

Private Equity Newsletter

Impact of the Dodd-Frank Act on Private Equity Funds, Hedge Funds and Their Investment Advisers

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the “**Dodd-Frank Act**”), enacted after a long and intensive legislative process, will impact private funds and their advisers both directly and indirectly.

For example, the Dodd-Frank Act includes new registration and reporting requirements for investment advisers of private funds as well as changes to the definition of “accredited investor” and “qualified client.” The “Volcker Rule” will, subject to a transition period and certain exceptions, restrict the ability of banks and their affiliates to invest in and sponsor private funds, to engage in proprietary trading and to engage in prime brokerage and other transactions with sponsored or advised funds. In addition, the new systemic risk regime could be comparatively more burdensome on asset manager subsidiaries of the largest and most complex bank holding companies, as the Federal Reserve is required to calibrate the standards to increase in stringency based on the size and scope of the company’s operations. These revisions may create opportunities for M&A and for financial innovation.

If a private fund qualifies as a “systemically important nonbank entity,” it will also be subject to significant new regulations, including certain restrictions under the Volcker Rule. More indirectly, new capital and securitization requirements may cause less capital to be available to finance buyouts. Finally, corporate governance and compensation-related provisions will affect investment advisers, funds and their public portfolio companies.

While the Dodd-Frank Act represents a significant change to the way the financial sector is regulated, its passage is only the first step. The bulk of the regulatory implementation will take place over the next six to eighteen months, so the real impact of the Dodd-Frank Act will not be known for some time.

Investment Adviser Registration Requirements

The most notable change for investment advisers in the Dodd-Frank Act is the elimination of the “private investment adviser” exemption for investment advisers. Under Section 203(b)(3) of the Investment Advisers Act of 1940 (the “**Advisers Act**”), an investment adviser is exempt from registration under the Advisers Act if it has fewer than 15 clients, does not hold itself out to the public as an investment adviser and does not serve as an investment adviser to a registered investment company or business development company. Many fund managers rely on this exemption to avoid having to comply with the numerous requirements associated with registration, including increased fiduciary burdens, the adoption of compliance policies, required records maintenance, periodic examination by the SEC and restrictions relating to fees and custody of assets.

Beginning on July 21, 2011, investment advisers that currently rely on the private investment adviser exemption will be required to register with the SEC unless an alternative registration exemption applies. Any investment adviser may elect to comply early, subject to the rules of the SEC.

The Dodd-Frank Act does provide a number of new exemptions from registration for investment advisers, including the following:

Foreign Private Adviser Exemption. The Dodd-Frank Act includes a narrow registration exemption for any “foreign private adviser,” which is defined as any investment adviser who: (1) has no place of business in the United States; (2) has, in total, fewer than 15 clients and investors in the U.S. in private funds advised by the adviser; (3) has aggregate assets under management attributable to clients in the United States

and investors in the United States in private funds advised by the adviser of less than \$25 million (or a higher amount that the SEC may, by rule, deem appropriate); and (4) does not hold itself out generally to the U.S. public as an investment adviser, act as an investment adviser to any registered investment company under the Investment Company Act of 1940 (the “**Investment Company Act**”) or act as a business development company under Section 54 of the Investment Company Act.

Certain Private Fund and Mid-sized Private Fund Advisers Exemptions. The Dodd-Frank Act directs the SEC to create a specific exemption from registration for investment advisers who advise “private funds” only and who have assets of less than \$150 million under management in the United States. Under the Dodd-Frank Act, a “private fund” is defined as a fund that would be an investment company but for Section 3(c)(1) or 3(c)(7) of the Investment Company Act. The Dodd-Frank Act further requires the SEC to establish exemptions for investment advisers of “mid-sized private funds,” although this term is not defined. The SEC is required to take into account the size, governance and investment strategy of these funds when creating these exemptions for advisers to mid-sized funds and to establish registration and examination procedures that reflect the level of systemic risk posed by such funds.

Advisers to Venture Capital Funds. The Dodd-Frank Act directs the SEC to provide an exemption from registration for investment advisers who solely act as advisers to one or more venture capital funds. The Dodd-Frank Act gives the SEC until July 21, 2011 to issue final rules defining the term “venture capital fund” for purposes of this exemption.

Advisers to Family Offices. Family offices are exempt from registration because they are excluded from the definition of investment adviser under the Dodd-Frank Act, but the SEC will have to promulgate rules to define “family office” in line with current positions taken by the SEC in no-action letters.

New Recordkeeping and Reporting Requirements for Private Funds

The Dodd-Frank Act also imposes new recordkeeping and reporting requirements on investment advisers with respect to the private funds they manage, and subjects investment advisers to enhanced SEC scrutiny and audit requirements, which will increase the burden and costs for private funds that do not currently prepare and maintain this information. These new requirements will become effective one year after enactment, on July 21, 2011.

Under the Dodd-Frank Act, an adviser to private funds will be required to *maintain* (but not necessarily file) records and reports for each private fund that it advises, including (1) the amount of assets under management, (2) the use of leverage (including off-balance-sheet leverage), (3) counterparty credit risk exposure, (4) trading and investment positions, (5) valuation policies and practices of the fund, (6) types of assets held, (7) side arrangements or side letters, (8) trading practices and (9) other information deemed by the SEC, in consultation with the Financial Stability Oversight Council (the “**Council**”), to be necessary and appropriate in the public interest and for the protection of investors or for the assessment of systemic risk.

The SEC is required under the Dodd-Frank Act to issue rules requiring each investment adviser to a private fund to *file* reports containing this information as the SEC deems necessary and appropriate.

Under the Dodd-Frank Act, the SEC must share with the Council copies of reports and other information provided to it so that the Council may assess the systemic risk posed by private funds. The Dodd-Frank Act would also allow an exception to Section 210(c) of the Advisers Act (which currently prohibits the SEC from requiring an investment adviser to disclose the identity, investments or affairs of its clients) if the disclosure of fund-specific information is required “for purposes of assessment of potential systemic risk.”

In addition, all records of private funds maintained by a registered investment adviser, not limited to those required to be maintained by law, are subject to periodic and special examination by the SEC.

To address confidentiality concerns, the Dodd-Frank Act expressly carves out from the Freedom of Information Act the disclosure of information regarding private funds provided to the SEC and to the

Council pursuant to the Dodd-Frank Act. Further, “proprietary information” provided to the SEC by investment advisers will be, at least to some extent, subject to enhanced confidentiality measures.

Minimum Assets for Investment Adviser Registration with the SEC

The Dodd-Frank Act reallocates the regulatory burden of monitoring many smaller advisers to the states, which should allow the SEC to focus its examination resources on larger investment advisers. Effective July 21, 2011, only those U.S. investment advisers that manage at least \$100 million in assets (a threshold that may be increased by the SEC) will generally be required to register with the SEC. Investment advisers with assets under management under \$100 million that are currently registered with the SEC will generally be forced to withdraw their SEC registrations and instead register with their home states (and potentially other states in which they have clients) as required by state law.

However, an investment adviser will be required to register with the SEC if it manages more than \$25 million in assets but is not subject to registration and examination in its home state or required to register in 15 or more states. An investment adviser that does not manage more than \$25 million in assets will not be required to register with the SEC or its home state under the Dodd-Frank Act but may separately be required to register under applicable state laws.

For advisers with less than \$100 million in assets under management that are forced to withdraw their SEC registration, state registration could prove more costly or administratively burdensome than registering with the SEC. These costs, along with the costs associated with the new recordkeeping and reporting obligations of investment advisers to private funds, could become significant and may be passed on to investors in private funds. On the other hand, those advisers that have already registered with the SEC may benefit as their competitors are forced to play on a more level playing field.

Changes to the Definition of “Accredited Investor” and “Qualified Client”

Private funds and their investors often rely on Regulation D of the Securities Act of 1933 to buy and sell securities in private placements. Under Rule 506 of Regulation D, funds can issue their securities to “accredited investors” in certain circumstances under the rationale that such investors have the financial sophistication and expertise to understand the risks of such an investment. To qualify as an “accredited investor,” an individual investor’s net worth must exceed \$1 million (including the value of a primary residence prior to the Dodd-Frank Act) or the individual’s income must exceed \$200,000 (or joint income of \$300,000) for the past two years and he or she must expect to meet those thresholds in the current year.

Effective immediately, the Dodd-Frank Act tightens the definition of “accredited investor” by expressly excluding the value of the investor’s primary residence from the \$1 million net worth calculation. Pursuant to recent SEC guidance, any indebtedness secured by the individual’s primary residence may also be excluded from the net worth calculation, up to the home’s fair market value. However, if the indebtedness exceeds the value of the home, the excess is considered a liability and must be deducted from the person’s net worth. The Dodd-Frank Act authorizes the SEC one year after the date of enactment to review and adjust the definition of “accredited investor” for individuals. In addition, the Dodd-Frank Act directs the SEC to review and adjust the definition of “accredited investor” for individuals four years after the date of enactment and every four years thereafter.

In addition, provisions in the Dodd-Frank Act that require adjustments to the definition of “qualified client” under the Advisers Act could affect when a private fund will be permitted to charge certain clients performance fees. Currently, Rule 205-3 under the Advisers Act permits certain funds, including 3(c)(1) private funds, to assess certain carried interest or performance fees on “qualified clients.” Under Rule 205-3, a “qualified client” is generally one that has at least \$750,000 of assets under management or a net worth of \$1.5 million. The Dodd-Frank Act requires the SEC to adjust for inflation these dollar-amount tests by July 21, 2011 and every five years thereafter.

The revisions to the qualified client standard will likely shrink the pool of investors for funds that qualify as 3(c)(1) funds under the Investment Company Act but not for 3(c)(7) funds because investors in 3(c)(7) funds must already meet the higher “qualified purchaser” standard, which generally means that the individual or company must have over \$5 million in investments.

Volcker Rule

Subject to certain exceptions and transition periods, the Volcker Rule prohibits any “banking entity” from engaging in proprietary trading or sponsoring or investing in a hedge fund or private equity fund.¹ In addition, although nonbank financial companies are not subject to these bans, the Volcker Rule requires regulators to impose on nonbanks that qualify as “systemically important nonbank financial companies” and engage in these activities additional capital and quantitative limits on these activities.

For a description of the ban on proprietary trading and a more comprehensive discussion of the Volcker Rule in general, please refer to the [Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Enacted into Law on July 21, 2010](#).

Effective Date. The Volcker Rule does not become effective until two years from now, on July 21, 2012, unless final rules are issued earlier than July 21, 2011, in which case the Volcker Rule would become effective one year after the final rules are issued.² Following the effective date is a two-year transition period, subject to the possibility of three one-year extensions, during which time existing fund activities and investments must be conformed. Investments in certain “illiquid funds” may be eligible for an additional extension of up to five years, but only “to the extent necessary to fulfill a contractual obligation that was in effect on May 1, 2010.” Note that regulators must issue rules for the transition periods by January 21, 2011, well before the deadline for issuing the other implementing rules. For a detailed flowchart of the implementation schedule, see Slide 8 of the [Davis Polk Regulatory Implementation Slides](#).

Limitations on Sponsoring or Investing in Funds. The Volcker Rule prohibits a banking entity from acquiring or retaining any equity, partnership or other ownership interest in, or sponsoring, any hedge fund or private equity fund unless the requirements described below are met. This means that upon effectiveness of the rule, subject to the transition period for existing funds, a banking entity generally may not “sponsor” a private equity or hedge fund, defined as:

- serving as a general partner, managing member or trustee of a fund;
- selecting or controlling a majority of the directors, trustees or management of a fund;
- having employees, officers, directors or agents who constitute a majority of the directors, trustees or management of a fund; or
- sharing a name or variant of a name with a fund for corporate, marketing or promotional purposes.

However, notwithstanding this prohibition (subject to certain limitations, and any additional restrictions that the regulators may impose), a banking entity may sponsor and invest in a private equity or hedge fund, if all of the following requirements are met:

- the banking entity provides bona fide trust, fiduciary or investment advisory services;

¹ “Banking entity” is defined as any insured bank or thrift, company that controls an insured bank or thrift, company that is treated as a bank holding company under the International Banking Act and any affiliate or subsidiary of such an entity.

² Specifically, the Volcker Rule becomes effective on the earlier of (i) 12 months after the issuance of final rules, which must be issued within 15 months after enactment, and (ii) two years after enactment.

- the fund is offered only in connection with the provision of these services, and only to persons who are customers of these services of the banking entity;
- the banking entity and its affiliates do not engage in covered transactions as defined in Section 23A of the Federal Reserve Act and comply with Section 23B (as further described below) as if the banking entity were a member bank and the fund were its affiliate;
- the banking entity does not guarantee the obligations or performance of the fund or any fund in which the fund invests (commonly known as the “anti-bailout provision”);
- the banking entity does not share with the fund the same name or variant thereof for corporate, marketing, promotional or other purposes;
- no director or employee of the banking entity takes or retains an ownership interest in the fund unless that person is “directly engaged in providing investment advisory or other services” to the fund;
- certain disclosure is made to investors in the fund that losses in the fund would be borne solely by investors in the fund; and
- the banking entity does not acquire or retain an ownership interest in the fund other than in the form of a seed investment or other de minimis investment, as described below.

The Volcker Rule prohibits activities that involve or could result in a conflict of interest or exposure to excessive risk. Any otherwise permitted activity, including sponsoring and investing in a private equity or hedge fund, is prohibited if the activity would result in a “material” conflict of interest between the banking entity and its clients, customers or counterparties. Moreover, any transaction that would result in a “material” exposure to “high-risk assets or high-risk trading strategies” or that would pose a threat to the safety and soundness of the banking entity or U.S. financial stability is also prohibited. Regulators are required to implement regulations expressly limiting activities in this manner.

What Does This Mean?

The full scope of the changes necessary to conform to the Volcker Rule will not be known until the implementing regulations have been issued (by October 21, 2011). However, it is apparent that the Volcker Rule will have significant impact on those financial institutions and other banking entities that currently sponsor private equity funds or hedge funds.

A banking entity may have an ownership interest in a fund only if it sponsors or organizes and offers the fund in compliance with the conditions described above and its ownership interest constitutes no more than a seed investment or other de minimis investment in the fund. To comply with this exception, the banking entity must actively take steps to seek unaffiliated investors to reduce or dilute its investment so that within one year of the fund’s inception the bank does not own more than 3% of the fund (with the possibility of a two-year extension). Thereafter, its ownership interest must be maintained at no more than 3%. The investment must also be “immaterial” to the banking entity, as defined by regulators pursuant to rulemaking, and the aggregate of a banking entity’s investments in hedge funds or private equity funds may not exceed 3% of the banking entity’s Tier 1 capital.

Certain transactions between the banking entity and any fund it sponsors, manages or advises will be strictly prohibited. The banking entity (and any of its affiliates) may not enter into any “covered transaction” (such as loans, asset purchases or sales of securities) as defined by Section 23A of the Federal Reserve Act³ with the fund (or with any hedge fund or private fund controlled by such fund). In

³ Under current law, a “covered transaction” includes (1) any loan or extension of credit; (2) any purchase of, or investment in, securities; (3) any purchases of assets, including assets subject to an agreement to repurchase from an affiliate, unless specifically (cont.)

addition, a banking entity that serves as a hedge fund or private equity fund's investment manager, adviser or sponsor will be subject to the requirement in Section 23B of the Federal Reserve Act that transactions between the banking entity and the fund be on arm's-length terms.

The Federal Reserve may grant to any banking entity an exemption from the prohibition on Section 23A covered transactions for purposes of entering into any prime brokerage transactions with a hedge fund or private equity fund if it determines that the transaction is consistent with the safe and sound operation and condition of the banking entity. The Federal Reserve must also be satisfied that:

- the banking entity is in compliance with each of the conditions set forth above with regard to permitted activities for sponsoring hedge funds or private equity funds; and
- the CEO or equivalent officer has certified in writing on an annual basis that the banking entity does not guarantee the obligations or performance of the fund or any fund in which the fund invests.

The Volcker Rule's ban on proprietary trading and significant limitations on sponsoring or investing in private funds could result in financial institutions restructuring their private equity businesses or spinning out existing groups. (Citigroup's recently announced sale of certain of its private equity business units is an example.) This may provide an opportunity for private equity sponsors to hire talented personnel or increase market share. Leverage may become less readily available to bank-affiliated private equity funds, or more expensive, because of increased risk weightings by financial institutions for loans to bank-sponsored funds.

Banking entities that are not directly or indirectly controlled by a U.S.-organized banking entity are excluded from the ban on sponsoring and investing in hedge funds and private equity funds, so long as they conduct these activities solely outside of the U.S. and do not offer or sell any interest in such funds to U.S. residents.

Systemic Risk Regime

Broadly speaking, the Dodd-Frank Act attempts to address systemic risk through stricter prudential standards at firms identified as "systemically important," and by greater oversight of the financial system as a whole. Large bank holding companies, those with \$50 billion or more in assets, are automatically deemed systemically important, and the identification of nonbanks as systemically important by the Council will begin in the coming months. The Federal Reserve is not required to issue regulations implementing the heightened prudential standards until January 2012, and it is uncertain how the systemic risk regime will apply to systemically important companies before regulations are issued.

Private equity funds that are affiliated with banks may become indirectly subject to the systemic risk regime as an affiliate of a bank holding company. Unaffiliated private equity funds would be subject to the systemic risk regime only if designated as systemically important, which we expect to be rare in the private equity sector.⁴

We do not believe that private equity funds are first-strike targets of the systemic risk regime. In addition, the Dodd-Frank Act's safe harbor provisions, which direct the Federal Reserve to set forth criteria to

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exempted by the Federal Reserve, which is not a broad exclusion; (4) any transaction in which the covered bank holding company accepts securities issued by an affiliate as collateral for a loan or extension of credit to any entity; and (5) the issuance of a guarantee, acceptance or letter of credit including an endorsement or standby letter of credit, on behalf of an affiliate. The Dodd-Frank Act expands the scope of "covered transactions" to include credit exposure on derivatives transactions, credit exposure resulting from securities borrowing and lending transactions and acceptance of affiliate-issued debt obligations as collateral for a loan or extension of credit.

⁴ See Testimony by Chairman Bernanke, House Financial Services Committee Hearing, Oct. 1, 2009.

exempt certain types of nonbank financial companies from the systemic risk regime, may in the future provide an avenue to exclude investment managers and funds. In determining whether to designate a private equity fund or investment adviser as systemically important, the Council is required to consider factors including the extent to which assets are managed rather than owned by the entity, and the extent to which ownership of assets under management is diffuse.

If a fund or its investment adviser is subject to the systemic risk regime, the fund or adviser will be subject to heightened standards, which will be set through regulation by the Federal Reserve. This heightened regulation must include enhanced risk-based capital, leverage and liquidity requirements, overall risk-management requirements, resolution plans, credit exposure reporting, concentration limits and early remediation requirements. In addition, the Federal Reserve may establish additional prudential standards, including contingent capital requirements, enhanced public disclosure requirements, and short-term debt limits, among others, that it, on its own or pursuant to Council recommendations, deems appropriate.

The competitive effects of the Dodd-Frank Act on the private equity market will become evident through the regulatory implementation stage, as regulators attempt to implement Congress's intent while ameliorating unintended consequences and addressing shifts in market participants' behavior.

Corporate Governance and Executive Compensation Provisions

The Dodd-Frank Act also includes a number of corporate governance and executive compensation provisions that will affect financial institutions, investment advisers and private funds as well as the public portfolio companies of private funds. For a comprehensive summary of these provisions, see the Davis Polk Memorandum [Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Enacted into Law on July 21, 2010](#). Two of the corporate governance provisions that will have the most profound effect on private equity and hedge funds and their advisers include:

Executive Compensation. The Dodd-Frank Act requires federal regulators, including the SEC, within nine months of enactment (by April 21, 2011), to jointly prescribe regulations to:

- require covered financial institutions, which is defined to include investment advisers, to report the structures of all incentive-based compensation arrangements; and
- prohibit covered financial institutions from providing incentive-based payment arrangements that are determined to encourage inappropriate risk-taking by providing compensation that is excessive or that could lead to material financial loss to the covered financial institution.

Covered financial institutions with assets of less than \$1 billion are excluded. In determining the standards for compensation, the Dodd-Frank Act requires regulators to take into consideration the value of cash, equity and other noncash benefits provided to an individual and the financial condition of the institution.

Proxy Access. On August 25, 2010, the SEC adopted "proxy access" rules that, under certain circumstances, will require a U.S. public company to include shareholder nominees for election as directors in its proxy materials. These rules will apply to public portfolio companies and to registered investment companies. For a discussion of the new rules and their impact, please see the Davis Polk Client Memorandum [Summary of Proxy Access Rules](#) and General Counsel Update [Proxy Access Year One: What to Expect and What to Do Now](#).

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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