



Private Equity Alert

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Weil News

- Weil advised ProSight Specialty Insurance (a portfolio company of Goldman Sachs Capital Partners and TPG Capital) in connection with its \$230 million going private acquisition of NYMagic
- Weil advised Providence Equity Partners in connection with its A\$660 million acquisition of Study Group, an Australia-based global private education provider
- Weil advised Keystone Foods (a portfolio company of Lindsay Goldberg) in connection with its \$1.26 billion sale of Keystone to Marfrig Alimentos
- Weil advised Lindsay Goldberg in connection with its acquisition of Philips Services Corporation
- Weil advised The Gores Group in connection with its proposed acquisition of the assets of envelope maker NEC Holdings
- Weil advised Credit Suisse in its joint venture with CME Indexes establishing the Dow Jones Credit Suisse Hedge Fund Indexes
- Weil advised Lone Star in connection with its acquisition of German mortgage bank Dusseldorfer Hypothekbank
- Weil advised Swett & Crawford (a portfolio company of HM Capital Partners) in connection with its merger with Cooper Gay, a London-based insurance broker
- Weil advised WL Ross in connection with the sale of its interest in SpiceJet, India's second largest budget airline

Private Fund Adviser Regulation Under the Dodd-Frank Act

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On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), comprehensive reform legislation imposing new requirements and restrictions on the financial industry. Private equity funds and hedge funds (collectively, "private funds") and their respective advisers are the subject of substantial requirements under the Dodd-Frank Act, many of which will be implemented by new regulations to be drafted by the Securities and Exchange Commission (the "SEC") over the coming two years. The new areas of regulation include the following:

- mandatory registration for many private fund advisers under the Investment Advisers Act of 1940 (the "Advisers Act");
- a prohibition on insured depositories, their holding companies, and their affiliates (collectively, "banks") from engaging in proprietary trading and certain activities relating to private funds (commonly referred to as the "Volcker Rule" after former Federal Reserve Board Chairman Paul Volcker);
- new disclosure requirements regarding short-sale transactions;
- registration, margin requirements, and position limits imposed on certain parties to derivatives transactions; and
- possible designation of large financial firms as "nonbank financial companies" with resultant supervision and regulation by the Federal Reserve Board (the "Board").

This article summarizes these provisions, outlines how they may affect private funds, and provides key "takeaways" to consider in the days ahead.

Expanded Registration and Disclosure Under the Advisers Act

The Dodd-Frank Act eliminates the exemption from registration for investment advisers with fewer than 15 clients (an exemption upon which many private fund advisers rely). Additionally, the Dodd-Frank Act modifies the intrastate exemption as it pertains to private funds. Previously, investment advisers could remain unregistered if their clients were residents of the state where the investment adviser maintained its principal office and the adviser did not furnish advice or analyses with respect to securities listed on any national exchange. Investment advisers to

private funds can no longer rely on the intrastate exemption.

The Dodd-Frank Act expands registration under the Advisers Act to include advisers to “private funds” – defined as issuers that would be investment companies but for the exclusions under Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 (the “’40 Act”) – regardless of the number of clients they manage. These exclusions cover issuers that have fewer than 100 owners or where all owners are qualified purchasers. The threshold for registering with the SEC under the Advisers Act has also been increased from \$25 million to \$100 million, with advisers managing assets under the revised threshold being subject to state regulation. As a result of this threshold increase, a number of smaller advisers will need to determine with which states’ laws they must comply. One state that many private fund advisers that are not eligible to register with the SEC will find themselves needing to register with is Connecticut, which requires registration of investment advisers who either have a place of business in Connecticut (regardless of the number of Connecticut clients), or have more than five Connecticut clients (regardless of the advisers’ geographic location).

The Dodd-Frank Act has created new narrow exemptions from registration for (i) advisers to private funds with assets under management of less than \$150 million in the United States, (ii) advisers to venture capital funds (as such term is to be defined by the SEC), (iii) foreign private advisers, (iv) advisers to small business investment companies, and (v) family offices.

Key Takeaway: Many more US private fund advisers will be subject to SEC or state registration, disclosure, and examination requirements. The new

SEC registration requirements will become effective on July 21, 2011. However, private fund advisers may register pursuant to the Advisers Act at any time prior to the effective date.

Exemption for Foreign Private Advisers

The Dodd-Frank Act exempts foreign private advisers from registration. Foreign private advisers are those advisers that:

- have no place of business in the United States;
- have fewer than 15 US-based clients and investors in private funds at any time;
- have assets under management attributable to US-based clients and investors in private funds of less than \$25 million or such higher amount as the SEC, by rule, deems appropriate; and
- do not hold themselves out as an investment adviser, nor act as an investment adviser to any investment company or company that has elected to be a “business development company” pursuant to the ‘40 Act.

Key Takeaway: Many foreign private fund advisers also serving US clients will be unable to meet this somewhat narrow exemption.

Disclosure and Examination Requirements

The Dodd-Frank Act expands the authority of the SEC to require investment advisers to maintain and file certain records, including materials that would allow the SEC to track:

- total assets under management;
- types of assets held;
- the use of leverage;
- counterparty credit risk exposure;
- trading and investment positions;

- trading practices;
- valuation policies and practices;
- side letters or arrangements treating some investors more favorably than others; and
- other information the SEC deems to be in the public interest or necessary for the assessment of systemic risk.

The records and reports of an investment adviser are also deemed to include records and reports of the private funds it advises. The Dodd-Frank Act also directs the SEC to conduct periodic inspections of the records of private funds maintained by a registered adviser, and authorizes the SEC to conduct other examinations it deems necessary.

Generally, disclosure of information is protected to the same extent as if provided pursuant to the Advisers Act, and the SEC may not compel advisers to disclose proprietary information to the public (including sensitive, non-public information regarding investment or trading strategies, analytical or research methodologies, trading data, and intellectual property). Nonetheless, the SEC may not withhold information from Congress, a federal department, agency, or self-regulatory organization requesting information within the scope of its jurisdiction, or a US court in connection with a federal enforcement action.

Key Takeaway: Private funds and their advisers will be subject to disclosure and confidential regulatory reporting requirements that previously have not been applied to the industry.

Accredited Investor Determinations

The Dodd-Frank Act changes the calculation for determining whether a

natural person meets the “net worth” test to be considered an “accredited investor.” “Accredited investors” include any natural persons whose net worth exceeds \$1,000,000, either individually or jointly with a spouse. Historically investors were able to include the value of their personal residence when determining net worth. The Dodd-Frank Act prohibits including equity in an investor’s primary residence when calculating net worth. No change was made to the annual income test for determining whether a person is an “accredited investor,” though the SEC is given discretion to evaluate its continuing appropriateness. The change to the net worth element of the “accredited investor” test is effective immediately, and all threshold amounts are to be evaluated and adjusted once every four years by the SEC.

The Dodd-Frank Act does not define the term “value” or discuss how mortgage indebtedness should be treated when determining net worth. A Compliance and Disclosure Interpretation issued by the SEC’s Division of Corporation Finance on July 22, 2010 indicates that, pending implementation by the SEC of final amendments to the applicable rules as required by the Dodd-Frank Act, the value of a person’s primary residence, along with any mortgage or other indebtedness secured by the primary residence, should be excluded when calculating net worth. To the extent that there is mortgage or other indebtedness secured by a primary residence in excess of the value of the primary residence, such excess should be considered a liability and deducted from a person’s net worth.

Key Takeaway: These changes immediately reduce the number of “accredited investors” and allow the

SEC to further limit the category of accredited investors.

Volcker Rule: Forbidding Bank-Operated Private Funds

The Volcker Rule is designed to prohibit banks from engaging in the types of investing carried out by private equity funds and hedge funds, whether through the ownership of private equity funds or hedge funds or direct trading for a bank’s own account. The Dodd-Frank Act prohibits any bank from acquiring or retaining any equity, partnership, or other ownership interest in or sponsoring any private fund, subject to certain exceptions. The relevant regulators may also include “similar funds” through rulemaking. “Sponsoring” a private fund can involve a number of activities, including:

- serving as a general partner, managing member, or trustee of a fund;
- selecting or controlling a majority of the directors, trustees, or managers of a fund; or
- sharing the same or a similar name with a fund.

While the above prohibition is comprehensive, a key exception will allow US banks to organize and offer private funds if the bank meets the following requirements:

- provides bona fide trust, fiduciary, or investment advisory services to the fund;
- organizes and offers the fund only to customers and only in connection with the provision of trust or related services;
- does not make, acquire, or retain an interest other than a seed investment in the fund and satisfies each of the following requirements:

- within one year after the fund’s establishment, the bank’s investment is reduced to 3% or less of the total ownership interest in the fund; and
- the aggregate of all the bank’s investments in private funds is 3% or less of the bank’s Tier 1 capital;
- avoids certain transactions specified in the detailed affiliate rules of the Federal Reserve Act with respect to the fund;
- does not guarantee, assume, or insure the fund’s obligations or performance;
- does not share the same or a similar name with the fund;
- does not allow an ownership interest by any director or employee not directly engaged in providing services to the fund; and
- discloses that losses will be borne solely by investors.

With respect to proprietary trading, the Dodd-Frank Act prohibits any bank from buying and selling any security, derivative, or other financial instrument for its “trading account,” as opposed to the accounts of customers. Certain transactions are, however, generally excluded from the ban on proprietary trading, including:

- customer transactions;
- transactions in connection with underwriting or market-making activities;
- bona-fide risk-mitigating or hedging activities;
- buying and selling of securities in the context of an insurance business;
- transactions in US government or government-sponsored enterprise securities; and

- proprietary trading by a non-US controlled bank that occurs outside the United States.

The Dodd-Frank Act requires a study to be completed by the newly formed Financial Stability Oversight Council (the "Council") (chaired by the Treasury Secretary and composed of other key regulators) within six months after enactment and the preparation of a report making additional recommendations. Within nine months after the date of the report or two years after the enactment of the Dodd-Frank Act, the Board and other regulators will consider the Council's findings and issue their final, coordinated regulations making the Volcker Rule "effective." After "effectiveness," banks have two years to comply with the rules, provided, that banks can apply for extensions from compliance for a maximum of three additional years. Extensions of up to five years are available in connection with commitments to funds considered "illiquid." As a practical matter, therefore, forced divestments could take place anywhere from approximately three to possibly 12 years from now.

Key Takeaway: The required sale of private funds owned or sponsored by banks has the potential to provide acquisition opportunities (of management and/or assets) for free-standing funds. The longer term effect on the industry, while uncertain at this time, is expected to be significant.

Expanded Beneficial Ownership Disclosures and New Short-Sale Disclosures

The Dodd-Frank Act amends the definition of beneficial ownership of equity securities to include, to the extent determined by SEC rule (after consultation with prudential regulators and the Secretary of the

Treasury), the purchase or sale of a security-based swap. Acquisition of a security-based swap, however, may be deemed to be ownership of the equity security only to the extent that the security-based swap provides incidents of ownership comparable to direct ownership of the equity security and it is necessary for the purposes of Sections 13 and 16 of the Securities Exchange Act of 1934 (the "Exchange Act") to deem the acquisition of such security-based swap as beneficial ownership of the equity security. The SEC potentially may use this provision to include notional shares underlying instruments such as cash-settled total return equity swaps in the determination of beneficial ownership for

Private equity and hedge funds and their respective advisers are the subject of substantial new requirements under the Dodd-Frank Act.

purposes of Sections 13(d) and (g) and Section 16 of the Exchange Act. A number of activist hedge funds and others base their tactical and economic strategies in part on being able to avoid exceeding the 5% (Schedule 13D and 13G) or 10% (Form 3/Section 16) thresholds of beneficial ownership, while nonetheless obtaining an economic exposure in excess of such thresholds, through the use of such instruments.

The Dodd-Frank Act also authorizes the SEC to shorten the required time period within which an investor is required to disclose the initial crossing of beneficial ownership reporting thresholds. Currently acquirers have a 10 calendar day period in which to publicly disclose such acquisitions with the SEC, which allows for

accumulations of large amounts of voting stock (sometimes well in excess of the specified thresholds) prior to the filing deadlines.

The Dodd-Frank requires the SEC to adopt rules imposing a new duty on institutional investment managers (which includes advisers to hedge funds) filing Form 13F to disclose their short positions on at least a monthly basis "in connection with" each class of equity securities of each portfolio company. Additionally, the Dodd-Frank Act states (perhaps gratuitously in light of Rule 10b-5) that it is unlawful to carry out a manipulative short sale of any security. Finally, the SEC is directed to conduct a study on the state of short selling (including the incidence of the failure to deliver shares sold short), and to submit a report with recommendations to Congress within two years. The study must address the feasibility of real-time short-selling reporting and a pilot program for public companies to have trades of their stock marked in real time as "short," "market maker short," "buy," "buy-to-cover," or "long."

Key Takeaway: Hedge funds employing equity swaps should re-evaluate their strategies in light of potential disclosure changes or prepare for compliance, with particular vigilance aimed at avoiding inadvertent triggers (e.g., a poison pill or 10% Section 16 threshold). Additionally, hedge funds should expect monthly disclosure, greater scrutiny, and the possibility of having to make real-time disclosures of short positions.

Regulation of Participants in the OTC Swaps Market

The Dodd-Frank Act requires that over-the-counter ("OTC") "swap dealers" and "major swap partici-

pants” that are not depository institutions (and therefore already subject to capital and margin requirements) register with the SEC or the Commodity Futures Trading Commission (the “CFTC”), as relevant, depending on the kind of swap involved. The SEC will regulate security-based swaps and mixed swaps, while the CFTC will regulate all other types of swaps. A swap dealer is defined as any person or entity who:

- holds itself out as a dealer in swaps;
- makes a market in swaps;
- regularly enters into swaps with counterparties in the ordinary course of business for its own account; or
- engages in any activity causing the person or entity to be commonly known as a dealer or market maker in swaps in connection with CFTC-regulated swaps.

A major swap participant is defined as any person or entity who is not a swap dealer (as defined above), and:

- * maintains a substantial position in swaps (excluding positions held for hedging or mitigating commercial risk and positions maintained by an employee benefit plan for the primary purpose of hedging or mitigating risk associated with the operation of the plan);
- whose outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets; or
- is a highly leveraged financial entity, not otherwise subject to capital requirements established by any federal bank regulator, which maintains a substantial position in any category of outstanding swaps.

Hedge funds classified as swap dealers

or major swap participants must meet minimum capital, initial and variation margin requirements to be prescribed by the SEC or CFTC to “help ensure the safety and soundness of the swap dealers or major swap participants.” The agencies will review all the activities of the swap dealers and major swap participants – including unregulated activities – when setting capital requirements. This could result in capital requirements being imposed on a given swap dealer or major swap participant, in part, due to the activities of its affiliates or subsidiaries.

Disclosure and Record Maintenance

Swap dealers and major swap participants must keep books and records open to inspection and examination by the SEC and/or CFTC. Required records include:

- daily trading records of swaps and other related records (including related cash or forward transactions);
- all recorded communications;
- daily trading records for each counterparty and customer; and
- a complete audit trail to allow for trade reconciliation.

The Dodd-Frank Act also requires swap dealers and major swap participants to follow certain conduct of business requirements, including mandated disclosures to non-swap dealer and non-major swap participant counterparties of information regarding material risks, incentives, and conflicts of interest associated with a transaction. Any communication with these counterparties must be made on a good faith and fair dealing basis. Additionally, when entering into swaps with a governmental entity, employee benefit plan, or endowment, swap dealers and

major swap participants must have a reasonable belief that the counterparty is represented by an independent representative that meets certain standards.

In terms of position limits, the Dodd-Frank Act expands the CFTC’s authority to limit the size of an entity’s overall derivatives portfolio via a newly granted power to impose aggregate position limits for contracts traded on exchanges or non-US boards of trade as well as any swaps that perform or affect a significant price discovery function. The SEC must establish similar limits (including related hedge exemption provisions) on the size of positions in any security-based swaps that may be held by any person.

Key Takeaway: Many hedge funds will be required to register with the SEC and/or the CFTC, maintain and disclose certain books and records, and be subject to capital and margin requirements.

Potential Classification as a Nonbank Financial Company

One of the major aspects of the Dodd-Frank Act is the regulation of large, complex financial firms that pose a systemic risk to the financial stability of the United States. Most of the companies contemplated immediately for purposes of this kind of macroprudential regulation are large bank and thrift holding companies. Nevertheless, Congress is aware that other financial companies – including hedge funds – could also grow to a point where their size, interconnectedness, and other relevant factors cause them individually to pose a systemic risk. (The bailout of Long-Term Capital Management in 1998 remains on the minds of many financial regulators and policymakers.) As a consequence, the Council is authorized to determine by a super-

majority vote that a company that has consolidated revenues of which at least 85% are attributable to “activities that are financial in nature” is a nonbank financial company, which in turn would subject such company to enhanced supervisory measures.

In making this determination, the Council may consider among other things:

- the degree of leverage at the company;
- the amount and nature of the company’s assets;
- the amount and types of liabilities of the company;
- the amount of off-balance sheet exposures;
- relationships with other nonbank financial companies and bank holding companies;
- the importance of the company as a source of credit for households, businesses, state and local governments, and as a source of liquidity for the US financial system; and
- the extent to which assets are

managed – as opposed to owned – by the company and whether the assets are diffuse.

Once a determination is made to subject a nonbank financial company to systemic risk prudential standards, the Council will notify the company, and the company may request a hearing to contest the determination (and potentially appeal to a US district court). The Council will consult with the applicable federal agency with authority over the specific nonbank financial company (in the case of hedge funds, this would most likely be the SEC) before making any final regulatory determination. If the Council’s determination stands, the company will be required to register with the Board within 180 days and thereafter be subject to the Board’s applicable standards.

The Dodd-Frank Act specifies that such standards may include risk-based capital requirements, leverage limits, liquidity requirements, resolution plans and credit exposure reporting requirements, concentration limits, a contingent capital requirement,

enhanced public disclosures, short-term debt limits, and overall risk management requirements.

Key Takeaway: While most hedge funds will not likely be classified as a nonbank financial company, larger funds may be considered for this classification and could be subject to the stricter supervisory requirements associated with being deemed a nonbank financial company.

* * *

As detailed above, the Dodd-Frank Act will significantly affect the operations of private funds and their advisers in the future. Further details for the implementation of many of these changes will be developed over the coming two years as the applicable regulatory bodies draft new regulations as directed by Congress. Stay tuned for further developments from Washington

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