Association News

Highlights of the IVCA Toolkit Luncheon: 'What Private Equity and Venture Capital Firms Need to Know About Dodd-Frank and New Investment Adviser Regulations

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CHICAGO – On July 21st, 2010 the "Private Fund Investment Advisers Act of 2010" was passed as part of the Dodd-Frank Reform Bill. This Act requires registration with the SEC for many funds not previously required to do so. As part of the IVCA Toolkit Luncheon Series, attendees got a breakdown of the new registration law and suggestions for how firms can best manage the process of compliance.

The panel of experts assembled by sponsoring firm **Winston & Strawn, LLP** was moderated by **Andrew McDonough**, a Partner at **Winston & Strawn**, and included **Wesley Nissen**, also Partner at **Winston & Strawn**, who handled the overview of the new law. Nell Blatherwick, Principal at RCP Advisors, a firm that has been registered for several years, related her firm's experiences with registration and examination by the SEC. Ileana Stone, Assistant Counsel at the Bank of America Corporation, explained new regulations for bank participation in Private Equity and Venture Capital Funds.

The following were the highlights of the presentation...

The Definition of 'Adviser'

Wesley Nissen: Any person who, for compensation, engages in the business of advising others as to value of securities or the advisability of purchasing or selling securities. Private Equity and Venture Capital managers would normally fall within that broad definition.

One of the things that the Dodd-Frank Act did was eliminate the main exemption that Private Equity and Venture Capital mangers relied on- section 203b3. This section exempted from registration any investment adviser with fewer than 15 clients. For these firms, the "fund" was considered the client thanks to the decision by the Washington, DC, Court of Appeals in 2006, known as The Goldstein Decision. Dodd-Frank eliminated the 15 or fewer exemption, and replaces it with narrower exemptions.

The New Exemptions under Dodd-Frank

Nissen: The first of the new exemptions is known as the **Private Fund Adviser Exemption**, and that provides an exemption from registration as an investment adviser to an adviser who acts solely as an adviser to "private funds." Funds that are exempt from registration under the Investment Company Act, and those funds have assets under management in the U.S. of less 150 million aggregate. Those advisers would still be subject to record keeping requirements under the Investment Advisers Act.

The next exemption is **Venture Capital Fund Adviser**. That term has not yet to define. The SEC must define it by July 21st, 2011. Even when it is defined, Venture Capital Advisers also will still have to maintain records and reports that the SEC will determine that is in the public interest or for the protection of investors.

The next one is the **Family Office Exemption.** Family Office is another term that must be defined by the SEC, in a manner consistent with prior SEC interpretations on this topic. There is no time frame on which SEC will have to define Family Office. The definition will come up sometime in the future, but we don't know when.

Next is the **Small Business Investment Company (SBIC) Adviser Exemption**, who exclusively advises certain small business companies.

Registration at Federal vs. State Level

Nissen: **Referring to a chart in the handouts that describe who must Register with the SEC and who may register with the SEC** - The Dodd-Frank Act changes the guidelines on which advisers will be registered and regulated by the SEC vs. the state. Large advisers, more than 100 million, will be registered by the SEC and smaller advisers will be regulated by the state where the primary office is located. There are certain advisers that will be eligible to register on the federal level depending on in which state the main office is located.

Time Frames for Registration

Nissen: Essentially, registration is required one year after the act was signed by President Obama, by July 22nd, 2011. By stature the SEC has 45 days to review or reject an application, so the last possible day to submit an application is June 7th, 2011. We anticipate the registration process can take 10-20 weeks. Shortly after the first of the year a firm should start to focus on registration.

Start of the Registration Process

Nissen: The way you kick off the process is by opening up an account with an organization called the Investment Adviser Registration Depository. The website is IARD.com. It is the electronic template to file all these forms.

There are several different ways in which to get support for the registration and ongoing compliance obligations. Law firms are doing it, and the big accounting firms also have consulting divisions that will work on these areas. There are also third party consulting firms that specialize in doing registration and regulation work. Whatever method, it's making sure that there is a good alignment of support in deciding how to proceed.

Finally, there must be a designated Chief Compliance Officer in each firm or fund. There are no SEC requirements for this position.

Case Study of Actual Registration

Nell Blatherwick: RCP Advisors initially registered in November, 2005. We made the decision to register, even though we weren't required to do so, primarily because we believed that some of our investors would take comfort from the fact that we were registered investment advisers.

Out of a total workforce of 25 employees, we don't have a separate Compliance Department. Our chief Compliance Officers are the Managing Principals, who primarily manage the process with one other paralegal.

We had our first examination in March of 2010, and received our examination letter last week. We actually did pretty well, with easily resolvable issues. To me, it just seemed like a normal audit of our financial statements.

Half the battle is making sure your employees and principals are aware of the rules and regulations. Key employee transaction statements, for example, have to be collected quarterly. In terms of disclosure to investors, nothing has changed.

Determination of Compliance Officer

Andrew McDonough: As far as registering for the first time, and determining who will draw the lucky straw as Compliance Officer, there are a number of models. First of course, it's the CFO's job, because everything goes to them. Some firms may use the general counsel. In other firms it may be the partner who had the misfortune of last having practiced law. And we hear about larger firms hiring a new Chief Compliance Officer, who may come out of a regulatory or legal background.

Nissen: Firms who haven't registered before either overestimate or underestimate the amount of burden that is associated from being registered. The Disclosure Brochure, for example, has gone from a government form 'check the box' to a format where it will all be narrative and in plain English. The SECs' own estimates are that a small firm will take 15 hours to complete the new Disclosure Brochure and a larger form might take 98 hours. We think those estimates are a bit low. Compliance hours might even blossom to about 1800 hours a year total. In our view, that's a full person.

What everyone needs to understand is that, as an industry, we're going from "regulated" to "registered". The cost of compliance goes up, and more likely than not, a dedicated person or team that will fulfill that compliance role.

The Role of Banks in Private Equity and Venture Capital Investment

Ileana Stone: This is the so-called Volcker Rule that prohibits proprietary trading and investing by banks in Private Equity funds. The whole provision is 13 pages that go over these definitions, but there are a lot of unknowns, as to how it will be applied and who it applies to, so we start with that. The rule does prohibit sponsoring or investing in Private Equity funds by banking entities. It is an outright prohibition.

The banking entities that this applies to are your traditional banks, bank holding companies and non-bank financial holding companies determined by the Board of Governors.

First and foremost, take a look at your limited partner base. Try to determine or have conversations with those LPs that you think are affiliated with banking institutions or financial services companies that may fall under this definition. Find out if they expect they will be covered by that rule. That is the best way to start.

The Volcker Rule itself is not effective until two years after its enactment date – July 21st, 2012. The transition rules can give an additional two years. So technically it's a four year period from now when banks will no longer be allowed to hold any Private Equity fund investments. There also can be a request in illiquid funds for an additional five years, so there might be nine years total.

All the institutions, the timing to which they must conform in this, will depend on capital requirements they have elsewhere. My expectation is the larger part of the portfolio will unwind naturally, before the end of the extension periods.

Performance Fees

Nissen: There are two different suitability standards that were changed by the Dodd-Frank Act, both replacing laws from the 1930s and '40s. Everyone in 3C1 funds must be Accredited Investors, and the SEC has amended the standard definition of Accredited Investor in a couple ways. The net worth standard of one million dollars to qualify no longer may include your primary residence. And every four years now, the SEC will revisit those thresholds, to adjust for inflation.

The other standard change is in Qualified Client. There is a section of the Investment Advisers Act, Rule 205-3, which says that an investment adviser is prohibited from charging an incentive or performance based fee, unless the client has a certain threshold, either $1.5 million in assets under management or a $750,000 dollar net worth. Again, the SEC will revisit this standard periodically to adjust for inflation.

So if your fund is a 3C1 fund (one hundred persons or fewer fund) chances are once you get registered, you're going to want to make certain that the investors are either Accredited Investors or at least Qualified Clients, so you can charge a carry against that fund. If it's the case that you admit people who are not Qualified Clients, you can still operate the fund, you just can't charge those people a carrying or performance based fee. You can only charge an asset-based management fee. All these suitability qualifications will be made at the time of investment.

Track Record Disclosure

Nissen: With traditional record keeping and asset management in place since the 1940s, how these requirements will apply to the Private Equity and Venture Capital Advisers circumstances is still being worked out. It will be a difficult fit. The difference in reporting for Private Equity and Venture Capital is that it's on a deal-by-deal basis. The rule that has developed around past performance doesn't fit with Private Equity managers.

Section 404 of the Dodd-Frank Act mandates that the SEC come up with some new rule making in terms of books and record keeping of managers in all types of private funds. We know that Congress has called on the SEC to deal with these rules in the following nine areas...

- The amount of assets under management
- The use of leverage
- Counter-party credit risk and exposure
- Trading and investment positions
- Value making policies and practices of the fund
- Types of assets held by the fund
- Side arrangements
- Trading practices
- The catch-all of "such other 'information' that the SEC consultation with the Financial Stability Oversight Counsel that determines to be necessary and appropriate to prevent systemic risk."

Attendee Q&A

Q: As for an Investment Advisor disclosure, how much of this if any will be publicly disclosed, and what red flags does that raise?

Nissen: All of it is publicly available, even part two and four of the Disclosure Brochure, which previously wasn't required to be electronically filed, and will now be electronically filed as well. It's all ascertainable.

Q: My question is on management fees, we do them in advance every six months. Will the SEC require us to do anything different as far as the timing on that? And if we were doing something different, would we be subject to audit?

Nissen: This has not changed. This is part of custody. If you take fees in advance, that too is deemed custody of assets. What that means is that you need to comply with the requirements as if you have custody of those assets. And you may have to provide a financial statement for the investment management firm to the SEC.

Q: With a fund structure that has General Partners and a management company, who is registering, both the GP and the management company? Does there have to be two separate filings and compliance managers?

Nissen: Ideally it would be one management company, the one you make your business cards for. Even in the case of creating special purpose General Partners, who gets to receive a carry or performance fee, it still would be the case that the management company would register as the investment adviser.

After the Q&A was over, Moderator Andrew McDonough adjourned the event by reminding the attendees of the beautiful weather, and also encouraged those who are registering for the first time to look over the official SEC request letter in advance of the examination. He added that the letter is a good illustration of what the expectations are for compliance procedures.

For a copy of materials distributed at the luncheon, please click here. Please note that you must be an IVCA member to see this file!
Instructions:
Click on link above
Log-in with email and password
Click left nav bar at Resources, Research & Statistics
Click on 9.14.10 IVCA Toolkit: What Private Equity and Venture Capital Firms Need to Know About Dodd-Frank and New Investment Adviser Regulations