Financial Reform
Task Force

Dodd-Frank Impacts Private Equity

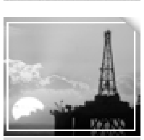
by Roy Goldman, Anita Tarar, Richard Bourgeois, Laura Grossman and Manny Rivera

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). While the Dodd-Frank Act primarily focuses on attempting to address the issues viewed as leading to the financial crisis the U.S. faced in 2008 and 2009, it also impacts the private equity and hedge fund industry and creates a broader and more inclusive regulatory and data collection regime with respect to investment advisers.

Registration and Exemption. Prior to passage of the Dodd-Frank Act, investment advisers to funds (including private equity funds and hedge funds) were typically exempted from registration as investment advisers under the Investment Advisers Act because of a provision known as the "private adviser" exemption for advisers with fewer than 15 clients that do not hold themselves out to the public as investment advisers. The Dodd-Frank Act eliminates this "private adviser" exemption, but creates a new exemption from registration for advisers to "private funds," but only if they solely advise private funds and have assets under management in the U.S. of less than $150 million. Despite this new exemption, such advisers must still maintain records and provide reports that meet SEC requirements. The term "private fund" is defined in the Dodd-Frank Act as an issuer that would be an "investment company" pursuant to section 3 of the Investment Company Act of 1940, but for the exemptions in sections 3(c)(1) (funds with less than 100 investors) or 3(c)(7) (funds consisting only of "qualified purchasers" under the Act). The elimination of the current "private adviser" exemption and the implementation of the new "private funds" exemption is effective July 21, 2011; however, investment advisers may register with the SEC during the 1-year transition period.

Advisers solely to venture capital funds are also exempt from registration with the SEC as investment advisers. The Dodd-Frank Act requires the SEC to define the term "venture capital fund" by July 21, 2011. Advisers under this exemption must still maintain records and provide reports as required by the SEC.

New recordkeeping and reporting requirements for registered advisers to private funds, including private equity funds and hedge funds, relate to the amount of assets under management and use of leverage, including off-balance sheet leverage, counterparty credit risk exposure, trading and investment positions, valuation polices and practices of the fund, types of assets held, side arrangements or side letters, and trading practices. The Dodd-Frank Act exempts from registration, reporting and recordkeeping requirements a "foreign private adviser" that has no place of business in the U.S., has fewer than 15 U.S. clients and U.S. investors in private funds, has less than $25 million in assets under management attributable to U.S. clients and U.S. investors in private funds, and neither holds itself out generally to the public in the U.S. as an investment adviser nor acts as an investment adviser to any registered investment company.



All registered investment advisers, which as a practical matter will include most private equity and hedge fund managers, are subject to further recordkeeping and data collection requirements for the purpose of aiding the SEC and the newly established Financial Stability Oversight Council ("FSOC"), whose purposes are to identify risks to the financial stability of the United States and to promote market discipline, in identifying systemic risks in the financial markets. Registered investment advisers will be required to make various disclosures to the FSOC, including the amount of assets under management, the use of leverage, counterparty credit risk exposure, trading and investment positions, valuation policies and practices of the fund, and types of assets held.

Investment advisers are not permitted to register as an investment adviser with the SEC unless they have assets under management of more than $100 million, or, if they have more than $25 million but less than $100 million under management, would have to register in 15 or more states. Otherwise, advisers are subject to state registration, a change that is intended to increase the number of advisers subject to more stringent state oversight.

GAO Study. The Dodd-Frank Act provides that the Government Accountability Office (GAO) will conduct a study on the feasibility of forming a self-regulatory organization to oversee private funds. The study will be submitted to the appropriate House and Senate committees within one year of the enactment of the Dodd-Frank Act, but the scope and outline of such regulation remains undefined.

"Volcker Rule." In general, the Dodd-Frank Act bans all banking entities from engaging in proprietary trading. Certain types of proprietary trading transactions are not subject to the ban, including trading in U.S. government or other federally backed obligations, state or municipal obligations, risk-mitigating hedging transactions, and trading conducted by an entity solely outside of the U.S. Notwithstanding those allowances, certain transactions are prohibited even if they fall into one of the permitted categories. Examples include any transaction that creates a conflict of interest between the banking entity and its customers, a transaction that results in a material exposure to high risk, or a transaction that generally poses a threat to the stability of the U.S. financial system.

The Dodd-Frank Act creates a new class of financial entities, called "nonbank financial companies," which may be designated by the FSOC for supervision by the Federal Reserve. Nonbank financial companies that are substantially engaged in financial activities, and which the FSOC determines are significant and may pose a threat to the stability of the U.S. financial system, may be designated for enhanced supervision and regulation. Nonbank financial companies are not subject to the outright ban on proprietary trading, but are subject to additional "capital requirements" and "quantitative limits" that are subject to regulation.

The Dodd-Frank Act also restricts the ability of banking entities and certain nonbank financial companies to sponsor or invest in private equity or hedge funds. In broad strokes, the committee language prohibits banks and certain nonbank financial companies from investing, in the aggregate, more than 3% of their Tier 1 capital in private equity and hedge funds. In addition, they may not own more than a 3% interest in any given private equity or hedge fund. An exception to these requirements is made in the case of providing seed capital for the inception of a new fund. In that instance, the 3% caps do not have to be observed at the outset, but the entity must actively seek unaffiliated investors in order to bring its own holdings down to within the prescribed levels within one year, with the possibility of an extension of two years. Further, banks are prohibited from bailing out a fund in which they are invested, no matter how small the amount.

In general, these requirements do not go into effect until one year after final regulations are published, but no later than two years after the enactment of the Dodd-Frank Act. From that time, banking entities have two years to come into compliance with the various requirements of the rule, with the possibility of being granted up to three one-year extensions. In the case of "illiquid funds," a banking entity can be granted an extension of up to five years.

Increases in the "Accredited Investor" Threshold. The Dodd-Frank Act significantly alters the Regulation D definition of "accredited investor" under the natural person net worth prong of the definition, but declined to modify the threshold under the income prong. Currently, an individual qualifies as an "accredited investor" if either (a) his or her individual net worth, or jointly with a spouse, exceeds $1 million, or (b) he or she has an individual income in excess of $200,000 (or $300,000 jointly with a spouse) in each of the last two years, with a reasonable expectation of reaching the same level of income in the current year. The net worth threshold will remain at $1 million, but effective immediately that amount no longer includes the value of the primary residence of the individual. The SEC is required to review the "accredited investor" definition at least every four years for necessary modifications to ensure adequate investor protection and to account for economic factors. The GAO is required to submit its own study of the appropriate thresholds for the accredited investor definition to the SEC no later than three years after the enactment of the Dodd-Frank Act.

Increases in the "Qualified Client" Threshold. Under SEC rules, a registered investment adviser can charge a performance or incentive fee only to persons who are "qualified clients." The Dodd-Frank Act requires the SEC to make inflationary adjustments to the qualified client standard every five years. Currently, a qualified client generally means an individual or a company with at least $750,000 under the management of the investment adviser; a net worth, individually or jointly with a spouse, of more than $1,500,000; a "qualified purchaser;" or an investment adviser's executive officer, director or employee who participates in the investment adviser's investment activities.

No New State Regulation of Regulation D Offerings. The Dodd-Frank Act does not include any changes in how federal preemption works for Regulation D private placements. The Senate version of the bill originally included provisions that would have decreased the scope of federal preemption of state registration requirements in Regulation D offerings, but those provisions were not adopted in the Dodd-Frank Act.

Financial Reform
Task Force

Compliance Date. Most of the provisions described in this briefing will become effective one year from the date of enactment of the bill.

The Authors

Roy Goldman
Partner
+1 212 318 3219

Anita Tarar
Sr. Associate
+1 214 855 8235

Richard Bourgeois
Partner
+1 212 318 3233

Laura Grossman
Counsel
+1 212 318 3237

Manny Rivera
Sr. Counsel
+1 212 318 3296