KIRKLAND & ELLIS LLP

KIRKLANDPEN
Private Equity Newsletter

May 25, 2010

Senate Financial Services Reform Bill - Effect on Private Fund Managers

PENpoints

The recently passed Senate Financial Services Reform Bill is significantly different than the House bill approved in 2009, and includes a potentially broadened exemption from federal investment adviser registration for private equity and venture capital fund managers.

On May 20, 2010, the Senate passed a comprehensive financial services reform bill with only minor amendments from the bill proposed by Senator Dodd in March.[1] The Senate bill is significantly different than the House bill approved in December 2009, including a potentially broadened exemption from federal investment adviser registration for private equity and venture capital fund managers.

Investment Advisers Act. The Senate bill repeals the existing Investment Advisers Act exemption from registration commonly relied upon by private fund managers and others with fewer than 15 clients, but would:

- **Exempt from federal investment adviser registration a manager of "private equity funds" and "venture capital funds"** (terms to be defined by the SEC within six months after enactment), regardless of the number of clients or funds sponsored by such manager. The Senate report accompanying the bill indicates "private equity funds" are expected to have the following characteristics:
  (1) limited or no fund-level leverage;
  (2) no redemption rights;
  (3) investments consisting of long-term investments of *equity* capital; and
  (4) not invested in securities "characteristic of a hedge fund."

  However, an exempt private equity fund manager may be subject to registration if it manages other products (e.g., managed accounts or hedge funds), unless such other products are separately managed by different management and investment personnel with no investment sharing across the firm. It is unclear whether a person who manages funds of funds, real estate funds, debt funds or other closed-end funds would qualify for this exemption. A private equity fund advised by an exempt adviser would still be subject to reporting requirements as determined by the SEC within six months of enactment.
- **Raise to $100 million the current AUM threshold of $25 million for federal investment adviser registration.** Although a U.S. adviser with less than $100 million AUM (assets under management) would face investment adviser regulation by the states, it is unclear whether individual states would take action to regulate a manager that falls within the federal exemption. Many states currently exempt from state registration an investment adviser with fewer than fifteen clients by virtue of a cross-reference to the existing federal exemption. Elimination of the federal exemption would require such states to determine whether to continue to exempt managers located in such states from state investment adviser registration.
- **Exempt from federal investment adviser registration a "foreign private adviser"** with: (1) no place of business in the United States; (2) fewer than 15 clients domiciled or resident in the United States; (3) less than $25 million AUM attributable to clients and investors in the United States (or such greater amount as specified by the SEC), and (4) no client that is a U.S.-registered investment company or business development company.
- **Create new recordkeeping and confidential reporting obligations for private funds advised by registered advisers**, including reporting of: AUM and use of leverage; counterparty credit risk exposures; trading and investment positions; valuation policies and practices; types of assets held; side letter arrangements; trading practices; and other information necessary or appropriate to assess the private fund's systemic risk.

Private Placement Rules / SRO Study. The Senate bill contains other changes of interest to private fund managers and would:

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- remove the value of an investor's primary residence from the calculation of net worth for the purposes of the individual "accredited investor" test (currently $1 million net worth);
- require the SEC to update for inflation (four years after the legislation becomes effective and every four years thereafter) the net worth standards for individual "accredited investors" and to evaluate the current standards for qualifying as an individual accredited investor;
- disqualify Regulation D Rule 506 offerings made by felons and certain "bad actors;" and
- require the GAO to complete a feasibility study within one year to determine whether a self-regulatory organization should be created to oversee and regulate private funds, including private equity and venture capital funds.

Banking Regulations. The Senate bill's "Volcker Rule"—a survivor of late proposed amendments—would generally restrict insured depository institutions, bank holding companies and their subsidiaries from engaging in proprietary trading (i.e., trading for their own account), owning, sponsoring or investing in private funds, or entering into certain transactions or relationships (e.g., custodial or brokerage relationships) with private funds advised by an affiliate.

Until the Senate bill and House bill are reconciled and the SEC adopts rules pursuant to the final legislation, the scope of final regulation will remain uncertain. In addition, one should expect many states to amend their investment adviser registration requirements in response to the changes to the federal rules and the elimination of the fewer-than-15-client exemption. The table below outlines certain differences in the Senate and House bills of interest to private fund managers.

TERM	SENATE BILL	HOUSE BILL
Client Type Exemption	"Private equity funds" and "venture capital funds" (each to be defined by SEC)	"Venture capital funds" (to be defined by SEC) and private funds with <$150M AUM
Foreign Private Adviser Exemption	Yes	Yes
AUM Threshold for SEC Registration	≥$100M AUM; states to regulate advisers with less	>$25M AUM; ≥$150M AUM for advisers solely to private funds; states to regulate advisers with less
Inflation Adjustment of Investor Sophistication Tests	Value of primary residence removed from determining $1M individual accredited investor net worth standard; test to be inflation-updated 4 years after enactment and every 4 years thereafter	Qualified client standard for registered adviser to charge performance fees to be updated for inflation
"Volcker Rule" Restrictions on Banks and Affiliates	Yes	No
Felons and "Bad Actors" Disqualified From Making Regulation D Offerings	Yes	No
Private Fund Reporting Requirements	Confidential reporting of information needed to assess systemic risk of RIA-sponsored private funds, with additional private equity fund reporting as required by SEC	Similar reporting proposal
Private Fund Disclosure Requirements	No additional disclosure to investors, counterparties and creditors	Disclosure to investors, counterparties and creditors non-private information required to assess systemic risk or in public interest

[1] Discussed in a previous *KirklandPEN*.

If you have any questions about the matters addressed in this *KirklandPEN,* please contact the following Kirkland authors or your regular Kirkland contact.

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The European Venture Capital Association's "CFO-COO Summit 2010"
Berlin, Germany
June 8-9, 2010

This summit, hosted by the EVCA, will cover issues including regulatory updates pertaining to the private equity industry, the role of the CFO in the management of portfolio companies, resource allocation and LP/GP relations. Kirkland partner Richard K. Watkins will participate in a panel on the "Tax Aspects of Fund Structuring" on Wednesday, June 9.

The International Bar Association's "9th Annual Mergers & Acquisitions Conference"
New York, New York
June 16-17, 2010

The 9th Annual International Mergers & Acquisitions Conference, hosted by the International Bar Association, will focus on significant trends and developments in mergers and acquisitions. Kirkland partner David Fox will speak on the panel titled "Private Equity Today." The panel will discuss the legal issues in representing private equity firms in the current environment, including alternative forms of financing, PIPE financings, co-investments and the future of regulation of private equity.

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Private Equity Practice at Kirkland & Ellis

Kirkland & Ellis LLP's nearly 400 private equity attorneys handle leveraged buyouts, growth equity transactions, recapitalizations, going-private transactions and the formation of private equity, venture capital and hedge funds on behalf of more than 200 private equity firms around the world.

Kirkland has been widely recognized for its preeminent private equity practice. Kirkland received the 2009 and 2008 awards for Best Law Firm (Private Equity Deals) in North America from *Private Equity International*. In *Buyouts Yearbook 2010*, Kirkland was named "Best Law Firm." Additionally, Mergermarket ranked Kirkland first by volume for North American Buyouts and Exits in its "North American Private Equity in Review for 2009," and Pitchbook named Kirkland as one of the most active law firms representing private equity firms in its "Private Equity Breakdown" in 2009.

The Lawyer magazine recognized Kirkland as one of the "The Transatlantic Elite" in 2008, 2009 and 2010, noting that the firm is "leading the transatlantic market for the provision of top-end transactional services ... on the basis of a stellar client base, regular roles on top deals, market-leading finances and the cream of the legal market talent."

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