Proskauer

Private Investment Funds Update

April 2011

Still Waiting for New Rules

The extensive rule making required by the Securities and Exchange Commission (SEC), Commodity Futures Trading Commission (CFTC) and other U.S. government agencies in order to implement provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) continues at a rapid pace. Among the key recent developments:

- **Investment Adviser Registration Likely to Be Delayed**: The SEC has not yet finalized proposed rules establishing exemptions from registration as an investment adviser for family offices, venture capital advisers, advisers to private funds with less than $150 million, and non-U.S. advisers. In an April 8, 2011 letter, the SEC staff indicated that final rules are expected to be published by the July 21, 2011 deadline, and that the SEC expects to "consider" extending, to the first quarter of 2012, the date by which certain unregistered advisers (including advisers to private investment funds) must register.
- **CFTC Proposes Repeal of Key Exemptions**: The CFTC recently proposed to repeal Rules 4.13(a)(3) and 4.13(a)(4), which are the principal exemptions from registration with the CFTC relied on by hedge fund managers who trade futures (see discussion below).
- **New Rules on Swaps Markets**: Both the CFTC and the SEC continue to work on extensive new rules to govern the OTC derivatives market, including rules requiring registration of swap dealers and major swap participants; moving the trading of swaps onto regulated trading markets and through clearing houses; registration of swap data repositories; and establishing reporting requirements and public dissemination of information regarding swaps. Although the new rules are required to be adopted by July 2011, there have been reports that the agencies will miss and may extend some or all of the deadlines, and reports of some legislative proposals to extend the deadlines.

At the same time, other regulatory authorities, including the IRS, FINRA and state and local government authorities, recently have taken actions affecting many private investment fund managers, some of which are summarized below.

CFTC Proposes to Repeal CPO Exemption Used by Many Hedge Fund Managers

On January 26, 2011, the CFTC proposed eliminating the exemptions from Commodity Pool Operator (CPO) registration contained in Rules 4.13(a)(3) and 4.13(a)(4), which are the principal exemptions relied on by hedge fund managers who trade futures. If adopted, these changes will require private fund advisers, sponsors, or other operators of funds that invest even occasionally in listed futures to register with the CFTC as a CPO.

CFTC Rule 4.13(a)(3) currently provides an exemption from CPO registration for persons that meet the following criteria: (i) they operate pools exempt from registration under the Securities Act of 1933; (ii) they offer those pools only to accredited investors, knowledgeable employees, or qualified eligible persons (QEPs) as defined under CFTC Rule 4.7; and (iii) the aggregate initial margin and/or premium attributable to commodity interests in each pool does not exceed 5% of the liquidation value of a pool's portfolio, or the aggregate net notional value of commodity futures positions held by each pool does not exceed 100% of the net liquidation value of the pool. Rule 4.13(a)(4) provides a broader exemption from CPO registration for persons who operate private funds offered only to certain QEPs, regardless of the amount of commodity interests held by the pool.

If the CFTC adopts the proposed rules, operators of private funds that invest in any commodity futures and certain non-security-based swaps (as described below) will have to register as CPOs with the CFTC and become members of the National Futures Association (NFA).

On February 24, 2011, the CFTC proposed rules to treat non-security-based swaps the same as commodity futures for purposes of determining the need to register as a CPO. Non-security based swaps generally include agricultural and commodity swaps, metal and energy swaps, options, calls, floors and caps based on a rate such as an interest or currency rate, and certain credit default swaps and total return swaps that do not fall under the definition of security-based swap. The definition of security-based swap is expected to include most types of single name CDs based on an individual security or loan. If these changes are adopted, CPOs will not be able to avoid CFTC registration by using swaps instead of futures.

Registration as a CPO usually takes from six to eight weeks to complete. Registration involves submission of certain forms and fingerprints for each principal and associated person, as well as proof that each associated person has passed the national futures exam (Series 3). Generally, anyone who solicits for a fund is an associated person.

SEC Proposes Restrictions on Incentive-Based Compensation by Investment Advisers with More Than $1 Billion in Assets

The SEC on March 2, 2011 proposed new restrictions on incentive-based compensation at large investment advisers, including private equity and hedge fund managers.

The proposed rule is similar to those proposed by other federal regulators having jurisdiction over "covered financial institutions," as required under the Dodd-Frank Act.

The proposal would only apply to investment advisers (both registered and unregistered) with more than $1 billion in assets as reflected on the adviser's balance sheet. The SEC has stated informally that this test is not meant to include assets of a fund that might be required to be consolidated with the adviser's assets pursuant to U.S. GAAP rules. As a result, the rule is not likely to be relevant to most private equity and hedge fund managers.

Final Rules on FBAR Filing Requirements

The Financial Crimes Enforcement Network (FinCEN) issued final regulations regarding Form TD F 90-22.1, the Report of Foreign Bank and Financial Accounts (FBAR). The final regulations largely adopt the proposed regulations, with some changes and clarifications discussed below. The effective date of the final regulations was March 28, 2011. The final regulations apply to FBARs required to be filed by June 30, 2011 with respect to foreign financial accounts maintained in calendar year 2010, and to FBARs required to be filed for all subsequent calendar years.

With very limited exceptions, the FBAR requires a U.S. person who has a financial interest in, or signature authority over, one or more financial accounts in a foreign country to report those accounts annually to the Internal Revenue Service (IRS) if the aggregate value of all such U.S. person's foreign financial accounts exceeds $10,000 at any time during the calendar year. An FBAR must be filed by June 30 of the succeeding year. Failure to comply with the FBAR reporting requirements can result in civil penalties and criminal penalties.

The final regulations are not retroactive but permit filers who properly deferred their filing obligations for calendar year 2009 and prior years under earlier IRS guidance to apply the provisions of the final regulations in determining their FBAR filing requirements for reports due June 30, 2011, with respect to foreign financial accounts maintained in calendar years beginning before 2010.

The final regulations continue to reserve the treatment of interests in pooled investment funds such as hedge funds and private equity funds that are not foreign mutual funds. ***Therefore, there continues to be no FBAR filing requirement for owners of hedge fund and private equity fund interests until further notice, although this matter remains under consideration and there may be such a requirement in the future***. As noted under a prior IRS notice, any such requirement would not apply to any hedge fund or private equity fund interest held in calendar year 2009 and prior years. In contrast, interests in foreign mutual funds or similar pooled funds which issue shares to the general public and have a regular net asset value determination and a regular redemption feature are considered foreign financial accounts and must be reported.

Significant clarifications to the definition of “signature or other authority” were made under the final regulations. Under these rules, an individual has “signature or other authority” only if such individual has the authority (alone or in conjunction with another) to control the disposition of money, funds or other assets held in a financial account “by direct communication (whether in writing or otherwise) to the person with whom the financial account is maintained.” Separately, FinCEN noted that the revised FBAR instructions will clarify that only individuals may have signature or other authority over an account.

FinCEN also clarified that a U.S. customer of a U.S. global custodian does not need to report any custody accounts created by the custodian outside the United States to hold the assets of multiple customers, so long as the U.S. customer has no legal rights in those foreign accounts and can only access its holdings in those accounts through the U.S. global custodian.

It is important to note that the FBAR filing obligations are in addition to other reporting obligations that a U.S. person may have under U.S. law, including reporting obligations imposed under the Internal Revenue Code. In particular, new tax rules adopted in March 2010 generally require individuals to report annually their interests in “specified foreign financial assets” with an aggregate value in excess of $50,000.

New FINRA New Issue Rule Will Require Additional Information from Investors in Private Funds

The Financial Industry Regulatory Authority, Inc. (FINRA) recently adopted new Rule 5131, which will become effective on May 27, 2011. Rule 5131 aims to prohibit “spinning” by brokers, which is directing new issues (i.e., shares of an initial public offering) to corporate insiders and others in a position to refer business back to the broker.

In order to be able to make the representations to brokers that will be required to comply with the rule, advisers to private funds that participate in initial public offerings will need to obtain additional information from their existing investors about their affiliations with public companies, and certain private companies before the May 27 effective date, and modify their subscription documents in order to obtain the same information, going forward, from new investors.

Rule 5131 will generally only be relevant when more than 25% of a private fund is owned by Covered Investors (defined below) of any one particular company.

Rule 5131 prohibits the allocation of new issues by a FINRA broker-dealer to an account in which an executive officer or director of a public company or a covered nonpublic company (each, a Company), or a person materially supported by such executive officer or director (collectively, a Covered Investor), has a beneficial interest if: (i) the Company is currently an investment banking services client of such FINRA broker-dealer (a Related Broker) or the Related Broker has received compensation from the Company for investment banking services in the past twelve months; (ii) the person responsible for making the allocation decision knows or has reason to know that the Related Broker intends to provide, or expects to be retained by the Company for, investment banking services within the next three months; or (iii) new issues are allocated on the express or implied condition that such executive officer or director, on behalf of the Company, will retain the Related Broker for the performance of future investment banking services.

In order to comply with this new rule, a FINRA broker-dealer must in good faith have obtained within twelve months of such allocation a representation from the beneficial owner(s) of each account receiving a new issue allocation (such as a hedge fund, private equity fund or venture capital fund) as to whether such beneficial owners are Covered Investors (or are partnerships or other accounts in which the beneficial interest of Covered Investors totals at least 25%), and, if so, the Companies they serve. Private fund managers will need to collect this data from their investors in order to be able to make this representation.

Rule 5131 does not apply to allocations to certain persons including: (1) registered investment companies; (2) certain insurance company general, separate or investment accounts; (3) private funds in which the aggregate beneficial interests of Covered Investors of a particular Company do not exceed 25% (the de minimis exemption); (4) certain publicly traded entities; (5) certain ERISA plans; and (6) state or municipal government benefit plans.

If you currently manage any accounts or funds that purchase new issues, you will need to contact your existing investors (both U.S. and non-U.S.) in order to determine the status of each client or investor under Rule 5131. Please contact us if you need assistance reviewing subscription agreements or preparing a form of notice to investors to comply with the new rule.

New York City Launches Initiative to Register Investment Managers as Lobbyists

Beginning in late December, 2010, the New York City Clerk's Office sent letters with respect to New York City's Lobbying Law (the Lobbying Law) to private equity, hedge fund and other alternative asset managers doing business with New York City's five public pension plans (the NYC Plans). The Clerk asserted that the managers' employees were acting as lobbyists, and thus subject to the Lobbying Law, when attempting to influence the NYC Plans' investment decisions.

Lobbying is broadly defined under the Lobbying Law to include "any attempt to influence . . . any determination of a board or commission" of New York City. A person or entity may be required to register under the Lobbying Law if he or it anticipates spending $2,000 or more in lobbying activities over the calendar year. Both projected expenses and lobbyist compensation count toward meeting the $2,000 threshold. Employees that have other duties beside lobbying need to include only the portion of their compensation that corresponds to the portion of their business time spent lobbying in New York City.

Potential lobbyists are required to register online, using New York City's "e-lobbyist" system. Limited information on registered lobbyists is publicly available on a searchable database, including the name and business address of the manager and its lobbyist employees, the names of the NYC Plans lobbied and the subject of the lobbying (such as solicitation of investment capital).

Once registered, the relevant rules provide that a lobbyist employee may not be compensated on a contingent basis. In other words, paying a sales commission with respect to a NYC Plan's investment probably is prohibited. However, paying a year-end discretionary bonus based on overall employee performance probably is not. Also, once registered, lobbyists must submit periodic reports detailing expenses, compensation paid with respect to lobbying, campaign contributions to New York City officials, and other activities.

Some potential exemptions from registration may be available under the Lobbying Laws, but the Clerk's office has not yet offered formal guidance (although such guidance is expected). For example, the Lobbying Laws exempt from registration "prospective contractors who … appear before city contracting officers or employees in the regular course of procurement planning," provided that (i) such persons provide actual services under the contract, and (ii) such persons do not lobby actual elected officials and their deputies. Put in practical terms, this exemption would appear to shelter a manager's staff members who actually provide investment management services (such as portfolio managers) as long as they do not solicit the New York City Comptroller (who sits on the boards of the NYC Plans) or the NYC Plan's Chief Investment Officer, who is a Deputy Comptroller.

However, the Clerk's office so far has given limited and at times conflicting guidance as to whether it will interpret this or other exemptions as applicable in the case of investment managers. The Clerk's office has indicated that it will grant temporary registration extensions until it issues formal guidance. Clients should consult with their assigned attorney at the firm to determine whether to apply for extensions.

It should be noted that in a letter dated March 10, 2011, the New York City Lobbying Commission announced that it would hold a series of public meetings on the Lobbying Law and invited interested parties to submit written comments to lobbyingcommission@cityhall.nyc.gov.

SEC Pay-To-Play Rules on Campaign Contributions Now in Force

The restrictions on investment advisers making and soliciting campaign contributions in SEC Rule 206-4(5) became effective on March 14, 2011. The new rule applies to advisers of hedge funds, private funds, venture capital funds and funds-of-funds ***if the adviser is either registered with the SEC or currently is relying on the "15-client" exemption from registration.*** The SEC has proposed to modify the "pay-to-play" rule so that it applies to registered investment advisers, "Exempt Reporting Advisers" (i.e., advisers solely to venture capital funds and advisers solely to private funds with less than $150 million in U.S. assets under management) and "Foreign Private Advisers" as defined in the Advisers Act. Registered investment advisers also are required to maintain detailed records of any campaign contributions and certain payments made to government officials, political parties and political action committees, effective as of March 14, 2011.

Under the new rule, investment advisers and their partners, members and employees holding policy-making and supervisory positions, as well as positions involving solicitation of government entities (Covered Associates) are largely prohibited from making contributions, or soliciting contributions from others, to public officials who can-directly or indirectly influence the selection of investment managers to manage assets for government entities. If an investment adviser or Covered Associate makes an impermissible campaign contribution, the manager cannot charge advisory fees (or carried interest) to the relevant government entity for two years. Although solicitation of others to make campaign contributions will not trigger the two-year "time-out," it can be a violation of the new rule and entail penalties. The new rule is detailed and complex, and is available (along with the SEC's explanatory notes) at http://www.sec.gov/rules/final/2010/ia-3043.pdf.

In addition, many state and local government entities and benefit plans have adopted policies with respect to campaign contributions that may differ from, or be more restrictive than, the new SEC rule, and many also have adopted rules and policies governing use of placement agents. (See, for example our advisory on new California rules here.) If an investment adviser has government entities as clients or investors in private funds it advises – or if it may solicit government entities as potential clients or investors in the future – it should adopt a campaign contribution policy as soon as possible.

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