

Private Equity Fund Manager Regulation After Dodd-Frank

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The Dodd-Frank Wall Street Reform and Consumer Protection Act

- Signed into law on July 21, 2010
- Dodd-Frank leaves a lot of discretion to the regulators
- This process will take years to play out
- Rulemakings related to private equity fund managers include rules proposed during December 2010-March 2011 and rule adoption during April-July 2011
- Private adviser exemption repeal provisions effective July 21, 2011

The Dodd-Frank Act (cont.)

Dodd-Frank will have a profound effect on the regulatory regime governing investment advisers and private funds

- Dramatically reshapes the registration, recordkeeping and reporting requirements for advisers
- Changes the “accredited investor” and “qualified client” requirements
- Empowers the SEC to conduct a much more aggressive examination and enforcement program
- Has the potential for additional regulation of large funds and fund complexes under a new systemic risk regulatory regime
- **Creates immense uncertainty pending rulemaking and agency guidance, which are currently ongoing**

Potential Application to Private Equity Managers

- Potential Exemptions
- Registration Process and Compliance Requirements
- Potential Changes to Fund Documents
- SEC Examination Process



Investment Adviser Definition and New Exemptions

Investment Adviser Definition and New Exemptions

- An investment adviser is defined as “any person who, for compensation, engages in the business of advising others...as to the value of securities or as to the advisability of investing in, purchasing, or selling securities...” Section 202(a)(11) of the Investment Advisers Act of 1940
- A general partner or manager of a pooled investment vehicle that (i) purchases or sells securities and (ii) pays the general partner/manager management fees and/or carried interest generally falls under this definition

Adviser Registration and New Exemptions (cont.)

- Dodd-Frank rescinds the “private adviser exemption” effective July 21, 2011
 - Many advisers to private funds (hedge, PE, RE and VC) currently rely on the private adviser exemption to remain unregistered
 - Section 203(b)(3) of the Advisers Act currently exempts an adviser that
 - during any rolling 12-month period had fewer than 15 clients,
 - does not serve as an adviser to a registered investment company or business development company (BDC) and
 - does not hold itself out to the public as an investment adviser
 - Generally, one fund counts as a single client
 - Most advisers that currently rely on the private adviser exemption will be required to register either with the SEC or state regulator(s) because of the limited scope of the new registration exemptions in Dodd-Frank

New Federal Exemptions in Dodd-Frank:

- Venture Capital Fund Adviser
- “Private Fund” Adviser
- SBIC
- Family Office

The Venture Capital Fund Adviser Exemption

- Dodd-Frank requires that the SEC provide an exemption for advisers solely to venture capital funds. Under the SEC's proposed definitions implementing this exemption, a "venture capital fund" would be a private fund that:
 - owns only:
 - equity securities (which would include preferred stock and debt instruments convertible into equity) of "qualifying portfolio companies," with at least 80% of the fund's holdings of each qualifying portfolio company having been acquired directly from the issuer, and
 - cash and cash equivalents (meaning bank deposits, certificates of deposit, bankers' acceptances and similar bank instruments) and U.S. Treasuries with a remaining maturity of 60 days or less;
 - for each "qualifying portfolio company," either directly or indirectly through its adviser:
 - has offered to provide, and if accepted does provide, significant guidance and counsel concerning the operations or business objectives and policies of the qualifying portfolio company, or
 - controls the qualifying portfolio company;
 - does not incur leverage in excess of 15% of the fund's aggregate capital contributions and uncalled capital and limits such borrowing arrangements to a non-renewable term of no longer than 120 calendar days;
 - does not provide investors with redemption, withdrawal or repurchase rights, except in extraordinary circumstances; and
 - represents itself to investors and potential investors as a venture capital fund
- Not exempt from certain Dodd-Frank reporting requirements or applicable state registration requirements
- Generally not applicable to PE managers because of "holding out" requirement and limitations on types of portfolio holdings and leverage
- Limited grandfathering

“Private Fund” Advisers Exemption

- Dodd-Frank requires that the SEC provide an exemption for advisers solely to private funds with aggregate AUM in the U.S. of less than \$150 million
- Under the SEC’s proposed rules implementing this exemption:
 - A U.S. fund adviser would have to include all of its funds’ assets, including the assets of non-U.S. private funds, for purposes of the AUM limit
 - A non-U.S. fund adviser could have clients that are not funds if they are outside the U.S., and it would only have to count the aggregate assets of its private funds that it manages from a place of business in the U.S. and would be able to exclude the assets of any non-U.S. clients and funds
- “Private fund” is defined as one that would be an investment company but for the exclusions in Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940
- Generally not applicable to PE advisers because most advise funds with over \$150 million aggregate AUM
 - AUM includes aggregate amount of any uncalled capital commitments
- Not exempt from certain Dodd-Frank reporting requirements or applicable state registration requirements

SBIC Adviser Exemption

- Exemptions for an adviser solely to one or more small business investment companies (each an SBIC) licensed by the Small Business Administration (SBA)
- Also applies to advisers solely to funds that:
 - have received notice from SBA that they may proceed to apply to become SBICs
 - Are affiliated with a licensed SBIC and are pending applicants to become licensed
- No reporting, recordkeeping or SEC examinations

Family Office Exemption

- Exempts a “family office” from registration
- The SEC has proposed a definition of “family office” under which:
 - The family office must provide investment advice only to “family clients,” as defined in the proposed rule
 - Family members must wholly own and control the family office, and
 - The family office must not hold itself out to the public as an investment adviser
- The proposed definition of “family client” is complicated, but generally includes parents, siblings, spouses, lineal descendants, charitable trusts, former family members, and key employees of the office
- A pooled investment fund is a permissible “family client” only if no outside ownership, control or investors
- Certain grandfathering relief
- No reporting or recordkeeping requirements; no SEC exams

Adviser Registration and New Exemptions – Records and Reports

- Dodd-Frank mandates the SEC to require “venture capital fund” and “private fund” advisers to “maintain such records and provide to the [SEC] such annual or other reports as the [SEC] determines appropriate”
- This means these advisers can be subjected to SEC examinations
- The SEC has proposed that advisers to these funds would have to file with the SEC on Form ADV Part 1A information concerning the private fund and its adviser, management, investors, service providers, assets, strategy and possible conflicts
- Registered advisers to private funds soon will have to report on Form PF
 - May require these advisers to value their funds for purposes of reporting
 - Advisers to private funds with more than \$150 million aggregate AUM and advisers to individual clients with over \$100 million in AUM would be required to file a Form PF on an annual basis
 - Advisers managing private funds that collectively have at least \$1 billion in AUM would be required to file a Form PF no later than 15 days after the end of each calendar quarter
 - Advisers solely to venture capital funds and advisers to private funds with less than \$150 million aggregate AUM will not have to report on Form PF under proposed Rule 204(b)-1



Investment Adviser Registration and Compliance Requirements

Investment Adviser Registration/Compliance

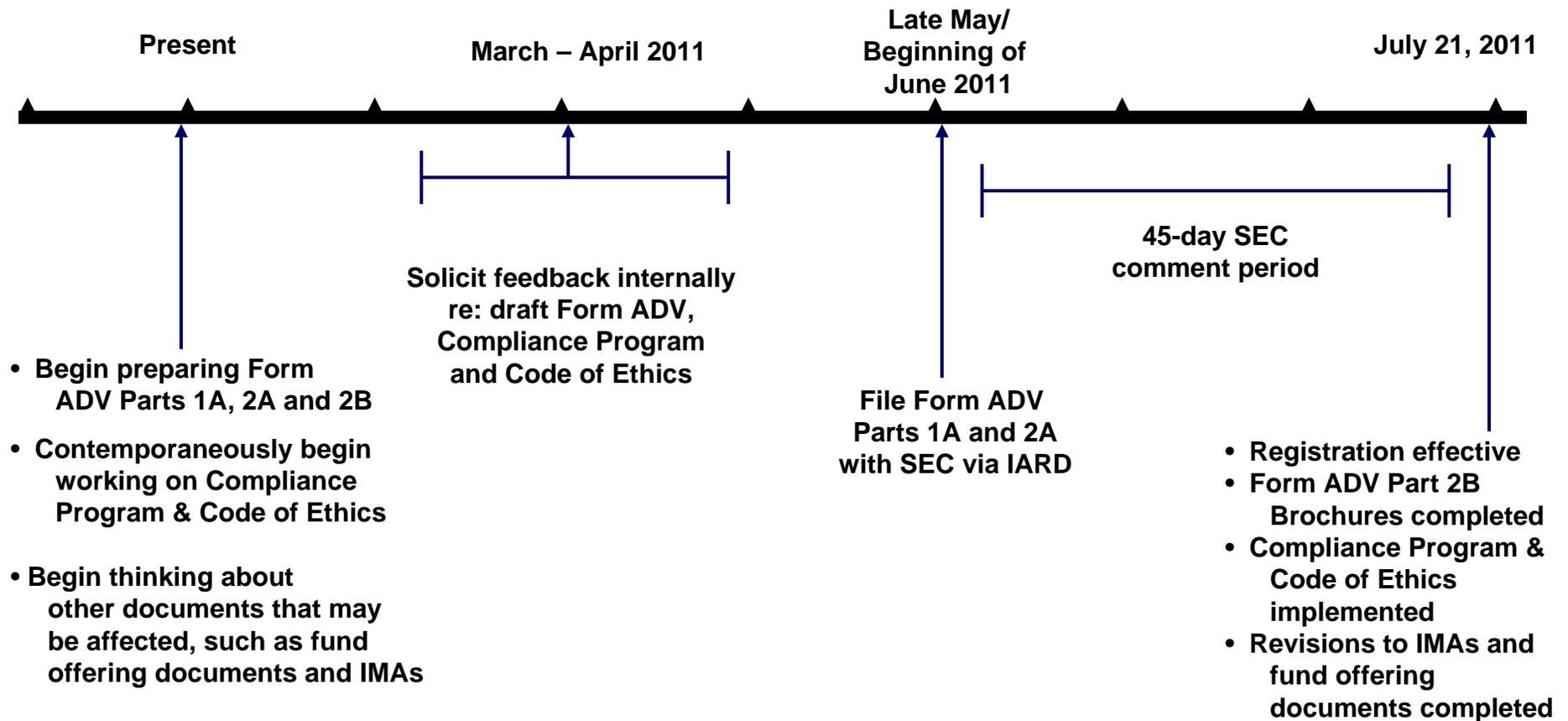
- Principal regulatory compliance issues:
 - Appointment and empowerment of a Chief Compliance Officer
 - Implementation of a comprehensive compliance program tailored to your business and its compliance risks
 - Code of ethics (including regulation and reporting of personal securities holdings and transactions) and insider trading policies
 - Annual compliance review
 - Strict safeguards regarding self-custody
 - Rules and guidance requiring extensive disclosure of conflicts of interest and consent for principal transactions
 - Rules governing advisory contracts (LP and LLC agreements) and performance fees
 - Change of control of manager requires investor consent
 - Preparation, maintenance and delivery of Form ADV/Brochure
 - Compliance with rules governing marketing materials, performance presentations and use of placement agents/solicitors
 - Periodic SEC examinations and strict enforcement
 - “Hedge clauses” potentially invalid
 - Maintenance of required books and records

What's Involved with SEC Registration

The SEC registration process will take 3-6 months, so PE advisers need to start planning now

- Fund managers will have to be **registered by July 21, 2011**, and exempt “venture capital fund” and “private fund” managers will have to make the applicable filings by August 20, 2011
 - Once an adviser has filed with the SEC, the SEC has 45 days either to approve registration or take action to deny it
 - This means that you must **submit** your registration filing by **no later than the beginning of June**
 - Once your registration becomes effective, you must be in full compliance with the Advisers Act
- To prepare for registration, each manager will have to prepare a Form ADV (SEC filing) as well as a compliance manual and code of ethics
 - These are complicated and interdependent documents that will have to be tailored to the manager’s operations and implemented in practice
- Larger and more complex managers may have to restructure some of their business operations to comply
- Fund documents may need to be reviewed and revised
 - E.g., subscription documents questionnaire must address “qualified client” status to receive carried interest
- Don’t wait until the last minute!

Timeline for Adviser Registration and Implementation of Compliance Program



SEC Registration – Form ADV

- Part 1 – SEC’s Examination Blueprint
 - General identifying information about your firm, advisory business (including employees, clients, compensation, assets under management, advisory activities and other business activities), financial industry affiliations, participation or interest in client transactions, custody, control persons and ownership and disciplinary history
- Part 2 – Client Brochure
 - Part 2A – plain English disclosure about your business practices, investment strategies and risks, conflicts of interest and disciplinary information
 - Part 2B – supplement focused on advisory personnel
- Filed and maintained online through the IARD, a national electronic depository
 - Requires setting up an account and getting a number
- Annual filing and delivery requirements
- Must amend if materially inaccurate (and redeliver if change to disciplinary information)



Required Written Policies and Procedures for Registered Advisers

Chief Compliance Officer

RIAs are required to appoint a Chief Compliance Officer or CCO. The CCO:

- may serve other functions within the firm
- must be given full responsibility and authority to develop and enforce appropriate policies and procedures
- should have a position of sufficient seniority and authority to force others to follow the firm's compliance policies and procedures

Compliance Manual

All RIAs are required to adopt a Compliance Manual

Compliance Manuals typically cover at least the following topics:

- portfolio management processes, including allocation of investment opportunities
- trading practices, such as allocation policies, principal transactions and cross-trades
- safeguarding of client assets from inappropriate use
- recordkeeping policies
- advertising and marketing policies
- valuation of client securities and other holdings
- safeguards for the protection of client records and information
- disaster recovery plans

Code of Ethics

All RIAs are required to adopt a Code of Ethics covering:

- basic fiduciary duties
- insider trading
- reporting of holdings and securities transactions
- the required pre-approval of trades
 - the Advisers Act requires pre-approval of only certain types of trades (private placements and IPOs)
 - advisers sometimes decide to require pre-approval of all trades or broader categories of trades

Insider Trading

- Registered advisers are required to adopt written policies and procedures reasonably designed to prevent the misuse of material, nonpublic information by the adviser or any associated person – IAA Section 204A
- Potential sources of material, nonpublic information in private equity context:
 - PIPEs investments
 - Sales of technology
 - Privately negotiated transactions with public companies
- Active compliance program
 - Develop system to regularly monitor watch and restricted lists, examine trading activity and seek explanations for unusual trades
 - Maintain effective information barriers within firm
- Regular training and educational efforts
 - Build sensitivity to what may be inside information
 - Stress importance of maintaining confidentiality
 - Emphasize awareness of consequences of using inside information to trade



Additional Issues and Requirements Applicable for Registered Advisers

Custody

- Rule 206(4)-2 under the IAA (known as the “Custody Rule”) regulates the custody practices of registered investment advisers
- The Custody Rule defines custody as “holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them”
 - Custody includes acting in any capacity (e.g., general partner of a limited partnership) that gives an adviser, or supervised person, legal ownership or access to client funds or securities
- The SEC amended the Custody Rule in 2009 adding new requirements for registered investment advisers with custody of client assets
 - Generally, advisers must maintain client funds and securities with a qualified custodian, custodian must send quarterly statements and adviser must undergo an annual surprise examination by an independent accountant registered and inspected by the Public Company Accounting Oversight Board (“PCAOB”)
 - Alternative for advisers’ funds: (i) fund must be subject to an annual financial statement audit by an independent public accountant registered with and inspected by PCAOB; and (ii) fund must distribute audited financial statements prepared in accordance with GAAP to investors within 120 days of fiscal year end (180 days for funds of funds); non-privately offered securities must be maintained with a qualified custodian

Advisory Contracts/Limited Partnership Agreements

General Provisions Impacted by SEC Regulation

- Ability to engage in principal or agency transactions when it or an affiliate is a counterparty
- Ability to engage in transactions involving potential conflicts of interest (principal transactions, use of affiliates)
- Standard of care/indemnification
- Compensation
- Assignment and termination
- Disclosure of changes in ownership if adviser is a partnership or LLC

Advisory Contracts/Limited Partnership Agreements (cont.)

Assignment and Change of Control

- Assignment occurs when there is a change in control of the ownership of the adviser
 - Change of control involves the transfer of a controlling block of voting securities (generally 25% or more)
- Unless client consents
- Otherwise, upon assignment contract is voidable

Advisory Contracts/Limited Partnership Agreements (cont.)

Liability

- “Hedge clauses”
 - A contractual provision under which a client agrees to indemnify and hold harmless an adviser from liability arising out of a service agreement, except to the extent a claim is based upon the service provider’s gross negligence, recklessness, or willfully improper or illegal conduct
- Issues with hedge clauses
 - A hedge clause may be problematic from a regulatory prospective if it is likely to lead an advisory client to believe that he/she has waived rights of action against the adviser that are provided by U.S. federal or state law that *cannot* be waived legally, e.g., a right to assert a claim against an adviser for a fraudulent act
 - *Heitman* No-Action Letter

Advisory Contracts/Limited Partnership Agreements (cont.)

Fees

- Reasonable fees
- Fee structure cannot impose a penalty on a client for deciding to terminate the adviser's services
- Performance fees
 - Prohibition and exceptions
- Existing Rule 205-3 "qualified client" exception
 - At least \$750,000 under management or at least \$1.5 million net worth
 - "Qualified purchaser" OR
 - Qualified employee or officer of adviser

Qualified Client Changes

- Dodd-Frank requires the SEC to adjust any dollar amount used for determining “qualified client” status for inflation:
 - By July 21, 2011, and
 - Every five years thereafter
- Issues and questions resulting from change:
 - It is unclear whether an adviser may continue charging a performance fee or incentive allocation with respect to an investor that is no longer a “qualified client” as a result of the initial or a subsequent adjustment
 - Generally, not an issue for 3(c)(7) “qualified purchaser” funds because “qualified purchasers” are automatically “qualified clients”

Advertising and Performance

- In essence, any print, electronic (including websites), broadcast or written communication addressed to *more than one person* (or used more than once) that offers investment advisory services with regard to securities is advertising
 - Generally, pitchbooks and other marketing materials are considered advertisements
- Core principle is that the advertisement cannot be false or misleading
- Specific rules apply to certain specialized forms of marketing, especially performance presentations:
 - model and “back-tested” performance
 - gross of fees performance
 - past specific recommendations – “cherry picking”
- Performance advertising
 - Include applicable disclosures
 - Requires maintenance of back-up to support performance data
 - “necessary to form the basis for or demonstrate the calculation of the performance”
 - internal account statements and worksheets
 - prepared contemporaneously with the period reported
 - third-party records (e.g., custodial and brokerage statements)
- Not an exception to general solicitation

SEC Pay-to-Play Rule

- On June 30, 2010, the SEC unanimously adopted Rule 206(4)-5
 - Effects of the rule:
 - If “covered associate” makes a “contribution” to an “official” of a “government entity” with intent to influence award of advisory contract or investment in a fund, 2-year time out
 - Limited exception for *de minimis* contributions
 - No coordination of contributions
 - Prohibition on third-party solicitors that are not registered investment advisers or broker-dealers
 - Prohibition on solicitation and bundling
 - The rule became effective September 13, 2010
 - Compliance with prohibition on contributions is required by March 14, 2011
 - Compliance with prohibition on third-party solicitors is effective on September 13, 2011
- Many states and local governments also have pay-to-play and related restrictions in place (including NY)

Recordkeeping

- Key advisory records must be kept for a minimum of 5 years, the first 2 in an “easily accessible place” (6 years if client or fund is “plan assets” under ERISA). Required records include:
 - records related to the adviser’s own affairs (LP/LLC agreements, etc.)
 - fund offering and organizational documents
 - all correspondence with clients
 - a memorandum of each order given by the adviser for the purchase or sale of any security, including terms of order, who recommended transaction to the client, who placed order, account, date and broker-dealer
 - originals of all written communications (e.g., due diligence files) received relating to the placing or execution of any order to purchase or sell any security
- The recordkeeping rules focus on the *content*, rather than the *form*, of the record
- Any electronic or paper record whose *content* is covered by the rule must be retained

Conflicts of Interest

Overview

- Discretionary investment management of client accounts – whether pooled vehicles such as private equity funds or separate accounts – inevitably creates conflicts between the interests of the manager (including its principals, employees and affiliates) and the interests of the account holders (including investors in a private equity fund)
- An investment adviser is a fiduciary to its clients and has an affirmative duty to act in the best interests of its clients – even if that action would be adverse to the interests of the investment adviser
- Since private equity managers are investment advisers as defined in the Advisers Act, they are subject to the anti-fraud provisions of Section 206

Allocation of Investment Opportunities

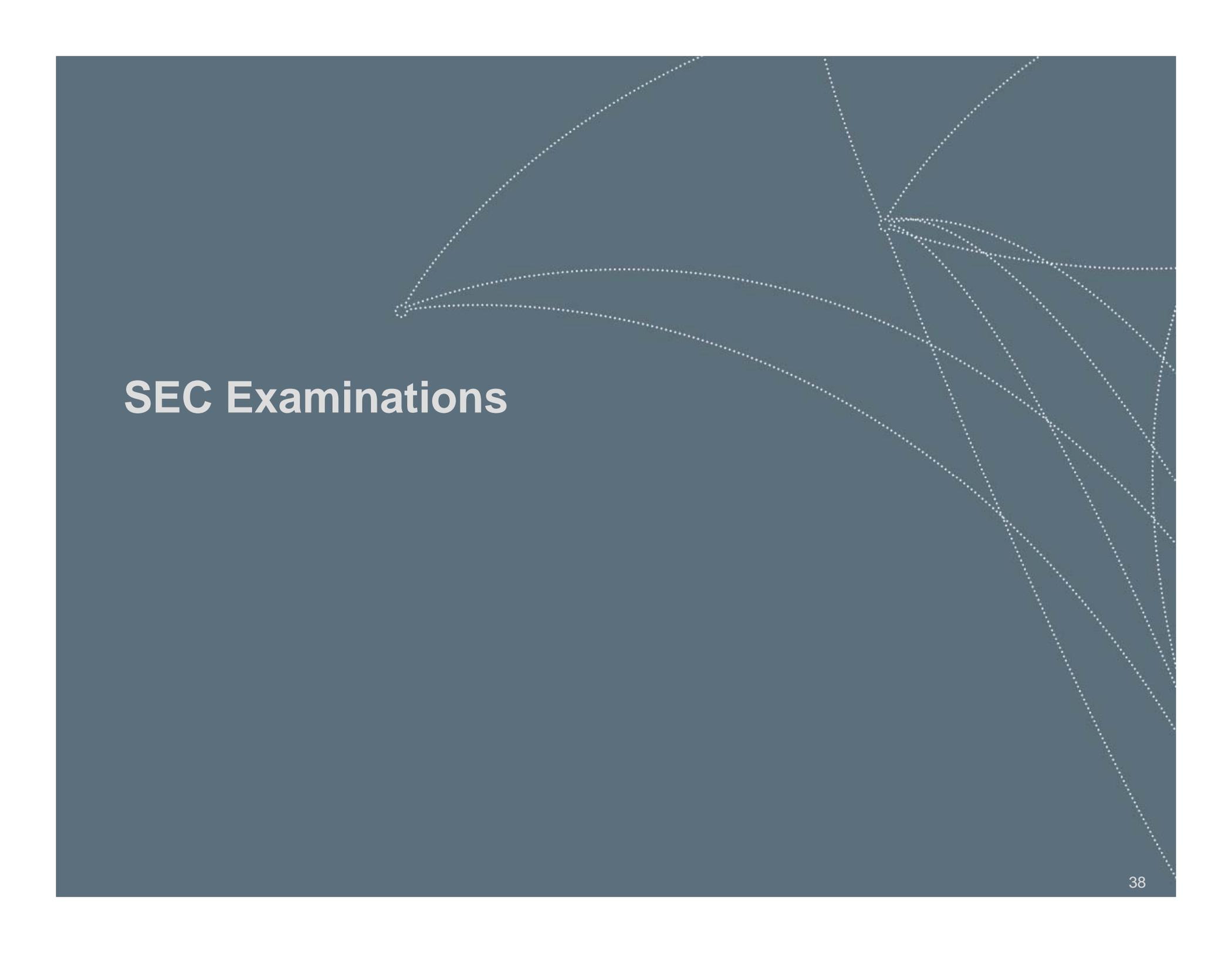
- Advisers must allocate investment opportunities among clients in a manner consistent with Section 206 of the Advisers Act
- The following factors have been identified in various releases by the SEC, in enforcement actions and by commentators as important in allocating investment opportunities among clients:
 - Adoption of a program or formula designed to ensure the fair and equitable allocation of investment opportunities among advisory clients
 - Consistent application of a program or formula in making allocation decisions (including, in particular, the absence of any indicia of discrimination toward particular categories of clients)
 - Documentation and review of the allocation decisions by the adviser and portfolio manager
 - Disclosure of allocation policies
- For PE managers, allocation issues arise when starting a new fund (and first fund isn't fully invested) and with respect to co-investment opportunities
- Two specific concerns relating to the side-by-side management of private funds and other investment accounts are cross-trades among accounts and favoring performance fee paying accounts

Principal Transactions

- *Principal Transaction* – a transaction in which an investment adviser, acting as a principal for its own account, buys securities from or sells securities to an advisory client
 - Requires prior client consent for each particular transaction
 - Cannot do principal transactions with a “plan assets” client or fund on one side without a prohibited transaction exemption
- The SEC staff has indicated that a principal transaction would include a transaction between a private fund, aggregately owned 25% or more by the fund’s investment adviser and its affiliates, and an advisory client of the adviser (such as another private fund managed by the same adviser)
 - *Gardner Russo & Gardner* No-Action Letter (pub. avail. June 7, 2006)
- Need mechanism within fund to provide approval – independent client representative or committee of limited partners

Cross Trades

- *Agency Cross Transaction* - A transaction for securities where an investment adviser acts for a client account on one side of a transaction and the adviser or its affiliate acts as broker for that client and another person on the other side of the transaction
- *Cross Trade* - A transaction for securities between two or more accounts, each of which is advised by the same investment adviser
- Effecting cross trades if no additional fee is charged other than advisory fee:
 - Must disclose to clients and generally must obtain general (not transaction-specific) prior consent
 - Must ensure “best execution” and that no client is disfavored
 - Use of independent pricing mechanism
- Additional rules apply if fees are charged



SEC Examinations

How to Handle an SEC Examination

- What is an SEC examination?
 - Assessment of compliance program
 - Interviews
 - Document review
- Office of Compliance Inspections and Examinations (OCIE)
 - Risk-based examinations
- Types of examinations
 - Routine – high risk cycle and low risk cycle
 - For Cause – driven by a firm-specific issue
 - Sweep – driven by an industry issue
- Possible outcomes of an examination
 - “Clean” closing letter
 - Deficiency letter
 - Enforcement referral

Handling Document Production

- The document request letter
- Organizing the production of documents
- Responding promptly
 - Rolling production
- Reviewing documents before production
 - Privilege
 - Understanding your exposure
- Freedom of Information Act (FOIA)
 - Scope
 - Confidentiality request
- Negotiating the scope of the SEC's request

Preparing Your People

- “Tone at the top” – the SEC’s mantra
 - How to show the right tone
- Preparing your personnel for an examination
 - Preserving and producing documents
- Preparing your personnel for SEC interviews
 - Answering directly, calmly, honestly, politely
 - Staying on topic
 - Addressing any issues up front
- Managing the interview process
- The importance of training

Handling the SEC Staff

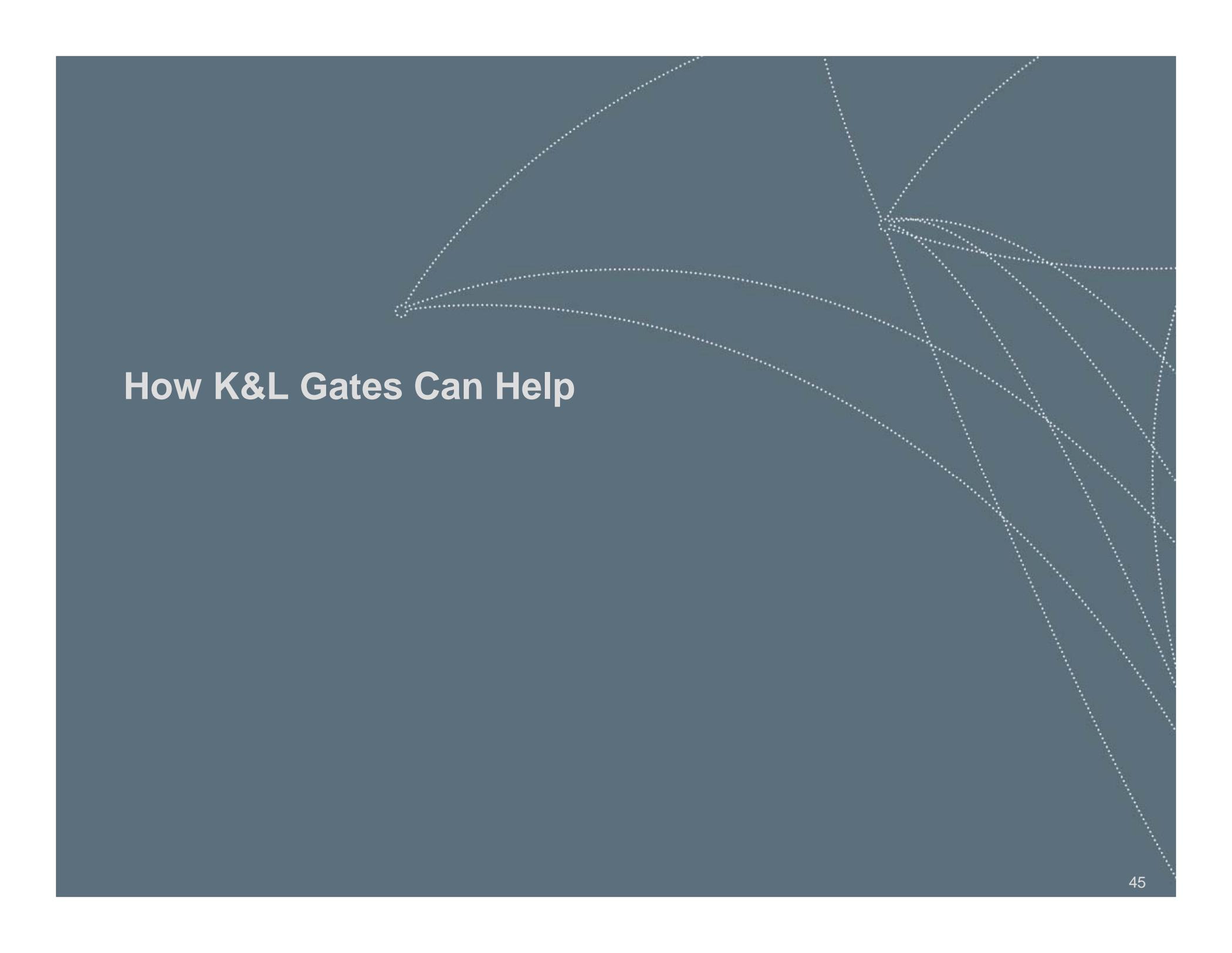
- Managing the staff's presence in your office
 - Interacting with the staff
 - Where to set them up
- Managing the process
 - Appoint a coordinator
 - Present the senior management first
 - Coordinator is present for all interviews
 - Keep it moving along
- The importance of honesty and keeping your promises
 - Embodying the compliance culture
- Arguing your case without alienating the staff

Responding to a Deficiency Letter

- The importance of responding:
 - Otherwise, the staff considers its assertions uncontested
 - Potential for referral to enforcement
- Decide which cited deficiencies to accept and which to contest
- For those you contest, clearly set forth your reasons:
 - legal arguments and interpretations of relevant authorities
 - set the factual record straight, diplomatically but clearly
- For those you accept:
 - Explain mitigating circumstances
 - Set forth remedial measures that you will take
- Keep your promises

Handling Violations

- The goal: deal with potential violations without creating a roadmap to an enforcement action
- Think strategically about the “audit trail”
 - How will it appear to the SEC after the fact?
 - Does it commit my firm to any specific actions?
- The 5-step program:
 - Investigate
 - Deliberate
 - Judge carefully
 - Reflect on lessons learned
 - Try to prevent future issues

The background of the slide is a dark blue color. On the right side, there are several white dotted lines that form a complex, abstract pattern of overlapping curves and straight lines, resembling a stylized leaf or a network of paths.

How K&L Gates Can Help

K&L Gates' Investment Adviser Regulatory Practice

- We have one of the largest, deepest, most experienced investment adviser regulatory practices in the U.S., with over 50 lawyers in Boston, Chicago, DC, NY and SF, many of whom are former SEC staff
 - We have wide-ranging experience in providing regulatory counseling on all issues and preparing regulatory filings and compliance programs for every type and size of investment adviser, including private equity managers
 - We also represent and counsel advisers during regulatory enforcement proceedings and examinations, and we perform “mock” SEC and compliance control examinations
- We are one of the few law firms with both a nationally ranked IM practice and a nationally ranked PE practice, giving us exceptional insights into PE managers, PE funds and PE deals and how regulation will impact them

Panelists



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AREAS OF PRACTICE

He has built a practice focusing on investment funds, hedge fund formation and private equity partnerships and joint ventures. He has significant experience in all types of flow-through entities and worked with clients ranging from small start-ups to billion dollar investors and entities.

Mr. Bernhart's practice emphasizes:

- Fund formations and structuring
- Business and partnership transactions

PROFESSIONAL/CIVIC ACTIVITIES

- Tarrant County Bar Association

BAR MEMBERSHIP

Texas

EDUCATION

J.D., Vanderbilt University, 1987 (Order of the Coif, Phi Beta Kappa, Beta Gamma Sigma)

M.B.A., Vanderbilt University, 1987

B.A., Indiana University, 1982 (*with distinction*)

ACHIEVEMENTS

Mr. Bernhart was named in "Top Lawyers in Fort Worth", *Fort Worth Magazine*, 2005.

REPRESENTATIVE EXPERIENCE

- Represents the world's largest private global real estate opportunity fund through five funds
- Represents global real estate opportunity fund formed by a major international bank with a \$1.2 billion established portfolio and \$360 million in a new fund, as well as their follow-up fund
- Represents a \$100 million mezzanine investment fund
- Represents several small to mid-sized investment funds and hedge funds
- Successfully negotiated with some of the largest fund investors in the country and their counsels
- Created and implemented complex structures in many of the large funds to meet tax and investor needs
- Provide counseling and advice to fund managers with respect to funds represented as well as advice to private individual clients and groups investing in other funds



Cary J. Meer

AREAS OF PRACTICE

Ms. Meer is a partner in K&L Gates' Washington, D.C. office and a member of the Investment Management practice group. She focuses her practice on private investment companies, including hedge and private equity funds, negotiated mergers and acquisitions of investment advisers and broker-dealers, derivatives and related areas.

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Ms. Meer structures private funds as limited liability companies, limited partnerships, common trust funds and business trusts, and prepares disclosure documents and organizational documents for such entities. She also advises investment advisers, private fund managers and investment companies on compliance issues, including under the Investment Advisers Act of 1940 and whether their futures-related trading or advice brings them within the regulatory structure of the Commodity Exchange Act and, if so, with respect to their obligations under the regulations of the Commodity Futures Trading Commission and the National Futures Association.

Ms. Meer also represents financial institutions with respect to private fund offerings and strategic alliances, counsels clients regarding federal securities law matters (for example, insider trading and short-swing profits issues), and structures employment arrangements and stock-based executive compensation programs.

PROFESSIONAL/CIVIC ACTIVITIES

- 100 Women in Hedge Funds, Washington, D.C. Education Committee
- Money Manager's Compliance Guide, Editorial Advisory Board Member
- Managed Funds Association, Member

BAR MEMBERSHIP

District of Columbia

New York

EDUCATION

J.D., Harvard Law School, 1982 (*cum laude*)

B.S., University of Pennsylvania (1979) (*summa cum laude*)



Mark D. Perlow

AREAS OF PRACTICE

Mr. Perlow's practice focuses on investment management and securities law. He regularly represents mutual funds, hedge fund managers, investment advisers, fund boards of directors, and broker-dealers on a variety of regulatory and transactional matters. He has represented clients on a broad range of traditional and novel matters, including:

- Representing funds, investment advisers, and broker-dealers before the SEC and FINRA in connection with registration, exemptive applications, no-action and interpretive requests, enforcement actions, examinations, and transactional and disclosure filings
- Forming and reorganizing mutual funds as well as preparing and negotiating the full range of fund documents and agreements
- Structuring and forming hedge funds
- Counseling and negotiating agreements for funds, investment advisers and broker-dealers on issues arising from distribution (including retirement plan issues) and on counseling on regulatory issues in marketing and advertising
- Representing and advising fund independent directors
- Serving in interim role as chief legal officer for major investment manager and mutual fund sponsor
- Advising and assisting clients on adviser and fund mergers, acquisitions and adoptions
- Conducting "mock" SEC examinations and compliance reviews
- Advising funds on legal and regulatory aspects of derivatives, short selling, and market structure
- Counseling clients on "investment company," "investment adviser" and "broker-dealer" status issues
- Representing and advising the Investment Company Institute on regulatory policy recommendations and preparing related SEC submissions
- Preparing comments on SEC rule-making
- Advising fund sponsors and investors on regulatory and market issues posed by exchange-traded funds
- Serving as expert witness on industry practices
- Counseling clients on compliance with the Dodd-Frank and Sarbanes-Oxley Acts
- Advising clients on fiduciary duties and corporate governance, including proxy voting responsibilities
- Advising and assisting fund sponsors on new investment vehicles, including funds of hedge funds, alternative strategy mutual funds, 130/30 funds, employees' securities companies, manager-of-managers funds, stable value funds and basket depository receipts

PROFESSIONAL BACKGROUND

Mr. Perlow served as senior counsel in the Office of the General Counsel of the Securities and Exchange Commission from 1998 to 1999, focusing on investment

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management, fund and corporate governance, and enforcement. He also served in the SEC's Division of Enforcement from 1994 to 1997. While on the SEC staff, Mr. Perlow worked on regulatory initiatives on fund governance, the scope of the securities laws online, codes of ethics, personal trading of investment personnel, and foreign custody of fund assets, and he advised the SEC on enforcement actions involving funds and investment advisers.

He also served as senior attorney on a number of enforcement actions and investigations, including the W.R. Grace 21(a) Report on independent directors' duties, and cases involving accounting fraud, market manipulation, insider trading, and broker-dealer sales abuses. Prior to government service, Mr. Perlow was associated with a California law firm and represented technology companies on corporate, securities, and intellectual property matters.

PROFESSIONAL/CIVIC ACTIVITIES

- American Bar Association (Member of Committee on Federal Regulation of Securities and Subcommittee on Investment Companies and Investment Advisers, Task Force on Investment Company Use of Derivatives and Leverage)
- Federal Bar Association
- Hedge Funds Care, West Coast Committee
- West Coast '40 Acts Group
- National Investment Company Service Association (West Coast Steering Committee)
- Adjunct Faculty, U.C. Berkeley School of Law, "Capital Markets and Financial Institutions: Crisis and Regulatory Response," Fall 2009 and 2010

BAR MEMBERSHIP

California
District of Columbia

EDUCATION

J.D., Yale Law School, 1991 (Executive Editor, *Yale Journal on Regulation*, Olin Fellow in Law, Economics and Public Policy)
M.A., Oxford University, 1988 (Newton-Tatum Scholar)
A.B., University of California, Berkeley, 1986 (*summa cum laude*)

PUBLICATIONS

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PRESENTATIONS

Mr. Perlow is a frequent speaker and panelist on subjects related to the investment management industry. His recent presentation topics include:

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- regulatory initiatives regarding hedge funds, private equity funds and their managers
- regulation of derivatives and funds' use of derivatives
- regulation of portfolio management and investment risk

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Additional Materials

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SEC and CFTC Propose New Forms to Gather Data on Systemic Risk Potentially Presented by Private Funds

As directed by the Dodd-Frank Act, the Securities and Exchange Commission and the Commodity Futures Trading Commission on January 26, 2011 jointly proposed new Form PF, which they would use to gather information aimed at evaluating the degree of “systemic risk” presented by certain types of private funds whose managers were either registered with the SEC or jointly registered with the SEC and the CFTC. On the same day, the CFTC also proposed new Form CPO-PQR and Form CTA-PR, which would solicit from commodity pool operators (“CPOs”) and commodity trading advisors (“CTAs”) that are registered with the CFTC, but not the SEC, information generally identical to that sought through Form PF.¹ Proposed Form PF encompasses over 60 categories of questions and would collect from private fund managers information unprecedented in its scope and detail.²

Information gathered through these forms would be used primarily by staff of the Financial Stability Oversight Council (“FSOC”), which is charged by Dodd-Frank with (among other matters) determining whether certain non-bank financial institutions should be designated for supervision by the Board of Governors of the Federal Reserve because of the risk they are deemed to present to the nation’s financial stability in the event of material financial distress or failure or because of their activities. The Dodd-Frank Act also directs the FSOC to recommend to the Federal Reserve Board “heightened prudential standards” for designated non-bank financial companies. The SEC/CFTC release further notes that the information gathered would also be available to the Commissions’ staff for use in examinations, investigations and enforcement actions. As discussed in more detail below, the SEC and CFTC indicated their intention to keep confidential the information gathered under the new forms.

Who Would Have to File?

Proposed Rule 204b-1 under the Investment Advisers Act of 1940 (and proposed Rule 4.27 under the Commodity Exchange Act, for dual registrants), which would implement the new reporting requirements, would require all registered advisers

¹ The CFTC was not required under the Dodd-Frank Act to gather such information from CPOs and CTAs. The CFTC’s stated reasons for proposing the new forms are to bring the CPO and CTA regulatory structure into alignment with the purposes of the Dodd-Frank Act, to encourage more congruent and consistent regulation of similarly situated entities, to improve accountability and increase transparency of the activities of CPOs and CTAs and to facilitate the FSOC’s collection of data. Because of the similar purposes and nearly identical content of Forms PF, CPO-PQR and CTA-PR, this alert will focus on describing Form PF.

² The SEC also has proposed amendments to Item 7.B of Form ADV, Part 1 that would require private fund advisers to report detailed, and in some cases overlapping, information about their private funds’ investment activities and service providers, adding to the scope and scale of new information that private fund managers would have to file with the SEC. For more information on this proposal, see our alert *SEC Proposes New Reporting Requirements for Private Fund and Other Advisers* [here](#).

that advise one or more private funds to file a Form PF.³ Advisers solely to private funds with less than \$150 million in assets in the aggregate are exempt from SEC registration and thus would be excluded from the reporting requirement, as would advisers that manage only venture capital funds and foreign private advisers.⁴

The reporting obligation is proposed to be tiered, based on assets under management, and would focus on three types of private funds – hedge funds, liquidity funds (essentially unregistered money market funds) and private equity funds. At least annually, all reporting entities would have to complete Section 1 of the form, which seeks aggregate information about the management complex and separate information about each private fund that the manager advises.⁵ A private fund is defined as any fund that would be deemed an “investment company” under the Investment Company Act of 1940, but for the exclusions contained in Sections 3(c)(1) or 3(c)(7).⁶ Most private fund advisers would have to file only Section 1 of Form PF and an annual amendment within 90 days after the end of the adviser’s fiscal year. However, “Large Private Fund Advisers” to hedge funds, liquidity funds and private equity

³ Private fund advisers that are registered as CPOs and CTAs would only have to file Forms PF, CPO-PQR or CTA-PR if they have \$150 million or more in assets under management.

⁴ However, the release notes that advisers with individual client assets in excess of \$100 million are not exempt from SEC registration and would have to report on any private funds they manage, no matter how small.

⁵ Sections 1 and 2 of Form PF are being proposed jointly by the SEC and the CFTC and Sections 3 and 4 by the SEC only. Because commodity pools that meet the definition of “private fund” are categorized as hedge funds for purposes of Form PF, CPOs and CTAs that are also registered with the SEC as investment advisers would have to file Sections 1 and 2 of Form PF. In so doing, they would satisfy the CFTC requirement to file Schedules B and C of proposed Form CPO-PQR and Schedule B of proposed Form CTA-PR. Irrespective of their filing a Form PF with the SEC, all private fund advisers that are registered with the CFTC as CPOs and CTAs would be required to file Schedule A of proposed Forms CPO-PQR and CTA-PR.

⁶ Section 3(c)(1) excludes from the definition of investment company a fund with 100 or fewer investors that has not made, and does not propose to make, a public offering of its securities. Section 3(c)(7) excludes a fund all of whose investors are qualified purchasers and that has not made, and does not propose to make, a public offering of its securities.

funds – advisers whose private fund assets aggregate \$1 billion or more (measured variously, depending on the type of fund; see below) – would be required to complete additional sections of Form PF and to file within 15 days of the end of each calendar quarter.⁷

In making the calculation to determine whether an adviser crosses this \$1 billion threshold, a manager would have to aggregate parallel managed accounts (*i.e.*, accounts that pursue substantially the same investment objective and strategy and invest in substantially the same positions as the private fund), as well as assets of that type of private fund advised by any of the adviser’s “related persons” (essentially, all of the adviser’s officers, partners, directors and non-clerical employees, and all persons and entities directly or indirectly controlling, controlled by or under common control with the adviser). The adviser would be permitted, but not required, to report the private fund assets that it and its related persons manage on a single Form PF. For funds that are sub-advised, only one adviser would have to report information regarding that fund on its Form PF. Advisers whose principal office and principal place of business are outside the U.S. would be permitted to disregard any private fund that, during the adviser’s last fiscal year, was neither a U.S. person nor offered to, or beneficially owned by, any U.S. person.

Information Required of All Reporting Advisers

Because the form is intended primarily to identify potential sources of systemic risk, the questions reflect a concern with relationships that could cause a failure at a private fund to spread to other financial institutions. Reflecting both this purpose as well as the need for international coordination, the SEC and CFTC consulted with both the FSOC and the U.K. Financial Services Authority (“FSA”) in developing the questions in the form; the FSA conducts a semi-annual survey of the largest hedge fund managers based in the U.K., and Form PF would request many of the same types of information.

⁷ An adviser also would be required to file Form PF to report that it is transitioning from filing quarterly to annually or from filing to not filing because it no longer meets the appropriate threshold.

All reporting advisers would be required to complete Section 1 of Form PF, which has three parts. Section 1a would require census-type information of each adviser, including identifying information and aggregate data about the adviser's private funds, including gross and net assets and the amounts attributable to hedge, liquidity, private equity, and other types of private funds. Section 1b would require reporting similar information for each private fund advised by the reporting adviser, including (1) the gross and net asset values of the fund; (2) the amount of any borrowings, broken down by whether it comes from U.S. financial institutions, non-U.S. financial institutions, or entities that are not financial institutions; (3) the identity of any creditor whose loans equal at least 5% of the fund's net asset value; (4) the notional value of all derivative positions (without netting long and short positions); (5) the total number of beneficial owners; (6) the percentage of the fund's equity that is owned by the five largest equity holders; and (7) fund performance information. An adviser would have to file a separate Section 1b for each private fund it advises.⁸

Section 1c would seek more detailed information only about the adviser's hedge funds, including (1) their investment strategies; (2) their use of computer-driven algorithms; (3) the trading counterparties to which the reporting fund has the greatest net counterparty exposure; and (4) the volume of their trading and clearing of securities, derivatives and repurchase agreements.

Hedge Funds

Advisers whose hedge fund assets under management are in the aggregate at least \$1 billion *on any day during the reporting period* would have to file Section 2 of Form PF on a quarterly basis.⁹

⁸ Note that the instruction appears to call for advisers to complete Section 1b for *all* of their private funds, whether or not they are hedge funds, liquidity funds or private equity funds.

⁹ Although the term "hedge fund" conceivably includes liquidity funds, the release does not clarify whether a manager's liquidity funds should be included in this threshold calculation. The SEC may believe that elements of its definition of "hedge fund" (see below) are mutually exclusive with a liquidity fund's

The form would define a "hedge fund" as any private fund that (1) has a performance fee or allocation calculated by taking into account unrealized gains; **or** (2) *may* borrow an amount in excess of one-half of its net asset value (including any committed capital) or may have gross notional exposure in excess of twice its net asset value (including any committed capital); **or** (3) *may* sell securities or other assets short. The release notes that in performing these calculations, the fund should not net long and short positions and that it should include any borrowings or notional exposure of another person that the fund may be obligated to satisfy. Note that by using the word "may" in the definition, the form could be read to include as hedge funds any private funds that may have written their investment parameters broadly, even if they do not currently engage in the specified activities.

Section 2a of the form would require all such large hedge fund managers to provide on an aggregate basis (1) a detailed breakdown of long and short positions by asset type; (2) the duration of fixed income holdings; (3) the funds' aggregate turnover rate; and (4) the geographical breakdown of portfolio assets. The adviser would be required to file a separate Section 2 for each hedge fund it manages. To give a sense of the detail potentially requested, the portion of the form asking for positions by asset type provides for over 80 reporting categories.

Section 2b of the form would require reporting more detailed fund-by-fund information for each "qualifying hedge fund," *i.e.*, a fund with at least \$500 million in assets. In determining whether a hedge fund is "qualifying," the adviser would have to aggregate parallel funds (including parallel private funds managed by related persons), parallel managed accounts, and funds that are part of the same master-feeder arrangement. The definition of parallel fund or account as one that pursues *substantially* the same investment objective and strategy and invests side-by-side in *substantially* the same positions as a private fund will likely generate comments regarding what constitutes "substantial" similarity, because a finding that they are parallel to a qualifying hedge fund will trigger the need to

objective of maintaining a stable net asset value or minimizing principal volatility.

aggregate the fund and the parallel accounts for reporting purposes, potentially compelling more burdensome reporting.¹⁰ Section 2b is the longest part of the form and requests information regarding a fund's (1) liquidity, (2) position concentration, (3) collateral arrangements with significant counterparties, and (4) the identity of, and clearing relationships with, the three central clearing counterparties to which the fund has the greatest net counterparty credit exposure (*i.e.*, prime brokers).

In what is likely to be one of the most controversial aspects of the proposal, Section 2b would require the adviser to report certain risk metrics for each qualifying hedge fund, *but only if the adviser regularly calculates them anyway*. If the adviser regularly calculated value at risk ("VaR") for the fund, it would have to report VaR for each month of the reporting period. There is debate regarding the effectiveness of VaR as well as its role in the lead-up to the financial crisis: some critics believe that risk managers took too much comfort from a flawed metric. Since reporting VaR is required only if it is calculated, this question might encourage some fund managers not to use VaR.

In addition, the adviser would have to report the impact on the portfolio of a number of specified potential changes in market factors (*e.g.*, equity prices increase/decrease by 5% or 25%; credit spreads increase/decrease by 10 bps or 300 bps, etc.) – a form of stress testing – if regularly "considered" in the fund's risk management. The instructions imply that a manager is to report the results of stress testing with regard to variations in such elements "whether [the element is considered] in formal testing or otherwise..." The only other choice is to check a box indicating that the particular market factor "is not relevant to the reporting fund's portfolio." The choice of wording here seems intended to steer hedge fund managers toward periodic evaluation of the listed risk parameters. While the purported purpose of Form PF is to gather

¹⁰ It is conceivable that a hedge fund manager would manage a single qualifying hedge fund but not manage funds that, in the aggregate, have at least \$1 billion of assets. The release does not address this situation in so many words, but the clear implication is that such a manager would not have to complete Section 2, and therefore would not have to report in detail with respect to its single qualifying hedge fund. Contrast this with the situation described in footnote 4, above.

information and not change substantive behavior, the questions on stress testing in Section 2 ultimately may push managers of large hedge funds towards a particular regimen of stress testing.

Although the proposing release asks for comment on whether hedge funds present systemic risk, it states that the SEC's and CFTC's "initial view" is that they do and notes that they believe that Congress intended that hedge funds would be required to report systemic risk information. Citing research from academics and the Federal Reserve Board as well as the report of the President's Working Group on Financial Markets on the lessons learned from the near collapse of Long Term Capital Management in 1998, the release notes five reasons why the Commissions believe that hedge funds might present systemic risk:

- Hedge funds may be important sources and users of liquidity in certain markets.
- Hedge funds employ investment strategies that may use leverage, derivatives, complex structured products, and short selling.
- Hedge funds often use financial institutions that may have systemic importance to obtain leverage.
- Hedge funds may also employ strategies involving high volumes of trading and concentrated investments.
- The simultaneous failure of several similarly positioned hedge funds could create contagion through the financial markets if the failing funds liquidate their investment positions in parallel at fire-sale prices.

While industry comment cannot eliminate all types of systemic risk reporting requirement, since it is required by Dodd-Frank, convincing data or comments showing that hedge funds do not present certain of these risks in a *systemic* way could lead the SEC and CFTC to scale back the proposal.

Liquidity Funds

Proposed Form PF would define a "liquidity fund" as a private fund that seeks to generate income by investing in a portfolio of short-term obligations to maintain a stable net asset value per unit or to minimize principal volatility for investors. The

proposing release notes that liquidity funds can resemble registered money market funds and suggests that they present similar systemic risks. Managers of liquidity funds would be required to complete Section 3 of Form PF and file it quarterly if the aggregate assets under management in their liquidity funds and registered money market funds total at least \$1 billion *on any day during the reporting period*. The adviser would be required to complete a separate Section 3 for each liquidity fund it manages.

Section 3 would require the adviser to report whether a liquidity fund uses the amortized cost or penny rounding methods of valuation, which the release states could make the fund more susceptible to runs. It also would seek information on the extent to which the reporting liquidity fund follows investment policies akin to those specified in Rule 2a-7 (which governs the diversification, credit quality, liquidity and maturity of registered money market funds) and would seek information on the size and structure of the portfolio, as well as the maturity of portfolio holdings broken down by type of holding. Section 3 also would ask for data on secured and unsecured borrowing and the existence of committed liquidity facilities. Finally, it would seek information about the fund's investor base, including concentration of holdings, the percentage of the fund that represents securities lending collateral, and restrictions on redemption.

Again, the release asks whether liquidity funds actually do present systemic risk. It notes, in particular, a concern that such funds may experience investor runs in times of market dislocation, similar to the run that affected some registered money market funds in September 2008. It also notes, however, that liquidity funds, because they are not registered under the Investment Company Act 1940, may retain the right to suspend redemptions or "gate" investor withdrawals, and it asks whether these features sufficiently mitigate the potential systemic risk coming from such funds. The release notes that the definition of liquidity fund may inadvertently sweep into the reporting scheme managers of some short-term bond funds, and seeks comment on ways to minimize or eliminate that possibility.

Private Equity Funds

Proposed Form PF would define a private equity fund as a private fund that is not a hedge fund, liquidity fund, real estate fund, securitized asset fund or venture capital fund and does not provide investors with redemption rights in the ordinary course.¹¹ Managers of private equity funds would be required to provide the detailed information called for in Section 4 of Form PF and file quarterly if the aggregate assets of their private equity funds exceed \$1 billion *as of the last day of the reporting period*. The adviser would be required to complete a separate Section 4 for each private equity fund it manages.

The regulators' concerns about potential systemic risks presented by private equity funds focus on the ways that potential failures in financing leveraged buyouts could be transmitted to the larger financial system. The release notes in particular that private equity firms often rely on banks to provide bridge loans, and that a sudden turn in the market may leave the bank holding, or committed to provide, potentially risky bridge financing, with no way to syndicate the loan and no way for the borrower to refinance through the issuance of debt.

The SEC also raised concerns about private equity funds' possible involvement in the leveraged buyout of systemically important financial firms. The release notes that the leveraged buyout model may impose significant amounts of leverage on portfolio companies in an effort to meet investment return objectives, which "subjects those portfolio companies to greater risk in the event of economic stress." The release notes, however, that advisers to private equity funds have argued that certain features of private equity funds mitigate their potential to create systemic risk, notably their reliance on long-term capital commitments from

¹¹ Proposed Form PF would define "real estate fund" as any private fund that is not a hedge fund, that does not provide investors with redemption rights in the ordinary course and that invests primarily in real estate and real estate-related assets. It would define "securitized asset fund" as any private fund that is not a hedge fund and that issues asset-backed securities and whose investors are primarily debt holders. It would define "venture capital fund" as any fund meeting the definition found in proposed Rule 203(1)-1. See our alert *Advisers Act Registration Exemptions for Venture Capital Fund Advisers and Private Fund Advisers* [here](#).

investors, lack of substantial debt at the private equity fund level, and investment in a diverse range of companies.

The release does note that the SEC believes it appropriate to seek less detailed information from private equity funds than from other private funds, because the Commission believes that private equity funds present less potential risk to financial stability. Nevertheless, Section 4 would require the reporting of a great deal of data about not only the fund, but also its portfolio companies: it would seek information about the outstanding balance of the fund's borrowings and guarantees, and it would require the adviser to report the weighted average debt-to-equity ratio of controlled portfolio companies in which the fund invests and the range of that debt-to-equity ratio among these portfolio companies. Section 4 also would ask (1) for the maturity profile of a private equity fund's portfolio companies' debt, (2) for the portion of that debt that is payment-in-kind or zero coupon, and (3) whether the fund or any of its portfolio companies experienced an event of default on any of its debt during the reporting period. It also would ask for the identity of the institutions providing bridge financing to the adviser's portfolio companies and the amount of that financing.

Confidentiality

In the proposing release, the SEC and CFTC seek to address concerns in the private fund communities that the information to be reported in Form PF, if made public, would compromise their trading strategies and other trade secrets. The SEC states that it does not intend to make the information reported on Form PF public, and it points out that amendments to the Investment Advisers Act made by Dodd-Frank preclude the SEC from being compelled to provide the information on the form except to Congress and the FSOC under agreement of confidentiality. Dodd-Frank instructed the CFTC to maintain a similar degree of confidentiality for private fund information. While both regulators maintain internal rules and cultures intended to protect the confidentiality of registrant information, private fund managers might not take as much comfort if their Form PF filings were provided to Congress, which has different rules and a different culture.

The Role of the FSOC

At numerous points in the proposing release, the SEC and the CFTC state that they intend to defer to the FSOC to use the information on Form PF to determine whether a firm or industry presents risk to the nation's financial stability, stating that their own role was one of gathering primary data that the FSOC could use to screen entities and determine whether it required additional data from a particular private fund adviser.

Ultimately, the FSOC's role is crucial, and the SEC release must be read in context with the January 18, 2011 release from the FSOC, proposing standards on the basis of which it would determine whether particular non-bank financial companies – which could include private funds and their advisers – should be designated for supervision by the Federal Reserve Board, which could include bank-like prudential regulation such as capital and liquidity requirements. Under the FSOC's proposed rule, designation as a systemically important financial institution would require a two-thirds vote of the Council members (including the affirmative vote of the Council Chair, the Secretary of the Treasury), and would be based on a range of factors, most of which are dictated by the Dodd-Frank Act.¹²

Unfortunately, these factors are sufficiently broad and general that they provide almost complete discretion to the FSOC and little guidance or comfort to private fund managers or any other non-bank financial company. In addition, despite the SEC's and CFTC's deferential stances, public and political pressure might compel the two regulators to use the information in Form PF to perform their own systemic risk evaluations: given the criticism directed at the SEC after the failures of Bear Stearns and Lehman Brothers – two investment banks under SEC prudential supervision – the SEC will be wary about allowing another large financial institution under its supervision to have a potentially systemic impact should it fail. It is possible that the SEC's examination program for large private fund advisers in time could evolve towards a type of bank-like prudential regulation. One can also imagine

¹² For more information on the FSOC proposal, see our alert *Financial Stability Oversight Council Issues Proposal on Oversight of Nonbank Financial Companies* [here](#).

advisers coming under pressure, either regulatory or judicial, to publicize the results of their stress testing or the fact that they do not follow the SEC's proposed regimen of tests.

Request for Comment and Proposed Effective Date

Comments on the SEC's proposed rule and form are due 60 days after the proposal is published in the Federal Register, or April 12, 2011. In addition to the points noted above, the SEC is seeking comments on whether the data it proposes to collect, and the frequency with which it proposes to require reporting, are appropriate to the task of identifying the potential of the specified private funds to create systemic risk. The Commission also asks whether other types of private funds should be subject to reporting. The release states that the anticipated effective date of the rule would be December 15, 2011, with the first filing due from large fund advisers by January 15, 2012.

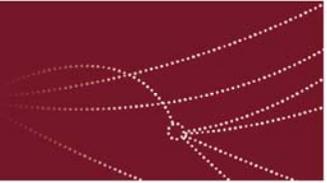
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Advisers Act Registration Exemptions for Venture Capital Fund Advisers and Private Fund Advisers: SEC's Proposed Rules Address Some Issues, But Many Remain

On November 19, 2010, the Securities and Exchange Commission issued a release proposing rules to implement and define the scope of two new exemptions from registration under the Investment Advisers Act of 1940.¹ Congress created or directed the SEC to create these exemptions in Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act, enacted on July 21, 2010. The Dodd-Frank Act exempts from registration, among others:

- an adviser solely to one or more venture capital funds (“Venture Capital Advisers”), and
- an adviser solely to one or more private funds with aggregate assets under management in the United States of less than \$150 million (“Private Fund Advisers”).

The release proposes rules and definitions that give substance to these exemptions and clarify the terms and methods of their application, but leave many issues unaddressed. Below we discuss each exemption and the proposed rules in the release relating to such exemptions.

Exempted advisers do not avoid new regulation entirely. We discuss below proposed reporting requirements that will be applicable to Venture Capital Advisers and Private Fund Advisers (referred to collectively in the release as “Exempt Reporting Advisers”) that were proposed in a separate release, also issued on November 19, 2010 (the “Reporting Release”), which addresses a broad range of changes to investment adviser registration and regulation as a result of the Dodd-Frank Act.²

I. Venture Capital Advisers

Section 407 of the Dodd-Frank Act creates a new Section 203(1) of the Advisers Act, which exempts Venture Capital Advisers from registration. The Dodd-Frank Act charged the SEC with defining the term “venture capital fund” within one year of the Act’s enactment. The release proposes a definition of “venture capital fund” and also proposes a broad grandfathering provision that would permit existing funds that

¹ *Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less than \$150 Million in Assets Under Management, and Foreign Private Advisers*, Investment Advisers Act Release No. 3111 (November 19, 2010), available [here](#). This release also addresses the Dodd-Frank Act’s exemption for foreign private advisers. For more information on the exemption for foreign private advisers, see K&L Gates’ alert on the subject, available [here](#).

² *Rules Implementing Amendments to the Investment Advisers Act of 1940*, Investment Advisers Act Release No. 3110 (November 19, 2010), available [here](#). For a more detailed discussion of these additional changes to investment adviser registration and reporting, see K&L Gates’ alerts on the subject, available [here](#) and [here](#), respectively.

meet certain requirements to be treated as venture capital funds even if they do not meet the proposed definition.

A. The Definition. The release proposes a new Rule 203(1)-1, which would define the term “venture capital fund” as a private fund that:

- owns only:
 - equity securities (which would include preferred stock and debt instruments convertible into equity) of “qualifying portfolio companies” (as defined in the release and discussed below), with at least 80% of the fund’s holdings of each qualifying portfolio company having been acquired directly from the issuer, and
 - cash and cash equivalents³ (meaning bank deposits, certificates of deposit, bankers acceptances and similar bank instruments) and U.S. Treasuries with a remaining maturity of 60 days or less;
- for each qualifying portfolio company, either directly or indirectly through its adviser:
 - has offered to provide, and if accepted does provide, significant guidance and counsel concerning the operations or business objectives and policies of the qualifying portfolio company, or
 - controls the qualifying portfolio company;
- does not incur leverage in excess of 15% of the fund’s aggregate capital contributions and uncalled capital (“Permitted Borrowing”), and limits Permitted Borrowing arrangements to a non-renewable term of no longer than 120 calendar days;

³ The rule defines “cash and cash equivalents” as having the meaning set forth in Rule 2a51-1 under the Investment Company Act of 1940. Rule 2a51-1 defines the phrase to include “bank deposits, certificates of deposit, bankers acceptances and similar bank instruments[.]” The instruments need not be “held for investment purposes” as provided in Rule 2a51-1. The proposed rule, in fact, places no limit upon the amount of or purpose for which a venture capital fund holds cash or cash equivalents.

- does not provide investors with redemption, withdrawal or repurchase rights, except in extraordinary circumstances; and
- represents itself to investors and potential investors as a venture capital fund.

“Qualifying portfolio companies” are companies that:

- are not publicly traded and do not control, are not controlled by, and are not under common control with a publicly-traded company, either directly or indirectly (but private companies that later go public will continue to qualify);
- do not incur debt in connection with the venture capital fund’s investment (*i.e.*, no buyouts of existing owners made with borrowed money);
- do not redeem, exchange or repurchase their securities or distribute cash or other assets to security holders in connection with the venture capital fund’s investment; and
- are not investment companies, private funds, issuers of asset-backed securities or commodity pools.

Under the proposed rule, a qualified portfolio company must not be publicly traded at the time of each investment made by the venture capital fund; however, a venture capital fund could continue to hold a qualified portfolio company’s securities once the company became public or otherwise subsequently failed to satisfy the definition.

B. Grandfathering Provision. The release proposes a broad grandfathering provision for existing funds that do not meet the criteria of the proposed definition. The grandfathering provision includes as an exempt venture capital fund an existing fund that:

- represented to investors at the time of sale of its securities that it was a venture capital fund;
- prior to December 31, 2010, sold securities to one or more investors that are not “related persons” of any adviser to the private fund; and
- does not sell securities to any person after July 21, 2011.

Given the broad scope of the grandfathering relief, the proposed rule would make the Venture Capital Advisers exemption primarily forward-looking in application.

C. Key Issues.

1. *Bridge Financing.* Under the proposed rule, a venture capital fund could not make any loans to a portfolio company, including short-term loans for bridge financing or other purposes, unless the debt was convertible into equity. It is not uncommon, however, for venture capital funds to provide bridge or other loans to portfolio companies, in some cases as convertible debt and in other cases as pure debt. The SEC specifically requests comment on whether it should permit a venture capital fund to provide loans to portfolio companies in exchange for debt other than convertible debt.
2. *Managerial Assistance or Control.* A venture capital fund would have to either (i) offer to provide to a portfolio company, and if the offer is accepted would have to provide, “significant guidance and counsel concerning the operations or business objectives and policies” of the portfolio company, or (ii) control the portfolio company. The release does not clarify what level of involvement in a portfolio company’s operations and which activities constitute “significant guidance and counsel.” It states that “managerial assistance generally takes the form of active involvement in the business operations or management of the portfolio company, or less active forms of control.” Many venture funds monitor their portfolio company investments and assist portfolio companies largely or solely through minority board representation, rather than taking an active role in day-to-day management. It is uncertain whether board representation alone would be deemed “significant guidance and counsel.”

In addition, the proposed rules provide that each venture capital fund investing as part of a group would each need to offer to provide the requisite guidance and counsel individually, meaning no member of an investing group of venture capital funds can rely on another to satisfy this obligation. This requirement would complicate group investing by venture funds. Although the SEC states in the release that group investing is

a feature of later-stage private equity vehicles, venture fund group investing is common. Therefore, the SEC’s definition could exclude many venture capital funds that participate in portfolio company investments with other venture capital funds.

3. *Portfolio Company as Investment Company.* The proposed rule expressly requires that a qualifying portfolio company not be an investment company or a “private fund,” meaning an entity that relies on the exemptions from investment company status in either Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940. On occasion, a venture-stage company may inadvertently fall within the definition of an investment company by virtue of its cash management investments pending its use of capital in operations or for research and development. Under the proposed rule, a venture capital fund must make certain that a potential portfolio company either is not within the definition of an investment company or can rely on an exemption from registration other than those in Section 3(c)(1) or 3(c)(7) (such as Rules 3a-1 and 3a-8).
4. *Restricted Ability to Manage Cash.* The proposed rules significantly limit the types of cash management instruments an exempted venture capital fund may use. A venture capital fund is permitted to invest only in cash and cash equivalents and U.S. Treasuries with a remaining maturity of 60 days or less. This requirement fails to include a variety of instruments venture capital funds currently use to invest cash temporarily, such as money market mutual funds.
5. *Opt-Outs and Other Non-Traditional Venture Fund Structures.* The SEC’s proposed definition of “venture capital fund” envisions a traditional venture capital fund. The SEC intentionally chose not to include venture capital funds of funds within the definition. The release does not indicate, however, how the SEC would treat less traditional venture fund structures, such as pledge funds or other vehicles in which investors have opt-out rights on an investment-by-investment basis. It is possible that the SEC would look through these types of vehicles as facilitating individual investments and require the adviser to treat each

investor as a client, making the exemption for Venture Capital Advisers unavailable.

6. *Redemptions.* The proposed definition of venture capital fund does not define “extraordinary circumstances” under which redemptions are permissible, but the release provides some guidance. The release states that “a fund that permits quarterly or other periodic withdrawals would be considered to have granted investors redemption rights in the ordinary course even if those rights may be subject to an initial lock-up or suspension or restrictions on redemption.” A change in law after an investment, however, could justifiably be deemed extraordinary circumstances, since such an event is “beyond the control of the adviser and fund investor[.]”
7. *VCOC Status.* Nothing in the proposed definition of “venture capital fund” would appear to conflict with such a fund constituting a venture capital operating company (or “VCOC”) for purposes of the Employee Retirement Income Security Act of 1974. In fact, the proposed definition appears narrower than the requirements for VCOC status.

II. Private Fund Advisers

The Dodd-Frank Act creates a new Section 203(m) of the Advisers Act that exempts Private Fund Advisers from registration. As noted above, a Private Fund Adviser is one that (1) advises only private funds, and (2) has aggregate assets under management in the United States of less than \$150 million. The release proposes rules that (1) define when assets are deemed to be managed in the United States, and (2) provide a means for calculating assets under management for purposes of the exemption’s \$150 million assets under management limitation (the “AUM Limit”).

A. U.S. vs. Non-U.S. Advisers. Under the proposed rules, the Private Fund Adviser Exemption would apply differently to an adviser with its principal place of business in the United States (“U.S. Fund Advisers”) than it would to an adviser with a principal place of business outside the United States (“Non-U.S. Fund Advisers”).

B. Private Fund Clients.

1. *U.S. Fund Adviser.* All of the clients of a U.S. Fund Adviser, regardless of whether the clients are U.S. or non-U.S. clients, would have to be private funds.
2. *Non-U.S. Fund Adviser.* A Non-U.S. Fund Adviser could not have any clients that are “U.S. Persons” (as that term is defined in Regulation S under the Securities Act of 1933) other than private funds; however, a Non-U.S. Fund Adviser may have other types of clients that are not U.S. Persons. (A “U.S. person” under Regulation S includes, among other persons, natural persons resident in the United States and any partnership or corporation organized or incorporated under the laws of the United States) For these purposes, U.S. investors in a fund would not be treated as clients; therefore, a Non-U.S. Fund Adviser could allow U.S. investors in an offshore fund without being deemed to have a client in the United States that is not a private fund. A Non-U.S. Fund Adviser would have to treat as a U.S. client, however, any discretionary account set up by or for the benefit of a U.S. person by the adviser or by an affiliate of the adviser.

C. Assets Managed in the United States.

1. *U.S. Fund Adviser.* A U.S. Fund Adviser would have to include all of its private funds’ assets, including the assets of non-U.S. private funds, in calculating its assets under management for purposes of the AUM Limit. All of these funds would be deemed managed from the United States.
2. *Non-U.S. Fund Adviser.* A Non-U.S. Fund Adviser, however, would only have to count in the AUM Limit calculation the aggregate assets of its private funds that it manages from a place of business in the United States, and would be able to exclude the assets of any non-U.S. client, including private funds not managed from the United States.

D. Calculating Assets under Management Quarterly; Undrawn Commitments Count.

Under the proposed rules, a Private Fund Adviser would have to aggregate the value of all of its funds (or, in the case of a Non-U.S. Fund Adviser, all of

its U.S. funds) in determining whether it crosses the AUM Limit. In valuing assets of its private funds, the Private Fund Adviser would have to apply a “fair value” standard of measurement. In addition to actual assets, a Private Fund Adviser also would have to include the amount of any outstanding but uncalled capital commitments. The release does not address commitments that are excused in whole or in part, although it would make sense for these to be deducted from assets under management when excused, if the excuse is legally binding and irrevocable. The Private Fund Adviser is not permitted to subtract outstanding indebtedness or other liabilities: thus, an adviser would not be able to deduct accrued fees, incentive allocations or expenses or the amount of any borrowing).

Although a Private Fund Adviser would only be required to report its assets under management to the SEC on an annual basis on the Amended ADV Part 1 (as defined and discussed below in Section III), it must value its assets under management quarterly for purposes of applying the AUM Limit.

E. Transition to Registration. If a Private Fund Adviser were to exceed the AUM Limit for a given quarter, the adviser would have until the end of the following quarter to either register or to come back into compliance with the AUM Limit. This one-quarter safe harbor would only be available to a Private Fund Adviser that was in compliance with applicable reporting requirements, as discussed below in Section III.

F. Key Issues.

1. *State Registration.* A Private Fund Adviser is exempt from federal registration, but still could be subject to registration in one or more states. Some states appear to be contemplating exempting Private Fund Advisers from state registration, but it is unclear whether such an exemption will be widely adopted. If a Private Fund Adviser were subject to registration in a state, it would be subject to regulation and inspection by state authorities as well as the recordkeeping and reporting obligations and SEC inspections to which Exempt Reporting Advisers will be subject (discussed below in Section III).
2. *Valuation.* Venture capital, private equity and other funds that hold illiquid assets may find it difficult to determine the fair value of such

assets. The release states that the use of cost basis could “understate significantly the value of appreciated assets[.]” Attempting to place a fair value on such assets, however, could expose the Private Fund Adviser to liability based upon value determinations made by investors, regulators or courts with the benefit of hindsight. Many Private Fund Advisers may have to employ expensive third-party valuation firms in valuing illiquid assets to provide an additional level of review and a stronger defense against later second-guessing.

3. *Uncalled Commitments in Calculating Assets under Management.* In calculating its assets under management in the United States, a Private Fund Adviser would have to include the aggregate amount of any uncalled capital commitments. The proposed rule assumes that these commitments are fully committed and that investors are contractually obligated to provide the funds upon request, subject to the terms of the fund’s governing documents. The proposed rules and the release do not address commitments that are conditional or that are not immediately callable. For example, some venture or private equity funds give investors opt-out rights for certain investments or may allow investors to determine individually whether to participate in a specific investment, as in the case of pledge funds, or may allow investors to opt out of an investment for regulatory or investor-specific reasons (such as pension funds with socially responsible or other mandates or Sharia’a compliant investors). Some funds make the obligation to provide additional capital contingent on some event, such as the location of a certain number of suitable investments. Often, a private equity or venture capital fund’s governing document limits the amount of capital commitments the adviser may call in a given period; if such assets were included, a Private Fund Adviser may be deemed to currently manage assets that it cannot access for a number of years.

The SEC may need to consider and clarify what level of commitment is required before a “capital commitment” is included in assets under management for purposes of the AUM Limit.

III. Exempt Reporting Adviser Recordkeeping and Reporting Requirements; SEC Inspections

Venture Capital Advisers and Private Fund Advisers, while exempt from Advisers Act registration, are nevertheless subject to certain recordkeeping and reporting requirements. Section 204 of the Advisers Act sets forth the recordkeeping and reporting obligations of investment advisers and authorizes SEC inspections. The only advisers that are exempted from Section 204 are those “specifically exempted from registration pursuant to section 203(b) of [the Advisers Act.]”

Because the Dodd-Frank Act exempts Exempt Reporting Advisers from registration under new Sections 203(m) and (l), the SEC is taking the position that Exempt Reporting Advisers are subject to (and Congress intended them to be subject to) Section 204, including the provision authorizing SEC inspections, which will be a new and unwelcome experience for them.

A. Reporting Requirements. In the Reporting Release, the SEC proposes new Rule 204-4, which would require Exempt Reporting Advisers to complete and periodically update a limited subset of the items required on the Form ADV Part 1A, as it would be amended by the Reporting Release (the “Amended ADV Part 1”). Exempt Reporting Advisers would not be required to complete a Form ADV Part 2A or 2B. Exempt Reporting Advisers would file and update the relevant items on the Amended ADV Part 1 through the Investment Adviser Registration Depository (or “IARD”) system currently used to file and amend the Form ADV Part 1. This filed information would be publicly available on the IARD system.

1. *Overview.* The designated Items on Amended ADV Part 1 would require an Exempt Reporting Adviser to provide information regarding:
 - basic identifying information, form and state of organization, location of its records, websites it maintains, and any non-U.S. registrations (Items 1 and 3);
 - the name of its executive officers, direct owners and indirect owners (Item 10 and Schedules A and B);

- other business activities of the adviser and its affiliates (Items 6 and 7.A);
 - disciplinary history of the adviser and its employees (Item 11, including criminal, civil and administrative disclosures); and
 - the funds the Exempt Reporting Adviser manages (Items 7.B and related Section 7.B of Schedule D).
2. *Fund Information.* Under the proposed Rule 204-4, an Exempt Reporting Adviser would need to provide certain information about the private funds it manages. Rather than using the funds’ names, however, the Amended ADV Part 1 permits an adviser to use a numeric or alphabetic designator for each fund. An Exempt Reporting Adviser would have to provide information about each fund it advises, including:
 - identifying and other basic information about the fund, including its entity type and jurisdiction of formation, any foreign registrations and the Investment Company Act exemption upon which it relies (*i.e.*, Section 3(c)(1) or 3(c)(7));
 - whether the fund is part of a master-feeder structure or is a fund-of-funds and the category of investment vehicle that best describes the fund (*e.g.*, hedge fund, private equity fund, venture capital fund);
 - the gross and net asset values of the fund and a breakdown of assets and liabilities between Levels 1, 2 and 3 in the “fair value hierarchy” under U.S. GAAP;
 - certain limited information about the fund’s investors, including:
 - total number of investors,
 - a percentage breakdown of the types of investors among a number of different categories (*e.g.*, high net worth individuals, non-profits, banking institutions, other private funds), and
 - the percentage of investors that are non-U.S. investors; and
 - information about the five types of service providers to a fund deemed “gatekeepers” by the SEC, including the fund’s auditor,

prime broker, custodian, administrator and “marketers” (including, among others, placement agents and solicitors).

3. *Initial Filing Deadline and Updates.* Under the proposed rule, an Exempt Reporting Adviser initially would have to file the sections of the Amended ADV Part 1 no later than August 20, 2011, 30 days after the effective date of the Dodd-Frank Act’s changes to the Advisers Act. Thereafter, an adviser would have to update the information within 90 days of the adviser’s fiscal year end, or “promptly” if responses to certain Items become inaccurate.

B. Key Issues.

1. *Disclosure Generally.* As noted above, the information an Exempt Reporting Adviser files about itself and its funds will be publicly available. These disclosures could bring public and perhaps unwanted attention to an Exempt Reporting Adviser and its listed control persons. Importantly, however, an Exempt Reporting Adviser will not need to disclose publicly the names or identifying information regarding any of its fund investors, although an adviser must make such information available to the SEC staff upon request.
2. *General Solicitation.* Most advisers rely on Rule 506 of Regulation D under the 1933 Act in selling interests or shares in private funds without registration of the offer and sale under the 1933 Act. In order to rely on Rule 506, an adviser or fund must not offer or sell interests through a “general solicitation.” Because the detailed information filed by Exempt Reporting

Advisers regarding the private funds they manage would be publicly available, the SEC or state regulators might deem responses to Items on the Form ADV a general solicitation in certain circumstances. The SEC’s recent changes to the Form ADV Part 2 raised a similar issue; in the release adopting those changes, the SEC stated that disclosures on the new Part 2A could constitute a general solicitation if they went beyond what was required. However, the disclosure applicable to Exempt Reporting Advisers may raise less of a “general solicitation” concern than the Part 2A because the responses to Amended ADV Part 1 are not in narrative form and provide less of an opportunity to exceed the scope of the questions.

3. *SEC Inspection Rights – May Lead to SEC Examinations of Exempt Reporting Advisers.* As noted above, Exempt Reporting Advisers are subject to inspection by the SEC staff. This will represent a major and unwelcome change for Venture Capital Advisers in particular, which generally have operated without SEC registration, oversight and inspection. SEC staff inspections can be relatively brief and issue-specific or can be extremely long and grueling ordeals, lasting for many weeks or months. Even in the best of cases, responding to a request for documents and preparing for an inspection of records requires a significant commitment of time by a wide variety of adviser staff and can significantly disrupt an adviser’s normal operations.

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Family Offices: the SEC's Proposed Exclusion from Advisers Act Registration and Regulation

On October 12, 2010, the Securities and Exchange Commission (“SEC”) proposed, and requested comment on, a new rule to define what constitutes a “family office” for purposes of excluding such offices from the definition of an “investment adviser” under the Investment Advisers Act of 1940, as amended (the “Advisers Act”).¹

The proposed rule (the “Proposed Rule”) provides three basic conditions for a qualifying family office, each of which is described in greater detail below:

1. The family office must provide investment advice only to “family clients,” as defined in the Proposed Rule;
2. Family members must wholly-own and control the family office; and
3. The family office must not hold itself out to the public as an investment adviser.

The Proposed Rule also provides “grandfathering” relief for family offices providing certain services without registration prior to January 1, 2010. The proposing release (the “Proposing Release”) states that comments must be received by November 18, 2010. In the Proposing Release, the SEC cautions that a rule of general applicability cannot contemplate every circumstance and permutation that may arise in the creation and operation of a family office, and a family office could seek an exemptive order from the SEC staff declaring that it is not an investment adviser based on its specific circumstances.

Background

The term “family office” generally refers to entities formed by high net worth families to provide a range of services to family members, including wealth and investment management, accounting, tax and other services. The Proposing Release notes that family offices generally meet the definition of “investment adviser” under the Advisers Act because the variety of services they provide often include providing securities advice for compensation. Traditionally, family offices have operated without registering as investment advisers in reliance on the private adviser exemption in Section 203(b)(3) of the Advisers Act (the “Private Adviser Exemption”), which provision exempts from registration an investment adviser that had fewer than fifteen clients during the preceding twelve months (with an investment fund generally treated as a single client), does not hold itself out generally to the public as an investment adviser and does not advise registered investment companies or business development companies. Some family offices that

¹ *Family Offices*, Rule Proposal, Investment Advisers Act Release No. 3098 (October 12, 2010), available on the SEC’s website by clicking [here](#). The proposed rule would be designated Rule 202(a)(11)(G)-1 under the Advisers Act.

could not, or did not wish to, abide by the limitations of the Private Adviser Exemption applied for and received exemptive relief from the SEC declaring that they were not within the intent of the Advisers Act. The SEC has granted thirteen of these orders since 1940. Exemptive orders have distinguished between “family offices” that provide advice to one family and “family-run offices” that, though owned and controlled by one family, provide advice to multiple clients, including non-family members. With limited exceptions, the SEC has provided relief only to family offices that provide investment advice to a single family and their lineal descendants.

The Dodd-Frank Act, signed into law on July 21, 2010, repeals the Private Adviser Exemption effective July 21, 2011. As a result, previously unregistered advisers that relied on the exemption will need to either register as investment advisers or find another exemption from registration. Congress and the SEC, however, both have indicated that the Advisers Act “was not designed to regulate the interactions of family members in the management of their own wealth.”² Specifically, the Dodd-Frank Act calls for the SEC to promulgate a rule to define a “family office” that is “consistent with the previous exemptive policy of the SEC,” as reflected in its past exemptive orders, and that recognizes “the range of organizational, management, and employment structures and arrangements employed by family offices[.]”³

Three Requirements of the Proposed Rule

1. The family office must provide investment advice only to “family clients.”

The Proposed Rule defines “Family Client” to mean:

- Family members (“Family Members”), meaning:
 - the founder of the family office and his or her spouse or spousal equivalent⁴

² Proposing Release at *8.

³ See Dodd-Frank Act § 409.

⁴ “Spousal equivalent” is defined as a co-habitant occupying a relationship generally equivalent to that of a spouse. See

(collectively defined in the Proposed Rule as the “Founders”);

- the Founders’ parents;
 - the Founders’ lineal descendants (including adopted children and stepchildren);
 - such lineal descendants’ spouses or spousal equivalents;
 - the Founders’ siblings and such siblings’ spouses or spousal equivalents; and
 - such siblings’ lineal descendants (including adopted children and stepchildren) and such lineal descendants’ spouses or spousal equivalents.⁵
- Former family members a (“Former Family Member”), such as a divorced spouse and his or her siblings and parents. Former Family Members would be permitted to maintain investments and fulfill contractual investment commitments made prior to the time they become Former Family Members, but would not be permitted to make any new investments through or contribute new assets to the family office’s management.⁶

Proposing Release at *12, n. 24. This term is taken from the SEC’s auditor independence requirements in Rule 2-01 of Regulation S-X. See *Revisions of the Commission’s Auditor Independence Requirements*, 1933 Act Release No. 7919 (Nov. 21, 2000). The SEC notes that it has never been asked in an exemptive application to permit a family office to provide advice to a spousal equivalent, and, therefore, has never before done so. Proposing Release at *12.

⁵ The SEC notes that this definition of “family member” generally conforms to the types of family members it has included in its exemptive orders, except that it has not always treated stepchildren in the same manner as other family members. Proposing Release at *10. The Proposing Release cites one instance in which it permitted a family office to provide investment advice to stepchildren, but required that the stepchildren be given additional disclosure and that the stepchildren provide written consent to the arrangement. See *WLD Enterprises, Inc.*, Investment Advisers Act Release Nos. 2804 (October 17, 2008) (notice) and 2807 (November 14, 2008) (order).

⁶ The SEC notes that none of its exemptive orders have permitted former family members to continue to receive advice

- Certain charitable entities, family trusts and other family entities, including:
 - charitable foundations, charitable organizations or charitable trusts established and funded exclusively by one or more Family Members or Former Family Members;
 - any trust or estate existing for the sole benefit of one or more Family Clients (a “Family Client Trust”); and
 - any limited liability company, partnership, corporation or other entity wholly-owned and controlled (directly or indirectly) by, and operated for the sole benefit of, one or more Family Clients (a “Family Client Vehicle”), which is not a registered investment company under the Investment Company Act of 1940, as amended (the “1940 Act”).⁷
- Certain key employees of the family office (“Key Employees”), including:
 - an executive officer, director trustee, general partner or person serving in a similar capacity;
 - any other employee of the family office (other than employees performing solely clerical, secretarial or administrative functions) who, in connection with his or her regular duties, has participated in the investment activities of the family office, or similar functions or duties for

or on behalf of another company, for at least twelve months;⁸ or

- a Family Client Trust or Family Client Vehicle created for the sole benefit of and wholly-owned and controlled by a Key Employee.

Once a Key Employee no longer serves as a family office employee, the employee is treated in the same manner as a Former Family Member, described above.

Subject to the grace period described below, a family office may not provide advice to clients that are not Family Clients under the Proposed Rule, even if those clients received investments as a result of an involuntary transfer from a Family Client, such as through gift or bequest either by a Family Client or his or her estate. In the case of such an involuntary transfer, the family office can provide advice with respect to the investment for four months after the date of the involuntary transfer. The SEC believes this grace period will give clients that are not Family Clients the opportunity to dispose of the investment, restructure the investment, transfer the investment or seek exemptive relief.⁹

⁸ This standard is based on the “knowledgeable employee” standard in Rule 205-3 under the Advisers Act. Proposing Release at *20. The SEC notes that key employees have been considered family clients in some of its exemptive applications to family offices. See Proposing Release at *20.

⁹ In the Proposing Release, the SEC notes it has never issued an exemptive order permitting a family office to advise a non-family member after an involuntary transfer of an investment to that person, but recognizes that the treatment of involuntary transfers under the Proposed Rule differs from the manner in which it and its staff have at times treated involuntary transfers in other contexts. See Proposing Release at *15. For example, the involuntary transfer of shares or interests in a private investment fund operating without investment company registration under Section 3(c)(7) of the 1940 Act does not require that the sponsor or manager look to the qualifications of the recipient for purposes of that section (which requires investors to be “qualified purchasers”); instead, the recipient is able to “piggy-back” off the qualifications of the transferring party and the transfer is treated as never having occurred regardless of whether the transferee could have made the investment directly. See Section 3(c)(7)(A) of the 1940 Act (“Securities that are owned by persons who received the securities from a qualified purchaser as a gift or bequest, or in a case in which the transfer was caused by legal separation, divorce, death, or other involuntary event, shall be deemed to be owned by a qualified purchaser[.]”).

from a family office, but it sought to provide clarity to family offices affected by a divorce or other legal separation. Proposing Release at *16.

⁷ The SEC notes that these entities, intended to serve Family Clients, have generally been deemed permitted clients of family offices under the SEC’s exemptive orders to “allow the family office to structure its activities through typical investment structures.” Proposing Release at *18.

The SEC states that it did not include as a Family Client under the Proposed Rule “every type of individual or entity that has been included in a prior exemptive order based on specific facts and circumstances.” Although the Dodd-Frank Act requires the SEC to adopt a rule “consistent” with its previous exemptive guidance, the SEC believes a rule of general applicability cannot contemplate every type of relationship between a Founder and another person that could or should justifiably cause that person to be deemed a Family Client.

2. The family office must be wholly-owned and controlled by Family Members.

To qualify as a family office under the Proposed Rule, a family office must be wholly-owned and controlled, directly or indirectly, by Family Members. Whole ownership was generally a requirement of the SEC’s exemptive orders granted to family offices. Whole ownership removes the need to require that a family office not operate in a manner that creates a profit, which the SEC commonly required in its exemptive orders. The SEC feels that this not-for-profit requirement is unnecessary when the family office is wholly-owned by family members, since “any profits generated by the family office from managing [Family Client’s] assets only accrue to family members.”¹⁰

Often, a portfolio manager of an investment adviser will hold an equity stake in the adviser, allowing the manager to receive as compensation and treat as capital gains a portion of the performance-based compensation paid to the adviser. Key Employees’ inability to hold an equity interest in the family office may complicate, but not necessarily preclude, efforts to provide such employees with performance-based compensation.

3. The family office must not hold itself out to the public as an investment adviser.

A family office, managing the wealth and investments of Family Clients, would have little reason to hold itself out to the public or to maintain any significant public presence whatsoever. This prohibition on “holding out” is consistent with the SEC’s exemptive orders for family offices.

¹⁰ Proposing Release at **23-24.

Grandfathering Relief

The Dodd-Frank Act requires the SEC’s family office rule to define those offices that are excluded from the definition of investment adviser to include certain family offices that were not registered or required to be registered on January 1, 2010 and that would meet all the requirements of the Proposed Rule, except that such offices provide (and were engaged to provide prior to January 1, 2010) investment advice to:

- Natural persons who were officers, directors or employees of the family office that invested with the family office prior to January 1, 2010 and who were “accredited investors” as defined in Regulation D under the Securities Act of 1933, as amended;
- Any company owned exclusively and controlled by one or more Family Members; or
- An investment adviser registered under the Advisers Act:
 - that advises and identifies investment opportunities for the family office,
 - that invests in such opportunities on substantially the same terms as the family office,
 - that does not invest in other funds advised by the family office, and
 - whose assets for which the family office directly or indirectly provides investment advice represent, in the aggregate, not more than 5% of the total assets advised by the family office.

A family office that is “grandfathered” under the Proposed Rule would be subject to Sections 206(1), (2) and (4) of the Advisers Act, which contain certain anti-fraud provisions under the Advisers Act. The Proposing Release does not discuss the proposed grandfathering relief in any detail nor does it attempt to justify or explain the rationale behind the specific types of clients included in the grandfathering provision.

Exemption from State Registration

Family offices that qualify for exemption from registration and regulation under the Proposed Rule also would be exempt from state investment adviser registration, as would their representatives. The Proposed Rule exempts a qualifying family office from the definition of the term “investment adviser” under Section 202(a)(11) of the Advisers Act.

Section 203A(b) of the Advisers Act, which governs the interaction of state and federal law regarding advisers, states that no state may require “the registration, licensing, or qualification as an investment adviser or supervised person of an investment adviser” exempted from the definition of investment adviser under Section 202(a)(11).

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