What Financial Regulatory Reform Means to Private Funds

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On July 21, 2010, President Obama signed HR 4173, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"), which puts in place a substantial regulatory overhaul for business, especially in the financial industry. The Act includes various new laws affecting fund managers, the most notable of which is "hedge fund registration," whereby advisers to hedge funds, as well as private equity funds, real estate funds and venture capital funds, will be required to register with and/or report to the SEC. Hedge fund registration, or "private fund registration," will substantially enhance compliance costs for fund managers. While the Act generally affects larger funds, it contains a number of provisions that will be troubling for middle-sized and even smaller funds, as well as additional record-keeping requirements and reporting requirements for investment advisers to private funds. The Act also creates additional challenges and opportunities for private investment funds, including (i) limiting bank involvement in the private fund space, (ii) introducing new corporate governance reforms and (iii) regulating the trading of swaps.

Andrews Kurth has worked with clients in the past in these areas and is continuing to follow the developments affecting private funds. This e-alert summarizes the key components of private fund registration, as well as the other challenges that may be of interest to private funds.

Overview of New Registration/Regulation Requirements

The Act eliminates (i) the "private investment adviser" exemption under Section 203(b)(3) of the Investment Advisers Act of 1940, as amended (the "Advisers Act"), and (ii) the intrastate registration exemption for investment advisors with any private fund client, thereby requiring a number of advisers to private investment funds, including hedge funds, private equity funds and real estate funds[1], to register with the SEC as an investment adviser and be subject to heightened regulation and examination by the SEC.

The Act creates a sliding scale of regulation, with different types of funds with different asset levels subject to varying degrees of regulation, as follows:

- Advisers to hedge funds, private equity funds and real estate funds with assets under management ("AUM") equal to or in excess of $150 million will be required to register, although certain "mid-sized funds" would be subject to streamlined registration and reporting requirements.
- Advisers to hedge funds, private equity funds and real estate funds with AUM equal to or in excess of $100 million (and lower in certain states that do not require registration and examination) and less than $150 million will not be required to register, but will be required to maintain such records and make such reports to the SEC that the SEC determines necessary or appropriate in the public interest or for the protection of investors.
- Advisers to all private funds with AUM equal to or in excess of $30 million and less than $100 million that are not required to be registered with the state in which it resides will not be required to register but will be subject to certain reporting and books and records requirements.
- Advisers to venture capital funds will not be required to register, but will be required to maintain such records and make such reports to the SEC as the SEC determines necessary or appropriate in the public interest or for the protection of investors.

New Reporting and Examination Requirements

In addition to the rules applicable to investment advisers generally, each investment adviser to a private fund (including currently registered advisers) will be required to keep books and records in respect of each private fund detailing the following:

- assets under management;

- leverage;
- credit counterparty risks;
- trading positions;
- valuation policies and practices;
- assets held;
- side letters with investors; and
- trading positions.

The Act also requires advisers to private funds to make records for each private fund available for inspection by the SEC, and directs the SEC to conduct periodic examinations of all registered investment advisers to private funds.

The Advisers Act already creates compliance burdens for currently registered investment advisers, and newly registered advisers will need to bring their funds into compliance with these rules as well. Among other things, each manager will need to appoint a chief compliance officer, establish a compliance program and adopt a code of ethics. Each investment adviser will also need to comply with existing custody requirements.

Expanded State Supervision of Private Funds

The Act subjects private funds with less than $100 million AUM (as opposed to the current $25 million AUM standard) to state regulation in the states where advisers to private funds are required to be registered with the state and subject to examinations by the state. In some circumstances, certain voluntarily registered funds will need to register with the applicable state authorities and subject such adviser (and its key principals) to applicable state licensing requirements, including certain state securities examinations. In Texas, this will likely require managers to certain hedge funds that have natural persons as investors to register with the State of Texas (and will subject the manager and its representatives to state licensing requirements).

Open Issues for the SEC

While the passage of the Act helps set expectations for fund managers, it grants the SEC significant leeway to write its rules. Accordingly, a number of open questions remain that will not be completely addressed until the SEC issues its rules over the next year. The following are some key questions that Congress chose to delegate to the SEC:

- *What Is a Venture Capital Fund?* The Act requires the SEC to define "Venture Capital Fund" within one year of the date of enactment. Most venture capital funds easily identify as such, however, there are situations where a venture capital fund and private equity fund (not otherwise exempted) can be similar.

- *What Is AUM?* The SEC currently defines AUM with reference to a securities portfolio. While this may apply to a hedge fund, and even a real estate fund holding debt securities, a private equity fund is not typically in a situation where it can value its securities portfolio on a daily or even monthly basis. Moreover, in contrast to a hedge fund, a private equity fund receives commitments from its investors and only calls capital upon making an investment. A new fund could have $500 million in commitments, but only have $50 million in investments. As part of its rulemaking under this Section of the Act, the SEC should clarify, and if possible, vary, the definition of AUM depending on the type of fund.

- *What Is a Mid-Sized Fund?* The Act grants the SEC the authority to streamline the reporting and books and records requirements for advisers to "mid-sized funds." The SEC has the power to determine who qualifies, and what those registration, reporting and books and records requirements will be. Congress chose to give the SEC some discretion to treat a $200 million fund different than a $2 billion fund, but until the new rules are issued, certain "mid-cap" funds will continue to face regulatory uncertainty.

- *What Reports and Record Keeping Are in the Public Interest?* Advisers to Venture Capital Funds and all private funds with AUM less than $150 million will be subject to reduced books and records and reporting requirements. In particular, it is unclear what the SEC needs to know about venture capital funds, which typically do not resort to leverage and whose investments don't typically pose a threat to the economy. The SEC should consider the value of reporting for these types of funds compared to the costs of compliance for these types of funds.
- *Will Certain Real Estate Funds Have an Exemption?* The new books and records requirements apply to all "private funds," which have been defined to include private funds exempt from registration under the Investment Company Act of 1940, as amended, under Section 3(c)(1) (no more than 100 beneficial owners) or Section 3(c)(7) (all investors are qualified purchasers). A real estate fund can also be exempt if it does not issue redeemable securities and is primarily engaged in the purchase of mortgages and other liens on and interests in real estate under Section 3(c)(5). While it is possible the SEC could address this issue through rulemaking, the Act contains a broader definition of private funds in other provisions (defining such funds to be those funds that are exempt under 3(c)(1), 3(c)(7) or similar provisions as determined by the appropriate regulator). Accordingly, an adviser to a 3(c)(5) fund, in the absence of new amendments or rulemaking, would not be subject to the new compliance requirements (other than registration) applicable to 3(c)(1) and 3(c)(7) funds.

Effectiveness/Transition Period

Generally, these requirements will not be effective until one year after the enactment of the Act. The SEC has a substantial workload to issue regulations covering these matters. All private funds face significant compliance burdens, although the full picture of these new challenges will not be complete until the SEC completes its rulemaking over the next year.

Additional Challenges and Opportunities Facing Private Funds

While the private fund registration provisions of the Act will have the most direct impact on private funds, the Act affects various aspects of the financial industry, including the ability of banks to enter and continue in the private fund space, the ability to trade over the counter derivatives, such as credit defaults swaps, the ability of shareholders to have greater power in influencing and shaping corporate policymaking and the compensation payable to employees of various companies, including broker-dealers and investment advisers. The following are areas that Andrews Kurth has been following that may be of interest:

- *The Volcker Rule: Limiting Investments in Funds.* The Act adopts the "Volcker Rule," placing various limits on proprietary trading by banking entities, including the investments in, and sponsorships of, private equity funds and hedge funds. Accordingly, banks will not be permitted to organize and offer funds except for certain funds that do not bear their name, do not have the implicit or explicit guarantee of the bank, and that do not in the aggregate constitute more than 3% of the Tier I capital of the bank. While the Act could have gone farther in restricting bank fund activity, banks will be limited in this space, and as this rule is phased in over several years, fund managers will need to look to other sources of capital (and sponsorship) to continue their business.
- *Say on Pay and Proxy Access.* Most public companies will be required to conduct a non-binding, advisory vote on the compensation of their named executive officers in the 2011 proxy season. Companies will also be required to solicit a vote from its shareholders on whether to hold these advisory votes on the compensation on an annual, biannual or triannual basis. The Act also gives the SEC the explicit authority to require public companies to include shareholder nominees in their proxy statements. The Act remains silent on the ownership or holding period requirements for shareholders to obtain access to a company's proxy statement. In 2009, the SEC tabled a rule granting access to shareholders between one percent to five percent of the outstanding securities (depending on the company's public float). Recent reports indicate that the SEC intends to issue a final rule at the end of the month with a three percent holding requirements for all public companies. To learn more about the executive compensation and corporate governance provisions of the Act, please click here.

- *New Compensation Restrictions.* While “say on pay” grants shareholders a greater role in influencing pay for executives, as well as requiring more transparency, the Act also grants regulators the authority to approve and restrict certain pay packages by “covered financial institutions.” The Act requires federal regulators to prescribe rules or guidelines that prohibit incentive-based compensation to any employee that the regulators determine encourages inappropriate risks by these institutions. A “covered financial institution” will include, in addition to banks and insurance companies, investment advisers (i.e., advisers to private funds) and broker-dealers with $1 billion in assets.
- *Limits Investors in Funds.* The Act will also limit the number of investors in certain smaller funds in the following ways:
    - Adjusts Accredited Investor Standard: The Act immediately amends the definition of an “accredited investor” for natural persons to exclude from the $1 million net worth standard the value of the primary residence of such natural person. In addition, the Act grants the authority to the SEC to review and determine if the definition of “accredited investor” for natural persons should be adjusted or modified (except for the net worth test) for the protection of investors, in the public interest and in light of the economy. Finally, the Act requires the SEC to review the definition of “accredited investor” for natural persons in 4 years, and at least ever 4 years thereafter, to determine whether the definition should be adjusted or modified for the protection of investors, in the public interest, and in light of the economy.
    - Adjusts Qualified Client Standard: A private fund cannot pay a performance fee (i.e., carried interest) in respect of an investment by a person that is not a “qualified client” under the Advisers Act. The Act directs the SEC to adjust in one year, and every five years thereafter, the thresholds for determining “qualified clients.” Any such adjustments shall be rounded to the nearest multiple of $100,000.
- *New Requirements for Trading Over the Counter Derivatives*: The Act introduces significant disclosure, trading requirements and capital and margin requirements for entities that trade over the counter derivatives, including credit default swaps. A hedge fund that regularly trades such “swaps” could be subject to registration requirements with the SEC and the CFTC, reporting requirements and capital requirements, as well as a requirement to settle all swaps through a “clearing agency” and trade them on an exchange. In the event that a hedge fund is not classified as being regularly in such business, any trades of swaps will in any event be subject to clearing, trading and margin requirements. The full impact of these new swaps rules will not be felt for some time as the rules are written and the clearing agencies and exchanges are set up and create their own set of rules. Nevertheless, regular players in this area should expect the cost to trade swaps will substantially increase in the next two years. A more detailed description of these new rules will be provided by Andrews Kurth shortly in a separate Client Alert.

Since the start of the financial crisis, the financial industry has known that it would face substantial changes in the regulatory environment. While the Act helps provide guidelines, the rulemaking begins now.

Andrews Kurth has been following the Act and will continue to follow the rulemaking over the course of the next year (and beyond). If you would like more information about these developments, please contact David Buck, Bill Rivers, Vic Zanetti, Peter Bogdanow or your Andrews Kurth contact.

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1. An adviser to a real estate fund must register as an investment adviser if the fund invests in “securities”. Given the broad definition of the term “securities”, a real estate fund that invests in debt or equity interests in real estate would likely be considered an investor in “securities”.

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