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INVESTMENT FUNDS NEWSLETTER

The Impact of Dodd-Frank Act on Private Fund Managers and Other Investment Advisers

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Many U.S. and international fund managers previously exempt from registration under the Investment Advisers Act of 1940 (the "Advisers Act") must now, as a result of passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Act"), contemplate registration with the U.S. Securities and Exchange Commission (the "SEC") within the next 10 months.

U.S. investment advisers with assets under management ("AUM") of $100 million or more will need to register; however, if such advisers manage only Private Funds[1] (other than SBICs, defined below) that do not meet the definition of a "venture capital fund," the threshold is raised to $150 million or more of AUM. Advisers that hit these thresholds are required to register under the Advisers Act on or before July 21, 2010, the first anniversary of the enactment of the Act. The relatively low threshold of $150 million of AUM will ensnare many previously unregistered investment advisers to private equity and hedge funds that benefited from the 14-or-fewer clients exemption now eliminated by the Act.

U.S. advisers having less than $100 million (or $150 million where solely advisers to Private Funds) of AUM will have to register under state "blue sky laws" rather than being able to register with the SEC under the Advisers Act, unless such an adviser would have to be registered in 15 or more states.

An even lower threshold awaits "foreign private advisers" which will be required to register generally if they have $25 million or more of AUM and/or of investments in their sponsored funds attributable to U.S. investors, or more than 15 clients domiciled in the United States. Conversations with the staff of the SEC's Office of International Corporate Finance indicate that it is currently unlikely that the SEC will increase the $25 million threshold (as it is permitted to do by the Act) prior to July 21, 2011. Accordingly, many non-U.S. investment advisers face the prospect of registering with and regulation by the SEC.

U.S. Advisers

The Act repeals in its entirety the so-called "Private Adviser Exemption"[2] previously found in the Act and removes "Private Fund" investment advisers from

[1] Private Funds are defined as entities that would be an "investment company" under the Investment Company Act of 1940, as amended (the "1940 Act"), but for the exceptions set forth in Sections 3(c)(1) and 3(c)(7) of the 1940 Act. For purposes of Title IV of the Act, Private Funds do not include "venture capital funds" (see "U.S. Advisers" below) but for purposes of the Volcker Rule Private Funds do include venture capital funds and as a result banks are restricted from sponsoring or investing in a larger set of fund types (see "Volcker Rule for Sponsorship of or Investment in Private Funds" below).

[2] Any investment adviser that has had fewer than 15 clients during the preceding 12-month period and does not hold itself out to the public as an investment adviser.

the general exemption for intrastate investment advisers found under Section 203(b)(I). Private equity, real estate opportunity and hedge funds have historically generally relied upon these exemptions to avoid registration under the Advisers Act.

The Act requires that the SEC provide an exemption from the registration requirements for U.S. advisers to Private Funds provided AUM in the United States are less than $150 million and such adviser is solely an adviser to Private Funds.

Additionally, the Act creates new exemptions from SEC registration, including advisers to "family offices" and advisers to "venture capital funds." The definition of a "family office" and a "venture capital fund" will be determined by the SEC by final rule before July 21, 2011. Finally, any investment adviser that solely advises small business investment companies ("SBICs") that are either licensed or are currently applying for licenses under the Small Business Investment Act of 1958 is newly exempted from registration.

As a result of the Act, the number of potential SEC registrants is expected to increase significantly. The responsibility of the states for licensing, monitoring and overseeing all hedge funds and other alternative investment management firms has also been increased significantly from firms having less than $25 million of AUM to firms having under $100 million AUM.

Non-U.S. Advisers

The Act exempts from registration any investment adviser that is a "foreign private adviser," which is defined in the Act as any investment adviser that:

- has no place of business in the United States;
- has fewer than 15 clients and investors domiciled in the United States in private funds advised by the investment adviser;
- has aggregate assets under management attributable to clients in the United States and investors in the United States in Private Funds advised by the investment adviser of less than $25 million (or such higher amount as the SEC may set by rulemaking); and
- neither holds itself out generally to the public in the United States as an investment adviser, nor acts as an investment adviser to any registered investment company.

The SEC has previously permitted a "regulation-lite" approach that registered non-U.S. advisers may observe with respect to their non-U.S. clients (including non-U.S. funds in which U.S. persons invest). Under the "regulation-lite" approach, a non-U.S. adviser is permitted to treat each non-U.S. fund as its "client" for many purposes of the Advisers Act. As a result, most of the substantive provisions of the Advisers Act would not apply to a non-U.S. adviser's dealings with a non-U.S. fund, even if the investors in the fund included U.S. persons.[3] It is expected that the regulation-lite approach will be carried forward, but there can be no assurance that certain policies reflected in the Act would not interdict the regulation-lite approach.

It should be noted that while domestic banks and bank holding companies are excluded from the definition of an investment adviser, non-U.S. banks and indeed U.S. branches or agencies of non-U.S. banks are not excluded, even though U.S. branches of non-U.S. banks are treated equivalently with domestic banks in other provisions of the Act, including the Volcker Rule.

"Qualified Client"

Section 205(a)(1) of the Advisers Act prohibits an adviser from receiving any type of advisory fee calculated as a percentage of capital gains or appreciation in the client's account ("performance fee arrangement"). The Advisers Act contains exceptions from this prohibition for contracts with registered investment companies and clients having more than $1 million in AUM, if specific conditions are met; private investment companies excepted from the

[3] For example, a non-U.S. adviser would not be required to comply with the following rules under the Advisers Act as to non-U.S. clients: (a) Rule 206(4)-7 (the "compliance" rule), (b) Rule 206(4)-2 (the "custody" rule) and (c) Rule 206(4)-6 (the "proxy voting" rule).

1940 Act under Section 3(c)(7) of that Act; and clients that are not U.S. residents.

In addition, Rule 205-3 under the Advisers Act permits investment advisers to charge performance fees to:

(a) clients with at least $750,000 under management with the adviser or more than $1,500,000 of net worth;

(b) clients who are "qualified purchasers" under Section 2(a)(51)(A) of the 1940 Act; and

(c) certain knowledgeable employees of the investment adviser.

Pursuant to the Act, the "qualified client" threshold under the Advisers Act (pursuant to which a registered investment adviser can charge a performance fee) has been changed. With respect to any dollar amount threshold used in determining whether a person is a "qualified client," the SEC shall be required before July 21, 2011, and every five years thereafter, to adjust for the qualifications to reflect effects of inflation on such test.

Recommendations

A U.S. private fund manager affected by the Act should begin to prepare for registration well in advance of the July 21, 2011 registration deadline so as to accomplish an orderly registration.

This advice applies with greater amplitude to non-U.S. managers who will likely have the additional burden (as discussed further below) of assessing the U.S. regulatory regime with which they may need to comply,[4] assessing the potential exposure of its non-U.S. operations to SEC inspection, as well as weighing the burden of the commercial efficacy of registration and compliance against the commercial impacts of actions to remove its operations from the expanded regulatory reach of the Act.

Managers having multiple funds, complex structures and/or numerous street-name investors or numerous sales personnel should be all the more mindful of commencing planning and assessments now to provide sufficient planning and implementation time for registration; or, in the case of non-U.S. advisers, potentially to take appropriate actions to avoid the need for registration.

A private fund manager that may be required to register should:

- Identify which entities in the structure provide investment advice and must register as investment advisers.
- If a "mid-sized" adviser (less than $100 million of AUM or $150 million of AUM limited solely to Private Funds), assess respective "blue sky" obligations.
- If a non-U.S. adviser, identify the current amount of AUM and investments attributable to, and the number of, U.S. investors and project both forward to determine whether registration will be required.
- If a non-U.S. adviser, determine if, via redemption of U.S. investors' interests or otherwise, affirmative actions can be taken to avoid triggering U.S. registration, as well as the commercial and local law implications of any such redemption.
- If a non-U.S. adviser required to register, consider establishing a separate entity to advise U.S. investors only and address, for example, overlapping personnel and data systems.
- If an asset management firm (either U.S. or non-U.S.) that is a "banking entity," examine the terms of the exception from application of the Volcker Rule and begin to assess the steps it must take to comply with the terms of the exception
- Gather information appropriate to complete Form ADV Part I and prepare the required investor disclosure for Form ADV Part II. Although much of the required information for Form ADV Part I is

[4] For example, whether or not registered with the SEC, all investment advisers doing business in the United States will be subject to the anti-fraud provisions of Section 206 of the Advisers Act. Additionally, SEC record-keeping rules may spawn issues under EU client privacy policies.

factual, it must be gathered from a number of sources, so ample time should be allowed for the information-gathering and disclosure preparation.

- Begin work on required Advisers Act compliance policies and procedures, and hire (or appoint) a chief compliance officer to oversee their development; consider implementing new compliance programs on a pilot basis prior to registration. Employee training should also be implemented.

- Implement a books-and-records retention system including e-mail retention, that is designed to meet Advisers Act requirements, and that, in the case of non-U.S. advisers, is distinct from records regarding non-U.S. clients that to the extent practicable should be kept beyond the newly permitted reach of the SEC.

- Review internal control structures to determine what changes should be considered prior to any registration. Given the Advisers Act requirement of client consent to a registered adviser's change of control or "assignment" (as defined in the Advisers Act), appropriate adjustments to the entity's control structure prior to any registration may well need to be made.

- Review the governing documents of private funds or managed accounts to determine which documents should be amended to comply with the Advisers Act.

- Revise offering documents and related materials to ensure compliance with Advisers Act requirements, particularly including advertising rules.

- Analyze the custody arrangements applicable to the managers' private funds or other clients, given the Advisers Act's custody rule requirement that U.S. client assets be held with qualified custodians, and in certain cases, new reporting obligations and SEC audit rights. Fund managers can avoid many of the custody rule's more onerous provisions by having their funds (including any co-investment or "side car" funds) audited in accordance with U.S. GAAP and audited financials promptly delivered to investors. Non-U.S. advisers may need to anticipate the incongruencies of doing so with local law obligations.

- Review compensation arrangements given that a registered adviser is not permitted to charge performance fees (including carried interest) unless the client falls within the definition of a "qualified client" (*i.e.*, a person who either has at least $750,000 under the adviser's management or $1.5 million net worth, subject to certain look-through rules[5]), or a person who is not a U.S. resident. Because it is not clear whether the SEC will grandfather existing Private Funds from this restriction, it may be necessary to amend compensation structures in certain cases (with investor consent, where necessary).

As a result of the Act, the number of potential SEC registrants is expected to increase significantly. The responsibility of the states for licensing, monitoring and overseeing all hedge funds and other alternative investment management firms with assets under $100 million has also been increased significantly.

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[5] A Section 3(c)(7) qualified purchaser fund would also fall within the definition of "qualified client."

IRS Issues Proposed Regulations on "Series LLCs"

Several states (including Delaware, Illinois, Nevada and Texas) have enacted statutes to provide for the creation of entities that may establish separate "series," including series limited liability companies ("series LLCs"). Although each series of a series LLC generally is not treated as a separate entity for state law purposes, each series has associated with it specified members, as well as specified assets, rights, obligations, investment objectives and business purposes. A member's association with one or more particular series is comparable to direct ownership by the member in such series, in that the member's rights, duties and powers with respect to the series are direct and specifically identified. The debts, liabilities and obligations of one series generally are enforceable only against the assets of that series and not against assets of other series or of the series LLC.

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The proposed regulations provide that each series of a domestic series LLC, whether or not a juridical entity for local law purposes, is treated for federal income tax purposes as a separate entity formed under local law. With the exception of certain insurance companies, the proposed regulations do not apply to series LLCs organized under foreign law.

On September 13, 2010, the Internal Revenue Service issued proposed regulations addressing the U.S. federal income tax classification of series LLCs (and other similar entities). The threshold question for determining the income tax classification of a series LLC (and a series therein) is whether an individual series should be considered a separate entity for U.S. federal income tax purposes.

Existing regulations provide that the state law classification of an entity is not controlling for federal income tax law purposes. Nonetheless, the proposed regulations provide that the characteristics of series LLCs under state law is an important factor in analyzing whether series should be treated as separate entities for federal income tax purposes.

All existing series LLC state statutes contain provisions that grant series certain attributes of separate entities. For example, as indicated above, individual series may have separate business purposes, investment objectives, members and managers; and assets of a particular series generally are not subject to the claims of creditors of other series or of the series LLC itself.

In light of the above considerations, the proposed regulations provide that each series of a domestic series LLC, whether or not a juridical entity for local law purposes, is treated for federal income tax purposes as a separate entity formed under local law. With the exception of certain insurance companies, the proposed regulations do not apply to series LLCs organized under foreign law. Also, the proposed regulations do not address how a series LLC should be treated for federal employment tax purposes.

Whether a series that is treated as a distinct entity under the proposed regulation is then recognized as a separate

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entity (*i.e.*, as opposed to a disregarded entity), and, if so, the classification of such an entity for federal income tax purposes (*i.e*, as a partnership or corporation), is determined under generally applicable entity classification ("check-the-box") rules.

The proposed regulations also provide that, for federal income tax purposes, the ownership of interests in a series, and of the assets associated with a series, is determined under general tax principles. For example, the series LLC itself is not treated as the owner of a series or of the assets associated with a series merely because the series LLC holds legal title to such assets. Instead, federal tax principles require an inquiry into who bears the economic benefits and burdens of the assets.

The proposed regulations are expected to be effective when finalized, rather than retroactively. Taxpayers who are treating a series for federal income tax purposes differently from the fashion described in the regulations generally will be required to change their treatment of such series as of such point.

However, the proposed regulations do provide an exception for series LLCs established prior to September 13, 2010, that treat all series and the series LLC as one entity. Such an entity generally may continue to be treated as one entity for federal income tax purposes until a change in control occurs with respect to the series (or series LLC).

To date, the use of series LLCs by private equity funds and hedge funds has been limited. Now that the IRS has provided guidance relating to their treatment for U.S. tax purposes, increased use of series LLCs is likely to be seen. For example, series LLCs could be used by investment funds as a substitute for creating multiple parallel fund entities designed to accommodate the needs of different classes of investors.

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Pledge Funds and Other Innovative Structures

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Private equity fundraising is tough these days. In the middle of 2010, buyout firms had on average just three years to invest about $400bn (€323bn), over one-third of the total "dry powder," or return it to their limited partners ("LPs"). With this reserve of dry powder still uninvested and the number of secondary transactions rising, one might wonder where all those attractive targets should come from that justify another generation of private equity funds. LPs are becoming more and more sensitive with regard to (in their eyes) voluminous management fees, and general partners ("GPs") are therefore looking for alternative arrangements to sweeten sought-after fund commitments.

On the other hand, empirical wisdom shows that exit returns tend to be higher where the portfolio company had initially been acquired in a down-phase and at a bargain price. Therefore, it should be worth the effort to think about fund structures that give LPs an extra amount of comfort. A pledge fund might be such a structure.

The Basic Model

Pledge funds are limited partnerships in the form of a soft-commited fund where investors have a high degree of discretion whether or not to finally invest on a deal-by-deal basis. The idea utilizes the model of the club deal and business angel camp, where the one opportunistic investment idea trumps a structured and long-term investment process.

For GPs, especially first-time sponsors, this alternative structure makes it potentially easier to raise a fund in the current environment. LPs might feel more comfortable without having to commit a huge amount of money over a defined investment period.

Economics

With regard to the economics of a pledge fund vehicle, a management fee can, to a certain extent, be based on the pledge commitment at a lower percentage rate plus an additional fee on the invested capital, for example. This allows the GP to actively source and monitor potential targets. Alternatively, a "membership fee" can be charged for the period in which the LP actively screens the GP's offers. A third model includes seed investors that make certain initial payments to cover operational costs.

The classic carried-interest model also applies to the pledge fund. The main question is to what extent the performance can be aggregated across all of the fund's investments. There are a number of structures in place that all aim to reward those investors who participate in a high number of transactions.

Potential Disadvantages

Time is of the essence for pledge funds. LPs need time to screen potential investments with a higher amount of

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diligence than the usual "passive" fund investor, taking into account their potential cluster risk. The GP still needs to bid effectively and potentially solicit third-party co-investors. Delays in getting consent (and money) from LPs could materially disadvantage the GP's investments.

Another disadvantage for pledge funds can be a negative perception among the sellers or the management of the target company. A lack of committed equity financing might be a problem for stakeholders of larger targets that could tend to prefer those investors that potentially would close the deal immediately. Another disadvantage might be the lack of diversification for those LPs who only participate in one or two of the pledge funds transactions.

Taken together, the pledge fund continues to be a viable alternative for GPs looking at small- and mid-market transactions. Large leveraged buyouts will likely continue to be undertaken under a classic fund regime. Even there, it is possible to address many LP concerns in a traditional fund structure, such as reducing the standard management fee over the fund term, switching from committed capital to invested capital as carry basis, deducting transaction and/or monitoring fees, or applying a higher hurdle rate.

A Few Words on Existing Funds

Finally, there is the question of those funds already raised and still left with a substantial amount of dry powder. One solution would be a renegotiation of the fund terms to achieve an extension of the investment period. Taking into account that the scarcity of targets drove up the prices for potential target companies at least at the beginning of 2010, such an extension can make sense for successful private equity firms that felt that they wouldn't want to pay such an ambitious price. Also, with syndicated and visible debt financings slowly but surely becoming available again, an additional number of players will become active in the coming quarters so that having more time to invest would be reasonable.

Perspectives

We find that with some effort on the structural/legal end, new funds have the option of either fundraising at more LP-favorable terms or trying out the pledge fund model. Existing funds may want to consider whether they see a need to renegotiate their investments terms or periods — or just proceed with new investments, provided that debt becomes more available, operative improvements harvest higher earnings again, and exit options become more realistic.

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FSA's Proposals for Revising the Remuneration Code — How are Alternative Fund Managers Likely to be Affected?

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In July 2010, the Financial Services Authority ("FSA") published Consultation Paper 10/19, "Revising the Remuneration Code." The proposals for revision are driven by various external requirements, in particular, amendments to the Capital Requirements Directive (generally referred to as "CRD3") and the standards implementing the high-level principles produced by the Financial Stability Board ("FSB").

The major and obvious change to the existing Remuneration Code (the "Code"), which came into force on January 1, 2010, is to its scope. The Code currently applies to some 27 firms, comprising the largest banks, building societies and broker-dealers. However, following the remuneration requirements of CRD3, the revised Code will apply far more widely — in broad terms, to all firms to which the Markets in Financial Instruments Directive ("MiFID") applies, which includes alternative fund management firms and advisory firms. The FSA's estimate is that over 2,500 firms will find themselves within the scope of the Code. The revised Code is intended to take effect from January 1, 2011.

Alternative fund managers also fall within the scope of the proposed Alternative Investment Fund Managers Directive ("AIFMD"). The AIFMD also contains remuneration provisions, currently drafted at a higher level than the Code. If that remains the case (the AIFMD is not yet in agreed form), then it is likely that these more general provisions will replace the Code where alternative fund managers are concerned, although this would not occur until late 2012 or early 2013 (the expected date for the AIFMD to come into force).

The revised Code consists of a general requirement — "a firm must establish, implement and maintain remuneration policies and practices that are consistent with and promote sound and effective risk management" — and twelve "remuneration principles." The definition of "remuneration" is wide, and includes any form of remuneration, including salaries, discretionary pension benefits, and benefits of any other kind. In addition, firms must maintain records of "Remuneration Code staff" — senior staff whose professional activities have a material impact on the firm's risk profile. Firms are required to apply the Code in full in respect of Remuneration Code staff, though the FSA proposes that firms should give consideration to applying the remuneration principles on a firm-wide basis.

Where UK firms are concerned, the Code must be applied to all entities within the firm's group, both regulated and unregulated. UK subsidiaries of

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third country groups (such as groups headquartered in the United States) must apply the Code to all entities within the sub-group, whether in the UK or not.

The remuneration principles are wide-ranging. Among other things, they require the following:

- firms must have remuneration policies that are consistent with and promote sound and effective risk management;
- the governing body of a firm must adopt and periodically review the general principles of the remuneration policy;
- employees engaged in control functions such as compliance or risk management must be remunerated independent of the performance of the business areas they control;
- firms must take into account current and future risks when calculating variable remuneration, and

ensure that total variable remuneration does not limit their ability to strengthen their capital base; and

- firms must not pay variable remuneration through vehicles or methods that facilitate the avoidance of the Code.

The remuneration principle that has attracted particular attention is principle 12 (Remuneration structures). Under this principle, a firm must ensure that the structure of an employee's remuneration is consistent with and promotes effective risk-management; and where remuneration is performance-related, the total amount of remuneration must be based on a combination of the performance of the individual, the relevant business unit, and the firm as a whole.

Principle 12 contains two other provisions that are likely to be of interest to alternative investment managers. The first is that any variable remuneration — or, in common language, "bonus" — must be at least 40% deferred, for at least three years. If the variable remuneration component is particularly high (£500,000 is by definition "particularly high," and the FSA leaves open the question of whether a lower amount might also satisfy the definition), the percentage that must be deferred rises to 60%.

Any variable remuneration is to be paid only if it is sustainable according to the financial situation of the firm as a whole, and justified according to the performance of the firm, the business unit and the individual concerned. This indicates that if the performance of the firm declines significantly in the period of deferment, the firm should not pay the deferred amount. It would also appear from the FSA's comments on severance pay that it will not be possible for the employee to accelerate payment of the deferred amount by resigning or otherwise negotiating his or her departure from the firm.

The second provision requires at least 50% of any bonus to consist of "an appropriate balance" of shares or equivalent ownership interests (subject to the legal structure of the firm concerned) and capital instruments that can be used to meet the firm's capital resources requirement at stage B1 of the calculation set out in the FSA's prudential rules. A failure by the firm to comply with this provision, as with the provision regarding deferred remuneration, gives the FSA the power to not only render the arrangements with the employee void, but also to recover any payments made to the employee under such void arrangements.

The key question is whether the Code will be applied in such a way as to allow entities such as LLPs to pay a bonus entirely in cash. If the answer to that question is affirmative, we may see firms that are currently set up as companies converting to LLP status, in order to retain the flexibility regarding the payment of bonuses.

While a listed company could comply with this requirement readily enough, it is less easy to see how an unlisted company could do so — still less an LLP (the legal form of many alternative investment managers regulated by the FSA). The FSA acknowledges that "this requirement is not easily applied" in cases where firms are unable to issue shares, but offers no suggestion as to what such firms should do.

FSA's hope would appear to be that guidelines from the Committee of European Banking Supervisors ("CEBS") will resolve this difficult issue, but it seems odd that the FSA should not give some clear indication of its own view on the matter in the meantime.

Alternative investment managers can perhaps take some minor comfort from the fact that neither of the provisions just mentioned will apply in relation to Remuneration Code staff whose bonus is less than

33% of total remuneration and whose total remuneration is no greater than £500,000. They may take greater comfort from the fact that the remuneration provisions of CRD3 include a requirement that the provisions be applied to firms in a way that is proportionate to a firm's size, internal organization and the nature, scope and complexity of its activities. The FSA has proposed applying this proportionate approach in the implementation of the Code.

While the FSA will not countenance the Code being ignored completely, it is prepared to concede that some provisions of the Code, including the provisions relating to deferral of bonuses and payment of parts of bonuses in shares or share-linked instruments, could be applied on a "comply or explain" basis. That is, providing that firms can justify not complying with the rules concerned, they will not be in breach of them.

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The FSA is prepared to allow firms to miss the January 1, 2011 date for compliance with the Code, but only in respect of remuneration principle 12, and then only if the firm has made reasonable efforts to comply with that principle by that date. In any event, the respite for such a firm will be slight, as firms must be in full compliance with the Code by July 1, 2011. This is a challenging timescale, which will require firms to review and amend their present arrangements in very short order.

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