - Subject to more onerous reporting requirements (completing multiple sections of Form PF)
- Initially proposed compliance date was December 15, 2011 (with reporting to begin in 1Q 2012). However, compliance date expected to be pushed back as the SEC has indicated that final rules may not be adopted until August - December 2011.

# Presenters' Contact Information

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