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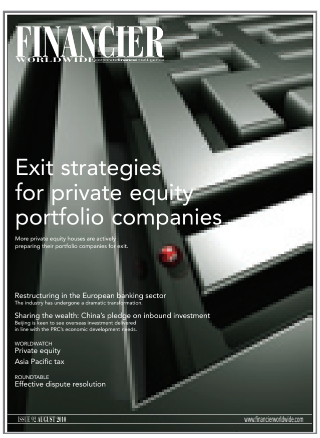

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US private equity industry assesses impact of financial industry reform legislation

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While the US private equity industry gains momentum and recovers from periods of inactivity, Congress passed, and the President is expected to sign, the 'Dodd-Frank Wall Street Reform and Consumer Protection Act' – comprehensive financial reform legislation intended to address the perceived causes of the financial industry-led economic downturn. Several aspects of the Act will impact the private equity industry. Fund managers will seek to adapt to the amendments to the Investment Advisers Act of 1940. Some fund managers will need to register with the SEC for the first time and others will experience changes in their compliance frameworks. Further, regulated financial institutions will attempt to navigate the 'Volcker Rule' components of the Act, which limit the ability of banks and their affiliates to sponsor, invest in or engage in certain transactions with private equity and other private investment funds.

Private Fund Investment Advisers Registration Act of 2010

The Act includes the 'Private Fund Investment Advisers Registration Act of 2010' (PFIARA), the most recent incarnation of a variety of similar bills considered by Congress in recent years designed to: (i) require more fund managers to register as investment advisers under the Advisers Act; and (ii) impose enhanced reporting and disclosure requirements applicable to all registered investment advisers. While these reforms were perhaps directed primarily at hedge fund managers, they also will impact private equity managers.

The PFIARA will be effective one year after enactment in July 2011 – but investment advisers may register before the effective date.

The PFIARA eliminates the 'private adviser' or '15 client' exemption from registration under the Advisers Act, the exemption commonly relied on by private equity fund managers sponsoring less than 15 investment vehicles. In its place, there are several new exemptions applicable to a variety of fund managers, including:

Small private fund managers. The PFIARA exempts from registration (but not recordkeeping and reporting) advisers that solely advise 'private funds' and have assets under management in the US of less than $150m. The term 'private fund' is defined to include any investment fund that relies on the exceptions from investment company status found in Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940.

Venture capital fund managers. The PFIARA exempts from registration (but not recordkeeping and reporting) advisers solely to one or more 'venture capital funds'.

Family offices. The PFIARA excludes 'family offices' from the definition of 'investment adviser', resulting in the exclusion of family offices from coverage by the Advisers Act, including its registration, record keeping and reporting requirements.

Foreign private advisers. The PFIARA adds a new narrow exemption from registration for 'foreign private advisers'. To qualify, the adviser must have no place of business in the United States and must have fewer than 15 US investors with aggregate assets under management of less than $25m attributable to such investors.

In addition, the PFIARA directs the SEC, in carrying out its rulemaking, to provide for registration and examination procedures for advisers to 'mid-sized private funds' that reflect the level of systemic risk those funds present, although such advisers are not exempt from the registration requirements generally.

Congress did not define the terms 'mid-sized private fund', 'venture capital fund' or 'family office', but directed the SEC to do so. As a result, it is not yet clear what advisers will be covered or how the recordkeeping, reporting and other regulations under the Advisers Act will differ for such advisers. Prior versions of the PFIARA included an additional exemption for 'private equity fund' managers, leaving to the SEC what constitutes a private equity fund. Such an exemption is noticeably absent from PFIARA.

As a result of these changes and subject to SEC rulemaking laying out the new exemptions, it appears that private equity managers with more than $150m in assets under management will need to register. Many of these firms, particularly the larger ones, have already registered for a variety of reasons, not the least of which is the sense that the LP community, particularly fiduciary investors, have a strong preference for investing with registered investment advisers. However, there are likely to be many middle-market fund managers and newer fund managers now needing to register as a result of PFIARA.

The PFIARA also directs the SEC to require registered investment advisers to private funds to maintain and file additional records and reports regarding the private funds they advise, including information relating to assets and investments under management, trading practices, use of leverage, counterparty credit risk exposures, valuations and side letters. We suspect these additional disclosures will assist the SEC in focusing attention (and possibly enforcement activities) on potential conflicts of interest, investor disclosures, valuation matters and other related topics on which the LP community increasingly has focused. As a result, even those fund managers that are already registered will need to run their businesses with a renewed focus on compliance.

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The Volcker Rule

The Act also includes provisions, known as the 'Volcker Rule', restricting certain regulated financial institutions from engaging in proprietary investment activities, requiring the new Financial Stability Oversight Council to conduct a study, and directing certain federal banking regulators and the SEC to issue regu lations implementing the Volcker Rule.

The Volcker Rule applies to banking entities, including insured banks or thrifts, companies that control insured banks or thrifts, companies that are treated as bank holding companies and their affiliates and subsidiaries. Since smaller banking entities generally have not focused on private equity as a business strategy, such banking entities generally will be less affected by the Volcker Rule.

The Volcker Rule imposes three general categories of restrictions on these entities. First, it prohibits these entities from acquiring or retaining any interest in or sponsoring a 'hedge fund' or 'private equity fund'. Second, it prohibits these entities from entering into a 'covered transaction' (including loans, purchases of assets or securities and guarantees) with a hedge fund or private equity fund. Third, these entities are prohibited from engaging in proprietary trading. The terms 'hedge fund' and 'private equity fund' are loosely defined to include many private investment funds.

The Volcker Rule permits certain de minimis investments in hedge funds and private equity funds that would otherwise be prohibited if those investments: (i) do not exceed 3 percent of the total ownership interests of any particular fund; and (ii) do not represent in aggregate more than 3 percent of the Tier 1 capital of the banking entity. This exception also permits organising, offering and serving as a general partner or managing member of the fund, provided the banking entity complies with a number of conditions. While this 3 percent exemption initially may appear helpful to the industry, it raises a number of questions. For example, what happens if a banking entity relying on this exemption experiences appreciation of fund investments or depreciation in other sectors resulting in an over-allocation to private funds? Presumably, these and other important questions will be addressed in the rulemaking process.

Compliance with the new prohibition on 'covered transactions' between a banking entity serving as investment adviser to a fund and the fund may be challenging. As a practical matter, 'covered transactions' include a number of related-party transactions between the fund and affiliated banking entities. Some banking entities will need to choose between providing debt financing and serving as sponsor to a fund group receiving an equity interest with potential for performance fee/carried interest returns.

Banking entities with captive fund management groups or fund portfolios will need to carefully assess their portfolios for compliance with the new Volcker Rule. As a consequence, we may see more activity in secondary sales of LP portfolios, spin-outs of alternative asset management operations and other divestitures of fund businesses by banking entities.

The Volcker Rule is effective on the earlier of: (i) 12 months after the date of issuance of the implementing rules; or (ii) two years after the date of enactment. After enactment, there is a two-year divestiture period. The Federal Reserve may provide up to three additional one-year extensions, provided the divesting party is using good faith to expedite its termination of ownership.

The Act could have real and lasting impacts on the private equity industry. It is clear that additional private equity fund managers will need to register with the SEC, but it is not clear the extent to which SEC rulemaking will exempt managers of certain funds or the extent to which enhanced fund disclosure and reporting will change GP behaviour and/or SEC priorities. Further, it appears alternative asset fund sponsorship and investment by banks will wane, while spin-outs and secondary portfolio sales will rise. However, whether continued meaningful bank participation in the industry is viable at all will depend on rulemaking by multiple federal agencies. Private equity participants will not sit idly by, but will engage, react and evolve as does their regulation. ■

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