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KIRKLANDPEN
Private Equity Newsletter

July 21, 2010

Dodd-Frank Act Affects Private Fund Managers and Investors

PENpoints

The Dodd-Frank Act, signed into law on July 21, 2010, addresses a wide array of financial industry matters, including many affecting the private fund business.

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act" or the "Act"), addressing a wide array of financial industry matters, including many affecting the private fund business. The scope of the Dodd-Frank Act is far-reaching: it is hundreds of pages long; requires 11 different federal agencies to generate a multitude of new regulations, studies and periodic reports; and the SEC alone has announced that it needs to hire 800 new staff members to satisfy its obligations under the Act.

Three of the primary ways in which the Act affects private fund managers and investors are:

(1) mandating most private fund managers to register with the SEC under the Investment Advisers Act,

(2) mandating the SEC to issue rules that will often prevent private fund managers from serving on the compensation committee of a public portfolio company, and

(3) severely restricting (in the so-called "Volcker Rule") bank holding companies and their affiliates from investing in or sponsoring private funds.

This *Kirkland PEN* discusses these three important developments.

–The Editors

Time for Many Private Fund Managers to Prepare for Investment Adviser Registration

The Dodd-Frank Act includes changes to the Investment Advisers Act of 1940, as amended (the "Advisers Act"), and Regulation D under the Securities Act of 1933, as amended, affecting private fund managers. As discussed in our June 16 *Kirkland PEN*, by eliminating the fewer-than-fifteen-client exemption from Advisers Act registration, the Dodd-Frank Act requires most private equity, hedge and real estate fund managers advising private funds (i.e., §3(c)(1) and §3(c)(7) entities) with aggregate assets under management ("AUM") of $150 million or more[1] in the U.S.[2] to register with the SEC as investment advisers by no later than July 21, 2011.

The Dodd-Frank Act does, however, provide several new limited exemptions from SEC investment adviser registration for:

- An adviser to "venture capital funds" (to be defined by the SEC),
- An adviser to "family offices" (to be defined by the SEC),
- An adviser to SBICs, and
- A "foreign private adviser" that (1) has no place of business in the United States, (2) has fewer than fifteen U.S. clients or U.S. investors in the adviser's private funds, (3) has less than $25 million AUM attributable to U.S. clients or U.S. investors in the adviser's private funds and (4) does not hold itself out as an adviser in the U.S. or advise a U.S. registered investment company or a business development company (a "BDC").

The Dodd-Frank Act also requires:

- Confidential reports to be filed with the SEC containing information to assess the systemic risk of a registered manager's private funds and, to the

INSIDE KIRKLANDPEN

extent specified by the SEC, of an unregistered manager's private funds with less than $150 million AUM.

- A change to the individual accredited investor test that a natural person's primary residence is not considered in determining if he or she satisfies the $1.0 million net worth threshold.[3]
- The SEC by no later than July 21, 2011, to adjust for inflation the "qualified client" test for carried interest/performance fees, currently $1.5 million net worth or $750,000 AUM.

Registration as an SEC investment adviser generally requires:

- Preparing and filing with the SEC registration forms (Form ADV Part I) for each manager,
- Preparing an investor disclosure document (Form ADV Part II),
- Preparing and implementing detailed compliance policies and procedures, and
- Appointing a chief compliance officer to oversee the manager's compliance function.

Preparation for Adviser Registration

An unregistered private fund manager affected by the new legislation should begin preparing for registration well in advance of the July 21, 2011, registration deadline. A manager with multiple funds, a complex structure, and/or numerous personnel should begin the planning process in Fall 2010 to provide sufficient planning and implementation time.

A private fund manager required to register should:

- Examine its organizational structure to determine which entity or entities in the structure provide investment advice and must register as investment advisers.
- Consider a person to appoint (or hire) as the manager's chief compliance officer and begin work on required Advisers Act compliance policies and procedures. The SEC expects advisers to conduct a risk assessment and draft policies and procedures specifically tailored to the adviser's business and practices. Advisers should review current policies and procedures in light of this requirement and consider implementing the new compliance programs on a pilot basis prior to registration. This will allow time for employee training and to address any significant problems with the policies, or their implementation, prior to the registration deadline.
- Review the management and control structure of their fund management and fund general partner entities to determine whether any changes should be considered prior to registration. As the Advisers Act requires client (i.e., investor) consent to a registered investment adviser's change of control or "assignment" as defined in the Advisers Act, making necessary adjustments to the entity's control structure prior to registration may be advisable.
- Review governing documents of private funds or managed accounts to determine whether these documents should be amended to comply with Advisers Act requirements.
- Revise offering documents and related pitch materials to ensure compliance with Advisers Act requirements, including advertising rules.
- Analyze the custody arrangements applicable to the managers' private funds or other clients, as the Advisers Act's custody rule generally requires that client assets be held with qualified custodians, and in certain cases imposes new reporting obligations or surprise audits. Most private fund managers can avoid many of the custody rule's more onerous provisions by having their funds (including co-invest funds) audited in accordance with GAAP and audited financials promptly delivered to LPs.
- Review its compensation arrangements because a registered investment adviser is not permitted to charge performance fees (including carried interest) unless the payor falls within an exemption, including a §3(c)(7) qualified-purchaser fund, a "qualified client" in a §3(c)(1) fund (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), 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).
- Gather information necessary to complete Form ADV and prepare the required investor disclosure (Form ADV Part II). While much of the required information is factual in nature, it generally must be gathered from a number of different individuals and sources so sufficient time should be scheduled for the information gathering process and disclosure preparation.
- Implement a books and records retention system, including email retention, designed to meet Advisers Act requirements.

1 A lower $100 million AUM threshold applies if the manager advises other products such as managed accounts or employee securities companies. Managers with AUM less than these $100 million/$150 million SEC-registration thresholds will be regulated by various states.

2 The Act does not define the meaning of assets in the United States.

3 In 2014, the SEC is also required to inflation adjust the $1.0 million net worth accredited investor standard.

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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Dodd-Frank Act May Prevent Private Fund's Representative from Serving on Public Company's Compensation Committee

Just as the Sarbanes-Oxley Act of 2002 reduced the ability of a private fund's representative to serve on the audit committee of a U.S. public company (a "public portfolio company"), it appears that the Dodd-Frank Act will have a similar impact on the service of a private fund's representative on a compensation committee.

The Act requires the SEC to adopt rules no later than July 16, 2011, directing NYSE and Nasdaq to prohibit listing any company not complying with enhanced independence requirements for compensation committee members. In determining compensation committee "independence," the Dodd-Frank Act requires public companies to consider at least the following factors:

- the source of compensation received by a compensation committee member, including consulting, advisory, or other compensatory fees (apparently including management fees paid by the public portfolio company to the private fund), and
- whether the compensation committee member is an affiliate of the public portfolio company or any of its subsidiaries.

Although subject to SEC rulemaking, the SEC will likely base "affiliate" status on the SEC's traditional definition, i.e., a person that directly or indirectly controls, or is controlled by, or is under common control with, the issuer, with a presumption that more than 10% direct or indirect ownership of a an issuer creates affiliate status. If so, a representative of a private fund owning more than 10% (or of a group of private funds acting in concert and owning in the aggregate more than 10%) of a public portfolio company would be precluded from serving on the company's compensation committee, subject to the "controlled company" exception described below.

While the Dodd-Frank Act exempts a "controlled company"—i.e., a company with more than 50% of its voting power held by an individual, a group or another issuer—from this compensation committee independence test, the Act does not exempt a public portfolio company if the private fund owns between 10% and 50% of its stock.

This compensation committee independence provision is apparently inconsistent with other provisions of the Dodd-Frank Act. On the one hand, the Act seeks to expand stockholder powers by giving stockholders (including a private fund stockholder) both a "say on pay" and access to the company's proxy statement for the election of directors. On the other hand, however, as discussed above, it would apparently deny a stockholder owning between 10% and 50% of the company's stock (including a private fund) the right to have its representatives serve on the company's compensation committee. Furthermore, the Act fails to address why is it acceptable for a private fund that owns more than 50% of the public portfolio company's stock to serve on the compensation committee but not acceptable for one that owns between 10% and 50%.

It is particularly noteworthy that, in contrast to the Sarbanes-Oxley Act, the Dodd-Frank Act does not impose an absolute and inflexible definition of "independence" and thus leaves discretion to the SEC, NYSE and Nasdaq in this regard. The SEC should carefully consider this provision of the Dodd-Frank Act—especially the "affiliate" requirement—before implementing rules that potentially disenfranchise those stockholders with the greatest interest in ensuring that executive compensation is appropriate and properly balanced.

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Volcker Rule Requires BHCs and their Affiliates to Divest Investments in Private Funds

As noted in our June 16 *Kirkland PEN*, the so-called "Volcker Rule" contained in the Dodd-Frank Act generally prohibits bank holding companies ("BHCs") and their subsidiaries and affiliates (a "BHC group")—essentially, all entities in a BHC's organizational structure[1]—from investing in, owning, operating or sponsoring a private fund, effectively requiring a BHC group to divest its investments in most private funds and its private fund management businesses.

Ban on Investing In and Sponsoring Private Funds

Under the Dodd-Frank Act, a BHC group is prohibited from (1) investing in a private fund (i.e., a fund exempt from registration under §3(c)(1) or §3(c)(7) of the Investment Company Act of 1940 or a "similar fund"[2]) or (2) "sponsoring" a private fund by serving as general partner, managing member or trustee, or selecting or controlling the election of a majority of its directors, trustees or management or (3) sharing the same name (or a variation of the same name) with a private fund.

A limited exception to prohibitions (1) and (2) above allows a BHC group to "organize and offer" a private fund, including "sponsoring" a private fund by acting as general partner, etc., and providing up to 100% of seed capital, so long as:

- The investment is reduced to not more than 3% of the total ownership interests[3] in the fund within one year[4] *and* the aggregate of all permitted investments by a BHC group in private funds does not exceed 3% of the BHC group's Tier 1 capital,
- The BHC group provides bona fide trust, fiduciary or investment advisory services to the private fund,
- The private fund is "organized and offered" in connection with such services and offered to the customers of such services,
- The BHC group does not guarantee or otherwise insure the obligations or performance of the private fund and makes it clear to investors that losses will be borne solely by the investors, not the BHC group,[5] and
- The private fund and the BHC group do not share the same name (or a variation thereof).

BHC groups may, however, invest in small business investment companies (SBICs) and other "public welfare" investments. In addition, the Volcker Rule does not limit a BHC group's merchant banking activities permitted under the Gramm-Leach-Bliley Act ("GLBA"), including direct investments by a BHC group in portfolio companies so long as such investments comply with merchant banking restrictions. A BHC group may also act as an investment adviser to a private fund in which the BHC group does not invest or sponsor, subject to the same affiliate transaction restrictions applicable to banks under the Federal Reserve Act.[6]

Transition

The Volcker Rule's restrictions on certain activities, including those relating to private funds, are not immediately effective. The Volcker Rule will become effective no later than July 2012, followed by a two-year transition period during which BHC groups must come into compliance, with the possibility of extensions granted at regulators' discretion.

Effects of the Volcker Rule

The Volcker Rule may have a significant impact on the private funds industry, such as:

- *Fundraising*. BHC groups will likely cease their fund manager activities and will no longer be a source of LP or GP capital. Their exit from the fundraising market will create a large hole requiring some private funds to seek new investors (with resulting longer fund-raising timelines).
- *Secondary Market*. There will also be a substantial increase in the secondary sale of private fund LP interests as BHC groups sell off their existing private fund LP investments, raising numerous issues for fund sponsors, as BHC groups seek consent to transfer LP interests, seek to disclose confidential portfolio information and seek release from clawback liability and other provisions to facilitate the sale of LP interests.

  In addition, complex (and fact-specific) tax rules may treat a partnership (or an LLC) as a taxable corporation if trading in such entity's LP interests exceeds certain regulatory safe harbors. Hence LPs (including BHC groups) in a private fund seeking to sell a substantial amount of LP interests may create tension between (a) the fund manager's desire to limit sales of LP interests to meet the tax safe harbors and (b) the selling LPs' desire to promptly effectuate the desired LP-interest sales without regard to the volume thereof.
- *Spin-Outs and Management Buyouts*. The current trend of fund manager (i.e., GP) spin-outs and management buyouts will likely accelerate.
- *SBIC Investments*. BHC groups may increase investments in SBIC funds, as these will generally be the only third party private funds in which BHC groups can invest without limitation.[7]

1 Affiliates of a foreign company treated as a BHC under the Bank Holding Company Act are generally covered, but a foreign company not controlled by a U.S. parent is not covered, so long as the group's activities are completely offshore.

2 The Volcker Rule also grants federal regulators discretion to include other investment vehicles that are currently not included within the definition, such as other exempt private funds (e.g., REITS) and possibly employee securities companies (ESCs) and registered investment vehicles such as business development companies (BDCs).

3 The Volcker Rule does not specify whether "total ownership interests" means the BHC group's percentage of committed capital or the BHC group's percentage profits interest.

4 The Federal Reserve may grant a two-year extension if it finds the extension to be consistent with safety and soundness and in the public interest.

5 It is unclear how this requirement affects the structuring of a profits interest for a general partner or sponsor of a private fund.

6 For example, a BHC group would be prohibited from lending to, buying assets from, or providing guarantees on behalf of, the advised fund, with a general exception for "prime brokerage transactions."

7 The Volcker Rule contains many other prohibitions, including, for example, a prohibition on a BHC group engaging in proprietary trading, defined broadly as purchasing or selling any stocks, bonds, options, commodities, derivatives or other financial instruments for short-term profit, subject to certain limited exceptions.

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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PENnotes

Kirkland & Ellis Private Fund Manager Advisers Act Registration Seminars

Please join Kirkland & Ellis at one of our Private Fund Manager Advisers Act Registration Seminars, chaired by partner Scott A. Moehrke, P.C. Panelists at the seminars will focus on how the Private Fund Investment Advisers Registration Act of 2010 will affect private fund managers and the steps private fund sponsors need to take to plan for SEC registration and operate as a registered adviser. The seminars will allow interactive dialogue with our panels and are designed to give practical, hands-on advice for private fund managers.

LOCATIONS

Chicago
Tuesday, September 14, 2010
8:30 a.m. CT

New York
Tuesday, September 21, 2010
8:30 a.m. ET

London
Tuesday, September 28, 2010
8:30 a.m. BST

San Francisco
Tuesday, October 5, 2010
8:30 a.m. PT

For more information, or to register to attend, please visit www.kirkland.com/pfmaar.

Kirkland & Ellis, PEI Media and Probitas Partners Panel Discussion on Distressed Debt
New York, New York - July 27, 2010
London, UK - July 29, 2010

Kirkland & Ellis, PEI Media and Probitas Partners will host a panel discussion in Kirkland's New York and London offices on the distressed debt and restructuring markets. Each event will bring together a panel of deal and regulatory professionals, including Kirkland partners David Eaton and Partha Kar, who will discuss current and future trends, opportunities and risks in this market. Topics will include credit-bidding purchased debt in sales of distressed companies, voting problems for investors in loan-to-own situations, and UK pension claims and related cross-border issues. For more information, or to register for either event, please contact Suzanne Svendsen at 312-862-4427 or suzanne.svendsen@kirkland.com.

Kirkland & Ellis 5th Annual Real Estate Private Equity Symposium
New York, New York
September 23, 2010

Kirkland & Ellis' 5th Annual Real Estate Private Equity Symposium will be held on September 23, 2010, in Kirkland's New York office. The keynote speaker will be Bryan Marsal, Co-Chief Executive Officer, Alvarez & Marsal and the Chief Executive Officer of Lehman Brothers Holdings Inc. For more information, or to register for this conference, please visit www.kirkland.com/repe2010.

Kirkland & Ellis & Houlihan Lokey Seminar: Investing in India: Opportunities and Challenges
New York, New York
September 28, 2010

Having emerged relatively unscathed from the financial downturn, the Indian economy is predicted to rival that of Europe by 2020. India has emerged as one of the world's most attractive investment destinations. The execution of an India strategy, however, can be fraught with often-bewildering plethora of rules, regulations, and operational pitfalls. It requires knowledgeable advisors, strong local partners and an understanding of the landscape. This works both ways—Indian companies coming to the U.S. face a no less daunting process. To hear solutions to these challenges and more, please attend an invitation-only seminar hosted by Kirkland & Ellis and Houlihan Lokey on September 28, 2010. For more information, or to register for this event, please visit www.kirkland.com/india2010.

PENbriefs

Shaping Up Top-Up Options in Tender Offers

Tender offers have become increasingly common in the M&A marketplace, including in going-private transactions. In conjunction with this uptick in tender offer activity, the use of "top-up" options has become nearly universal. Under a top-up option, the target company grants the buyer an option to purchase at the deal price, upon successful completion of the tender offer at or above the minimum condition level (usually 50%), enough newly-issued shares of the target—in Delaware, the buyer would need to own 90% of the target's shares—to allow the buyer to complete the back-end squeeze-out merger as a simple short-form merger. The short-form merger accelerates the transaction timetable, benefiting the buyer and the target's remaining shareholders by hastening the inevitable exchange of 100% control for cash.

Inevitably, plaintiff's lawyers have attacked top-up options. While no court has issued a decision on the merits of these attacks, preliminary proceedings in and recent settlements of tender-offer cases offer dealmakers guidance to mitigate the deal and litigation risk associated with top-up options. To learn more about these developments, please see our recent *Kirkland M&A Update*.

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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. The Firm was named "Law Firm of the Year" in *Buyouts* magazine's "2010 Deal of the Year Yearbook," and was also honored with the 2010 "Award for Excellence" in Investment Funds by Chambers & Partners at its annual Chambers USA Awards. Kirkland was ranked in the first tier among law firms for both Private Equity Buyouts and Private Equity Funds by *The Legal 500 U.S. 2010*. Additionally, *Pitchbook* named Kirkland as one of the most active law firms representing private equity firms in its 2009 "Private Equity Breakdown."

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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