Memorandum

To: Private Equity Clients and Friends

From: Mark A. Egert

Date: February 28, 2011

Re: **Changes in Regulation of Private Equity Funds**

A. OVERVIEW

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). The Dodd-Frank Act will, depending upon regulations to be issued by the Securities and Exchange Commission (the "SEC"), impose significant new registration and compliance burdens on managers of private equity funds, hedge funds, fund of funds and, to a lesser extent, venture capital funds. This memorandum discusses some of the major provisions introduced by the Dodd-Frank Act and the rules proposed by the SEC.

In particular, this memorandum outlines: (i) the requirements for investment adviser registration and the exemptions from such registration (Section B); (ii) the basic requirements for registered investment advisers (Section C); the private fund rules recently proposed by the SEC as required by the Dodd-Frank Act (Section D); and other provisions in the Dodd-Frank Act likely to impact private funds (Section E).

B. INVESTMENT ADVISER ACT REGISTRATION AND EXEMPTIONS

1. In General

Under the Investment Advisers Act of 1940 (the "Advisers Act"), investment advisers are required to register with the SEC and are subject to various regulatory and record keeping requirements unless they qualify for an exemption. The term "investment adviser" is broadly defined to include any person who, for compensation, engages in the business of advising others as to value of or the advisability of investing in securities or issues analyses or reports concerning securities.

2. Prior Exemption

Managers of private funds typically are considered to be investment advisers. Prior to the Dodd-Frank Act, many private equity fund managers avoided registration by relying on the "private investment adviser" exemption, which exempted firms that (i) had fewer than 15 clients over the course of the preceding 12 months and (ii) neither had held themselves out generally to the public as an investment adviser nor acted as an investment adviser to any investment company registered under the Investment Company Act of 1940 (the “Company Act”). Title IV of the Dodd-Frank Act, known as the "Private Fund Investment Advisers Registration Act of 2010" (the "Private Fund Act"), has replaced the private investment adviser exemption with new, more narrow exemptions.

3. New Exemptions

The most notable exemption to registration in the Private Fund Act exempts private fund managers with less than $150 million under management, but those with less than $100 million under management may be subject to state registration or examination. Foreign fund managers with no U.S. place of business that have fewer than 15 U.S. investors and less than $25 million under management attributable to U.S. investors are also exempt. Also, certain family offices and private fund managers that provide advice solely to one or more "venture capital funds" are exempt from registration. These exemptions are explained in Section D below.

4. Registration

If a firm is not exempt, registration will be required beginning July 21, 2011. These firms will also be subject to periodic, on-site SEC inspections which are sometimes unannounced. See Section C below for the requirements that apply to registered advisers.

5. Recordkeeping and Reporting

Whether or not a firm is exempt from registration, all investment advisers will be required to maintain certain specified records and comply with reporting requirements to be established by the SEC. In the case of registered firms, information required to be maintained and subject to inspection will include the amount and types of assets under management and the use of leverage (including off-balance-sheet leverage), trading and investment policies, valuation policies and practices, side letters with investors and other information determined by the SEC to be necessary and appropriate for the protection of investors or for the assessment of systemic risk. Information required to be maintained and reported by managers that are exempt from registration will be determined by the SEC as necessary or appropriate in the public interest or for the protection of investors. See Section D.7 below for additional details.

C. BASIC REQUIREMENTS OF REGISTERED INVESTMENT ADVISERS

If a private fund is required to register, it will need to comply with the following requirements.

1. Registration on Form ADV — To register, advisers must complete Form ADV, which requires substantial disclosures to the SEC and to the adviser's clients. Form ADV must be updated at least annually and, with respect to certain key information, at the time of certain changes in the reported information.

2. Disclosures to Adviser's Clients — Part 2 of Form ADV, or the "brochure," calls for a substantial narrative description of the adviser's business, products, management, material adverse financial or disciplinary matters, conflicts of interest and policies designed to address conflicts of interest. Advisers are required to deliver their brochure to advisory clients annually. The brochure is often used as a means of conveying other required disclosures, such as privacy policies.

3. Adoption of a Comprehensive Compliance Program — Registered advisers must adopt written policies and procedures designed to prevent violation of the Act and its rules. Such written policies must be reviewed at least annually for adequacy and effective implementation, and a chief compliance officer must be appointed to oversee the administration of the program.

4. Adoption of an Anti-Insider Trading Policy — A policy must be designed to ensure that material, non-public information is not misused in violation of the Act or the Securities Exchange Act of 1934 (the "Exchange Act"), and may entail (i) circulating a written policy to all employees, (ii) employee training programs, (iii) creating physical and organizational information barriers, (iv) maintaining restricted lists and watch lists, and (v) maintaining a procedure for monitoring client and personal trades.

5. Adoption of Code of Ethics and Personal Trading Policy for Access Persons — Access persons must report their personal securities holdings and transactions. Some access persons must also obtain pre-clearance before participating in, and may be barred from investing in, initial public offerings and limited offerings

6. Subject to SEC Examination Authority — The SEC conducts periodic examinations of registered advisers. It is important to stay abreast of "hot topics" and periodic SEC staff statements about the focus of the SEC's examination program.

7. Substantial Recordkeeping Obligations — The Exchange Act imposes requirements with respect to adviser records substantiating the basis of performance claims and other records reflecting the relationship between the adviser and its clients. New legislation would add to these records for each private fund under management. A list of these records is set forth in Section D below.

8. Compliance with Anti-Fraud Laws — The Exchange Act generally prohibits an investment adviser from employing any "device, scheme or artifice" to defraud clients or engaging in a "transaction, practice or course of business" that operates as a "fraud or deceit" on clients. The Exchange Act's anti-fraud provisions also prohibit certain

securities transactions absent disclosure to clients, as well as any "act, practice or course of business which is fraudulent, deceptive or manipulative." Rules under the Exchange Act extend these protections to investors in the adviser's private funds. In addition to the antifraud provisions of the Exchange Act, funds may also be subject to the anti-fraud and manipulation provisions of the other federal securities laws, such as section 17(a) of the Securities Act of 1933 and Rule 10b-5 under the Exchange Act.

9. Custody Rules — The Exchange Act imposes specific measures registered advisers must take to safeguard client assets over which the adviser has, or is deemed to have, custody. These steps include maintenance of client assets with a "qualified custodian" and submission to an annual surprise examination by an independent public accounting firm (or the issuance of annual audited financial statements by private funds advised by the adviser).

10. Processes — The Exchange Act requires that advisers have adequate processes for marketing, advertising and fund solicitation, political contributions, side letters, proxy-voting, oversight of service providers, valuation and pricing.

D. SEC PROPOSED RULES

1. In General

Congress delegated certain critical elements of the implementation of the Dodd-Frank Act to the SEC. During October and November 2010, the SEC proposed several key regulations called for by the Dodd-Frank Act (the "Proposed Regulations").

The Proposed Regulations affect all private funds which claim exemption from the Company Act under Section 3(c)(1) or 3(c)(7) of that statute. This includes practically all hedge, leveraged-buyout, venture-capital, real-estate, mezzanine-debt, and distressed-debt funds, as well as funds-of-funds. As they related specifically to private funds, the Proposed Regulations do three major things:

- First, they propose definitions and details regarding certain exemptions from registration with the SEC under the Advisers Act.
- Second, the Proposed Regulations would require every firm that serves as an investment adviser to any 3(c)(1) or 3(c)(7) fund to file with the SEC and update annually a Form ADV. This requirement would apply even to smaller advisory firms which will remain exempt from registration because their assets under management are below the Dodd-Frank Act's registration threshold.
- Third, the Proposed Regulations would impose new recordkeeping and reporting requirements on registered investment advisers.

2. Key Definitions and Details Included in the Proposed Regulations

Advisers whose only clients are private funds and whose assets under management (AUM) are less than $150 million will generally remain exempt from registration under the Advisers Act when the Dodd-Frank Act becomes effective in July 2011. (For advisers who have at least some non-fund clients, the applicable AUM threshold is $100 million.) Section D.3 below gives guidance on how AUM is to be measured for this purpose.

Advisers whose only clients are venture capital funds will remain exempt from registration, regardless of the amount of the AUM. Section D.4 below summarizes how the term “venture capital fund” is defined.

Advisers who qualify as “family offices” will also remain exempt from registration under the Advisers Act, regardless of the amount of AUM. Section D.5 below explains how the term “family office” is defined.

3. Exemption for Advisers to Private Funds with Cumulative AUM Less than $150 Million

The Advisers Act defines the term “assets under management” by reference to the “securities portfolios” with respect to which an investment adviser provides “continuous and regular supervisory or management services.” The Proposed Regulations provide guidance on the calculation of AUM for private funds, as follows:

- An adviser to a private fund must include the fund’s unfunded capital commitments in its AUM.
- An adviser to a private fund must include the value of proprietary assets, assets which the adviser manages on an uncompensated basis, and assets of foreign clients in its AUM.
- Advisers must use a fair-value methodology when measuring AUM and cannot simply rely on cost basis.

4. Exemption for Advisers to Venture Capital Funds

The Dodd-Frank Act exempts advisers solely to venture capital funds from registration under the Advisers Act. The Proposed Regulations define the term "venture capital fund" to include only private funds which satisfy all of the following criteria:

- The private fund invests only in equity securities of qualifying portfolio companies to provide them with business expansion and operating capital. At least 80% of the private fund's interest in the issuing company must be acquired directly from the company and not from the issuer's existing equity holders. An issuer can be a qualifying portfolio company if no more than 20% of the private fund's interest was acquired from founders or other preexisting investors.

- The private fund controls, or provides significant managerial services to, the qualifying portfolio companies.
- The private fund does not incur leverage at the private fund level, other than certain permitted short-term borrowings.
- The private fund is a closed-end fund, i.e., it does not offer routine redemption rights to investors.
- The private fund holds itself out as a venture capital fund to investors.

To be a "venture capital fund" a private fund may invest only in "qualifying portfolio companies." The Proposed Regulations define that term to include only an entity which satisfies all of the following criteria:

- is not publicly traded at the time of the venture capital fund's investment;
- does not incur leverage in connection with the investment by the venture capital fund;
- uses the capital provided by the venture capital fund for business expansion or operating purposes; and
- is not itself a fund.

5. Exemption for Family Offices

The Dodd-Frank Act exempts family offices from registration under the Advisers Act. The Proposed Regulations define "family office" as an adviser whose clients include only persons who are family members. A "family member" includes a spouse, a spousal equivalent, a subsequent spouse, a parent, a sibling, a child (including children by adoption and stepchildren), and a spouse or spousal equivalent of the foregoing.

In the event of an involuntary transfer from a family member, the Proposed Regulations would afford the adviser a four-month transition period in which to register under the Advisers Act or transfer the management of the assets. In case of a divorce, a former spouse could continue to receive advice for the assets already being managed by the family office, but could not make additional investments with such adviser.

The clients of a family office may include any charitable organization that is funded solely by a family member, and any trust or estate existing for the sole benefit of a family client, or any investment vehicle wholly-controlled by a family client and operated for the sole benefit of family clients. Clients may also include non-family members who are executive officers, directors, trustees or general partners of the adviser, or other persons who have participated in the investment activities of the family office for at least 12 months.

6. New Filing Requirements for Advisers Exempt from Registration

Under the Proposed Regulations, all investment advisers who are exempt from registration under the Advisers Act, but whose clients include any 3(c)(1) or 3(c)(7) private fund, would nevertheless be required to comply with certain limited reporting obligations. These exempt advisers would be required to file a limited Form ADV with the SEC and provide certain information about their activities to the SEC. The information required to be reported would include, among other things, the adviser's form of organization, a description of its other business activities, its financial industry affiliations, the identity of its control persons and owners, and any disciplinary history for the adviser and its employees.

The Proposed Regulations would require exempt advisers to file their first limited Form ADV by August 20, 2011, and to update their Form ADV filings annually. On January 25, 2011, the SEC proposed new Rule 204(b)-1 under the Advisers Act, which would require registered investment advisers to make periodic filings on new Form PF with the SEC. The proposed rule, along with a companion rule under the Commodity Exchange Act, has been jointly proposed by the SEC and the Commodity Futures Trading Commission to implement provisions of the Dodd-Frank Act.

Proposed Rule 204(b)-1 would require substantial new periodic disclosures by all affected investment advisers. The rule is designed to require more detailed information from larger advisers than from smaller advisers. The proposed differences are based on the SEC’s assessment of varying levels of systemic risk associated with the difference activities undertaken by these advisers. The rule would exempt from any Form PF requirements those investment advisers that are exempt from registration under the Advisers Act, including advisers to venture capital funds, advisers to private funds with less than $150 million in assets under management in the United States and advisers availing themselves of the “foreign private adviser” exemptiion. Form PF requirements would also not apply to those investment advisers whose funds rely solely on Section 3(c)(5)(C) for purposes of the Company Act. The SEC anticipates that the proposed rules would have an initial compliance date of December 15, 2011.

7. <u>Additional Reporting for Advisers to Private Funds</u>

The Proposed Regulations amend Form ADV for a registered adviser to a private fund (exempt advisers will also be required to provide certain of this information in its limited Form ADV) in order to require reporting of the following information:

- The amount of AUM.
- Information regarding its private funds, including: (1) names and jurisdictions of such funds (though a code can be used to preserve anonymity); (2) general partners and directors; (3) names and jurisdictions of any foreign financial regulatory authorities are subject; and (4) status as a master/feeder.
- Whether private fund is a fund of funds.
- The fund's investment strategy.
- The fund's gross and net asset value, minimum investment and number of beneficial owners.
- Whether clients of the adviser are solicited to in the fund, and the percentage of the adviser's clients invested in the fund.

- The number and types of investors in the fund.
- The name of the adviser's auditor, whether it is independent and registered with the PCAOB and whether audited financials are distributed to investors.
- The name of the adviser's prime broker and whether it is SEC-registered and acts as a fund's custodian.
- The name and role of the fund's administrator.
- The name of each marketer, whether it is a related person of the adviser, its SEC file number and URL for any website used to market the fund.
- Information regarding employees, including the number employees registered as representatives of a broker-dealer.
- Information regarding the adviser's clients, including disclosure as to whether any are business development companies, insurance companies or other investment advisers and whether any are subject to ERISA.
- Disclosure about participation in client transactions. The Proposed Regulations require advisers with discretionary authority to determine whether brokers or dealers used in client transactions would be required to report whether any such brokers or dealers are related persons.
- Information about the adviser's non-advisory activities.
- Advisers with $1 billion in AUM may be subject to future rules regarding certain incentive-based compensation arrangements.

E. OTHER DODD-FRANK PROVISIONS THAT IMPACT PRIVATE EQUITY FUNDS

1. <u>Volcker Rule</u>

Section 619 of the Dodd-Frank Act (the "Volcker Rule") amends the Bank Holding Company Act of 1956 to broadly prohibit banking entities from engaging in proprietary trading and private sponsorship of investment funds. As a general rule, the Volcker Rule would restrict covered banking entities from sponsoring or investing in a hedge fund, private equity fund or such similar funds as the regulators may, by rule, determine. The Volcker Rule broadly defines "hedge fund" and "private equity fund" as a company or other entity that is exempt from registration as an investment company pursuant to section 3(c)(1) or 3(c)(7) of the Company Act. While the Volcker Rule does not specifically mention bank investments in venture capital funds, for the purposes of the Volcker Rule, a venture capital fund will almost certainly be included in this definition.

Notwithstanding this general rule, the Volcker Rule will allow banking entities to make and retain an investment in a hedge fund or private equity fund so long as the banking entity's interest in the fund does not exceed more than 3% of the total ownership interests of the fund.

Additionally, a banking entity is permitted to sponsor a private equity or hedge fund so long as (i) its investment is made to provide the fund with sufficient initial equity and to attract unaffiliated investors and (ii) its investment represents not more than 3% of the total ownership interests of the fund within one year of the date on which the fund is established. In any event, a banking entity's aggregate investments in private equity funds and hedge funds may not exceed 3% of the Tier 1 capital of the banking entity. The Volcker Rule will become effective on the earlier of 12 months after the date on which final implementing regulations are issued or July 21, 2012.

2. <u>Accredited Investor Standard</u>

Private funds and other issuers raising capital in private offerings often rely on the Regulation D exemptions from registration under the Securities Act. Many Regulation D exemptions require that securities or fund interests be offered only to "accredited investors." The Dodd-Frank Act changes the definition of "accredited investor," effective immediately.

Prior to the Dodd-Frank Act, a natural person was an accredited investor if: (i) such person had an individual income in excess of $200,000 in each of the two most recent years or joint income with their spouse exceeding $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year; or (ii) such person's net worth, together with their spouse, exceeds $1 million at the time of purchase. For the purpose of determining net worth, individuals previously could include the value of their primary residence.

Under the Dodd-Frank Act, individuals may no longer include the value of their primary residence for the purpose of determining net worth under the accredited investor definition. The other provisions of the accredited investor definition remain unchanged.

3. <u>Recommendations</u>

All issuers relying on the "accredited investor" definition in connection with private offerings should immediately revise their subscription documents to reflect the modified net worth calculation.