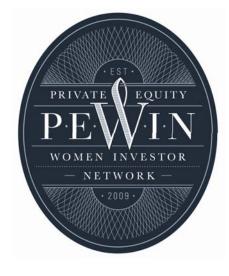
PE WIN Educational Series

"The Changing Regulatory Environment and the Impact on the Private Equity and Venture Capital Industry"

November 11, 2010



PE WIN Educational Series

"The Changing Regulatory Environment and the Impact on the Private Equity and Venture **Capital Industry**" Moderator Georgette Schaefer, Partner, Morgan Lewis Featured speakers Kathleen Collins, Partner, Morgan Lewis > The Dodd-Frank Wall Street Reform and Consumer Protection Act: The Volcker Rule Mary Kuusisto, Partner, Proskauer Updates on Carried Interest Taxation and The Alternative Investment Fund Managers Directive (AIFMD) > Jennifer Klass, Partner, Morgan Lewis Dodd-Frank & SEC Pay to Play

Kathleen Collins, Partner *Morgan Lewis*



Sponsoring and Investing in Hedge Funds and Private Equity Funds

What is a "banking entity" subject to the Volcker Rule?

Any FDIC-insured bank or thrift, any company that controls an insured bank or thrift, and any company that is treated as a bank holding company under the International Banking Act of 1978, and any affiliate or subsidiary of such an entity.

Generally, the Volcker Rule prohibits a banking entity from:

 \succ investing in or

➤ "sponsoring"

- > general partner, managing member, or trustee of a fund
- > ability to select or control a majority of directors, trustees, or management of a fund; or
- to share with a fund, for corporate marketing, promotional, or other purposes, the same name or a variation of the same name
- ➤ "hedge funds" or "private equity funds"
 - An issuer that would be an investment company but for Section 3(c) (1) (funds with 100 or fewer beneficial owners) or Section 3(c)(7) (funds all the holders of which are "qualified purchasers") of the Investment Company Act of 1940, or "such similar funds" as the banking agencies, SEC and CFTC may determine

Exclusions from the Rule

- Small business investment company investments
- Sponsorship of and investments in funds pursuant to Sections 4(c)(9) or 4(c) (13) of the BHC Act solely outside of the U.S., provided that no ownership interest in such hedge fund or private equity fund is offered for sale or sold to a U.S. resident and that the banking entity is not directly or indirectly controlled by a banking entity that is organized under the laws of the U.S. or of one or more States.
- Private equity and hedge funds that are sponsored by the banking entity itself, subject to the following conditions:
 - Organized and offered only in connection with bona fide trust, fiduciary, or investment advisory services and only to persons who are customers of such services of the banking entity (interpretation will be critical)

(cont'd)

- Investment in the fund is a de minimus investment or providing seed money and the investment is reduced to 3% or less within 1-3 years;
- Investment is not material to the banking entity and in aggregate, all such investments do not exceed 3% of banking entity's Tier I capital; and
- aggregate amount of such investments is deducted from both the assets and tangible equity of the banking entity and the amount of the deduction is to increase commensurate with the leverage of the fund
- > no director or employee of the banking entity, other than those directly engaged in providing investment advisory or other services to the fund takes or retains an ownership interest
- It the banking entity does not directly or indirectly guarantee the obligations or performance of the fund or share its name or any variation of its name with the fund, and investors are informed that losses will be borne by investors the banking entity complies with affiliate transaction restrictions
- Future rulemaking by banking agencies, SEC and CFTC may create additional exemptions.

Process and Timeline for Implementing the Rule

- January 2011 Financial Stability Oversight Council completes study and issues recommendations (Council received over 8,000 comment letters)
- January 2011 Federal Reserve to issue rules implementing initial transition period and the extended transition period for "illiquid funds"
- October 2011 Bank regulators, SEC, CFTC to consider findings of Council and adopt rules to carry out Volcker Rule
 - Regulators issue rules to impose additional capital and other requirements on sponsoring or investing in funds during the transition period
- > July 2012 Effective date of Volcker Rule
- July 2014 End of initial transition period (last day for fund activities and investments to be conformed, divested, or extension obtained)
- July 2017 End of 3 year potential extension period (unless obtain extension for investment in "illiquid funds"
- ➤ July 2022 End of extension period for illiquid funds

Mary Kuusisto, Partner *Proskauer*



Status of current proposed legislation

Consequences of current proposed legislation, if passed

> What does the future hold for carried interest?

Status of current proposed legislation

> House/Senate/Administration

Effect of Mid-Term Elections

Status of current proposed legislation, if passed

- Recharacterization of capital gain as ordinary income
- Limitations on losses
- > Taxation of distributions in kind
- ➤ Enterprise value tax

What does the future hold for carried interest?

Not off the table – it's a big number
Overall tax reform alternatives
Politics vs. Policy

- > Status of current compromise text
- ➤ General consequences of proposals
- ➤ Compliance obligations
- "Third Country Provisions": Applicability of proposals to US fund managers marketing US funds

Status of current compromise text

> Parliament vote on compromise text imminent

> If passed, as is expected, will likely become final in January 2011

> Implementation by the 27 EU member states will be required by January 2013

➤ Two years to figure it all out

General consequences of proposals

 Restricts marketing by AIFMs to EU investors unless comply with the AIFMD
 Exemption for AIFM under the threshold of EU 500 million of funds under management

Compliance obligations

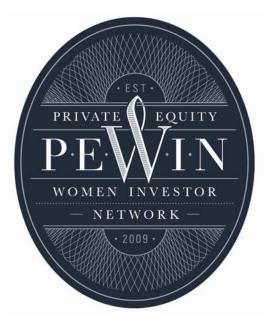
Compliance includes: pre-marketing notice, increased capital requirements, engagement of a depositary with strict liability; detailed annual report; disclosure rules and restrictions on distributions for "controlled" (>50%) portfolio companies; remuneration code application; valuation changes
 Some overlap with SEC Investment Adviser compliance obligations, but not complete

Third Country Rules: Applicability of proposals to US (non-EU) fund managers marketing US funds to EU investors

- Now 2013: Current rules apply national private placement regimes (NPPRs) in each member state where marketing
- 2013 2015: NPPRs plus certain AIFMD compliance (transparency/portfolio company information) and cooperation agreements between US and EU countries where marketing
- 2015 2018: Passport available with full AIFMD compliance, but NPPRs will operate in parallel

Around 2018: NPPRs no longer available – passport only with full AIFMD compliance

Jennifer Klass, Partner *Morgan Lewis*



Private Fund Investment Advisers Registration Act of 2010

- > All advisers to "private funds" must register, subject to certain exceptions \mathbb{P} "Private fund" is any issuer that relies on Section 2(a)(1) or 2(a)(7)
- > "Private fund" is any issuer that relies on Section 3(c)(1) or 3(c)(7)
- Eliminates Section 203(b)(3) exemption for fewer than 15 clients
- Increases threshold for SEC registration to \$100 million in AUM for regular investment advisers

\$25 million threshold remains in effect for investment advisers not subject to state registration or examination

- Creates SEC registration obligation for "private fund advisers" with \$150 million in AUM
 - Advise exclusively private funds
 - \$30 million threshold for private fund advisers not subject to state registration or examination

Advisers to "venture capital funds" – are not required to register
 Pending SEC rules to define "venture capital funds"
 Must keep records and provide annual or other reports to the SEC
 "Foreign private advisers" – are not required to register

- ➢ No place of business in U.S.
- Does not hold itself out in U.S.
- Fewer than 15 U.S. clients/investors within last 12 months
- Less than \$25 million in AUM from U.S. clients/investors within last 12 months
- Does not act as investment adviser to a registered investment company or business development company

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Collection of systematic risk data about private funds – registered advisers
 Amount of AUM

- > Use of leverage, including off-balance sheet leverage
- Counterparty credit risk exposures
- Trading and investment positions
- ➤ Trading practices
- ➤ Valuation policies and practices of funds
- ➤ Types of assets held
- ➤ Side letters
- Records of private funds are considered records of registered investment advisers
- Advisers to venture capital advisers must keep records and provide reports to SEC even though not required to register

Municipal Advisors	 New category of registered persons SEC registration required effective October 1, 2010 Broad definition that includes businesses and individuals that advise municipal entities concerning municipal financial products and municipal securities who solicit certain types of business from municipal entities Narrow exclusions Subject to MSRB rules
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SEC Rules – Pay-to-Play

 Advisers Act Rule 206(4)-5 > Two-year "time out" > Prohibits an adviser from receiving compensation for the two-year period after the adviser or any of its covered associates makes a contribution to an official of a government entity who is in a position to influence the award of the government entity's business > Ban on using unregistered third parties to solicit government business > Ban on soliciting and coordinating contributions and payments > Compliance dates 	
 March 14, 2011 September 13, 2011 for ban on using unregistered third parties to solicit and certain other provisions 	 Prohibits an adviser from receiving compensation for the two-year period after the adviser or any of its covered associates makes a contribution to an official of a government entity who is in a position to influence the award of the government entity's business Ban on using unregistered third parties to solicit government business Ban on soliciting and coordinating contributions and payments Compliance dates March 14, 2011 September 13, 2011 for ban on using unregistered third parties to solicit and certain

SEC Rules – Pay-to-Play

 Look-through for "covered investment pools" includes mulas well as private funds and collective in trusts that are not registered in reliance of 3(c)(1), 3(c)(7) or 3(c)(11) of the Investme Company Act ▷ Prohibitions of rule apply to advisers that seek to provide services directly to a government entitie investors or are solicited to invest in cover investment pools managed by the advised 	vestment on Sections ent t provide or vernment es are ered
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