KIRKLANDPEN

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KIRKLAND & ELLIS LLP

Private Equity Newsletter

SEC Proposes Stricter Accredited Investor Test for Private Equity, Hedge and Certain Other Funds

PENpoints

SEC proposes to narrow the class of individual investors who would be permitted to invest in many private funds.

SEC Proposal

As part of the SEC's recent attempts to regulate the hedge fund industry and its concern over the growing participation of individuals in private funds, the SEC in late December 2006 proposed narrowing the class of individual investors who would be permitted to invest in many private funds.[1] The proposal would amend the current accredited investor ("AI") definition (which generally requires an individual to have either $1 million net worth or $200,000 annual income) by requiring an individual also to own at least $2.5 million in investments in order to invest in private equity, hedge or certain other funds under Reg. D's private placement safe harbor.[2]

The proposal would apply to an individual's investment in a fund (a "covered fund") which relies on the §3(c)(1) "not-more-than-100-investor" exemption from Investment Company Act ("ICA") regulation, including both private equity and hedge funds,[3] but would *not* apply to:

- a private fund using the §3(c)(7) qualified purchaser exemption from ICA regulation (since an individual investor in this type of fund must already have at least $5 million in investments),
- a "venture capital fund" meeting a complex asset composition test designed for business development companies,
- an employer-sponsored fund made up of employees of a single company (or group of affiliated companies) organized under the SEC's employee securities company ("ESC") rules,
- a commodities or real estate fund exempt from ICA registration other than under the §3(c)(1) exemption, or
- an operating company not primarily engaged in the business of investing in securities (since an operating company is automatically exempt from the ICA).

The $2.5-million-of-investments proposal would affect an individual who invests directly in a covered fund, as well as an individual who invests in such a fund through an intermediate entity (e.g., a partnership or LLC) formed for the purpose of making such investment.

Current SEC Rules Compared to Proposal

Federal and state laws have long required that a private fund (like any other issuer of securities) may issue securities without 1933 Act registration only if the fund qualifies for an exemption from registration. Under the SEC's Reg. D exemption used by most private funds, a private fund may sell its securities to an unlimited number of AIs plus up to 35 non-AIs without registration, although in practice most private funds admit only AIs to avoid (1) the more detailed disclosure requirements for an offering which includes non-AIs and (2) the requirement

that non-AIs meet an investment "sophistication" test.

To qualify as an AI under current Reg. D standards, an individual must have:

- net worth in excess of $1 million or
- income in excess of $200,000 per year (or $300,000 of income with spouse).

The SEC's December 2006 proposal would require an individual investing in a covered fund (1) to qualify as an AI under the above net worth or income test and (2) also to own at least $2.5 million in investments (which threshold would be adjusted for inflation every 5 years).

This new proposed $2.5 million test does not change the current AI standards for an investment in a covered fund by an entity (unless the entity includes individuals and was formed for the purpose of investing in the covered fund) or by an executive officer, director or general partner of the covered fund. Nor does the new proposed $2.5 million test change the rule allowing up to 35 non-AI investors (so long as enhanced disclosure requirements and investor sophistication test are satisfied) in a covered fund.

Calculating Individuals' Investment Holdings

The proposal measures an individual's investments by (1) excluding his/her residential real estate, (2) excluding a privately-held company controlled by the individual unless the company's shareholders' equity is at least $50 million, (3) deducting any indebtedness incurred by the individual to acquire investments, and (4) for a married couple investing in both spouses' names, counting 100% of both spouses' investments (but for a spouse investing only in his/her name, counting 50% of investments held jointly with his/her spouse or in which the natural person and his/her spouse share a community property or similar interest).

Conclusion

The SEC's comment period on the proposal is open until March 9, 2007, and we are preparing comments on various elements of the proposed rule. Because the SEC explicitly requested comments on many aspects of the proposal, the SEC undoubtedly will receive many comments, and the final rule may be significantly different than the proposal as described above.

Should you have any questions about the matters addressed in this Kirkland PEN article, or wish to discuss the SEC comment letter that we are preparing, please contact the following Kirkland authors or your regular Kirkland contact.

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1 The SEC has also proposed a new rule prohibiting any registered or unregistered investment adviser to a pooled investment vehicle (including a general partner of and a management company to a private equity fund or hedge fund) from making false or misleading material communications to investors or otherwise engaging in conduct or practices that are fraudulent, deceptive or manipulative to investors.

2 This proposal follows on the heels of the *Goldstein* federal appellate court decision invalidating the SEC's 2004 hedge fund investment adviser registration rule, which would (if not held invalid) have required most hedge fund sponsors to count each investor as a client towards the fewer-than-fifteen client exemption from investment adviser registration.

3 The proposal would also generally cover an individual's investment in a family investment company or a neighborhood investment club, since these types of funds generally use the §3(c)(1) exemption. The proposal might also cover certain club deal or co-investment vehicles formed to acquire a company or to roll up several companies.

Changes in Luxembourg Corporate Law: Impact on Private Equity Investors in Europe

PENpoints

Luxembourg now permits commonly-used legal entities to implement a two-tier board structure.

For tax and corporate governance reasons, many investments by U.S. private equity funds in European businesses have been structured using Luxembourg holding companies. Luxembourg has implemented new legislation that revises the treatment of certain types of entities commonly used in such structures.[1] These changes affect both the *société anonyme* (SA) and the *société en commandite par actions* (SCA).[2] Importantly, the changes apply to such entities that existed on the effective date, potentially leading to unintended consequences under the existing organizational documents of these entities. Accordingly, investors should consult with counsel regarding the impact of these changes on such entities.

Some of the key changes include:

Board Structure and Board Voting: SAs may now employ a two-tier structure with a supervisory board and a management board. An SA's supervisory board oversees the management board, which exercises day-to-day management of the company. The two-tier board structure potentially allows an investor to maintain representation on an SA's supervisory board while mitigating tax risks (arising under certain home country tax regimes, such as Germany) associated with deemed operational activity otherwise arising to that investor in a one-tier board structure. Additionally, each board must now elect a chairman (in both one-tier and two-tier structures), who may now break tie board votes unless the company's charter expressly provides otherwise. The amendments also reduce the quorum for board action to half (from a majority) of directors unless the company's charter requires a different quorum.

Company Directors: A legal entity may continue to act as a director on the board of an SA, but such director entity now must appoint an individual person to act as its "permanent representative." The person so appointed is jointly and severally liable with the associated director entity for actions as a director.

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1 Because Kirkland & Ellis International LLP does not practice Luxembourg law, for transactional advice we rely on qualified local counsel such as Arendt & Medernach (*Avocats à la Cour*). We are grateful for Arendt's assistance in preparing this article and have consulted extensively, among other sources, Arendt's *Legal Update*, October 2006, available at: http://www.arendt-medernach.com/upload/pdf/Legal%20Update%20October%202006.pdf

2 Except where otherwise stated, the legislative changes were effective September 4, 2006.

PENbriefs

SEC Releases Interim Final Rules Regarding Reporting and Disclosure of Equity Awards

The SEC unexpectedly released interim final rules on December 22, 2006 that significantly changed the reporting and disclosure of equity-based awards to named executive officers and directors. For Kirkland's discussion and analysis of these rules, please see the Kirkland *Alert* at:

http://www.kirkland.com/files/tbl_s14Publications/Document1303/1709/SEC_Releases_Interim_Final_Rules.pdf

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IMN Winter Forum on Real Estate Opportunity & Private Fund Investing
January 17-19, 2007
Laguna Beach, CA
Kirkland is sponsoring the IMN Winter Forum on Real Estate Opportunity & Private Fund Investing. Kirkland partner Stephen Tomlinson will participate in a panel discussing issues involved in structuring first-time funds.

A Guide to Mergers & Acquisitions 2007
New York, NY
January 22 - 23, 2007
Kirkland partner Joshua Korff will be a speaker at the Practising Law Institute's "A Guide to Mergers & Acquisitions 2007." Joshua will discuss the legal groundwork for transactions, including transaction timetables, confidentiality agreements, and what to look for in due diligence and third-party consents.

American Securitization Forum 2007
Las Vegas, NV
January 28-31, 2007
Kirkland is a sponsor of the American Securitization Forum, through which participants in the U.S. securitization market discuss legal, regulatory and market practice issues. Kirkland partner Ken Morrison will be speaking on the Retail Auto Loan ABS Sector Review panel.

Kellogg Private Equity Conference
Evanston, IL
February 21, 2007
Kirkland is a sponsor of the 2007 Private Equity Conference of Northwestern University's Kellogg School of Management. Kirkland partner Meg Gibson will moderate a panel discussing large-cap vs. mid-cap private equity.

Kirkland & Ellis LLP's Private Equity Practice

Kirkland & Ellis LLP's private equity and venture capital attorneys handle leveraged buyouts, early-stage venture capital investments, later-stage growth capital transactions, recapitalizations and going-private transactions. In addition, we have significant experience in the formation of private equity and venture capital funds. Kirkland represents more than 200 private equity firms from all industries in every major market around the world. Kirkland was named the 2006 "USA Law Firm of the Year" by Chambers & Partners for providing superior service in all practice areas.

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