

CORPORATE AND SECURITIES LAW

ALERT

NEWS FOR THE CLIENTS AND FRIENDS OF BASS, BERRY & SIMS PLC

Regulation of Private Funds and Their Advisers under the Dodd-Frank Act

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On July 21, 2010, President Obama signed into law the "Dodd-Frank Wall Street Reform and Consumer Protection Act" (the "Dodd-Frank Act"). While the majority of the Dodd-Frank Act is dedicated to reforms specific to the banking and financial services industries, Title IV, entitled the "Private Fund Investment Advisers Registration Act of 2010" (the "Private Fund Act"), will directly impact sponsors of private investment entities, including private equity (or buy-out) funds, hedge funds, and venture capital funds (collectively referred to in this Alert as "private funds"), as well as future fund-raising practices of private funds. Additionally, the change in the definition of "accredited investor," discussed below, will require immediate changes to subscription documents and related disclosures. Below are some important elements of the Private Fund Act.

Registration of Private Fund Advisers

The Private Fund Act amends rescinds the private investment adviser exemption from federal registration currently enjoyed by sponsors of private funds. Under the Private Fund Act, sponsors of private funds will be required to register as investment advisers with the Securities and Exchange Commission (the "SEC") unless they qualify for a specific exemption. Registered sponsors of private funds will become subject to new reporting and recordkeeping requirements pursuant to rules to be established by the SEC during the next year. The final scope of these rules is unknown, but they will require registered private fund sponsors to maintain and, upon request, make available for examination by the SEC records and reports concerning, among other things, the amount and type of assets under management, side-letter arrangements providing certain investors more favorable rights than others, and a description of trading practices, including the use of leverage and credit risk exposure.

If required to register, sponsors of private funds will become subject to the rules and requirements of the Investment Advisers Act of 1940 (the "Advisers Act"), including its anti-fraud and compliance program provisions as well as the reporting and recordkeeping rules prescribed by the SEC. Information filed with the SEC under the new rules, including information shared with the newly established Financial Stability Oversight Council and proprietary information revealed through an SEC examination of a private fund sponsor, will be considered confidential and exempt from Freedom of Information Act (FOIA) discovery.

Any sponsor required to register under the Private Fund Act will incur compliance costs that will not be fully known until the SEC adopts the implementing rules and regulations. The extent to which a sponsor of private funds falls subject to the Advisers Act will likely be graduated under new rules, based on the type and size of private funds being advised. In particular, the Private Fund Act

directs the SEC to tailor the registration and examination requirements applicable to sponsors of “mid-sized private funds” based on the “size, governance, and investment strategy” of such funds and their “systemic risk” profile.

Exemptions from Registration

Not all private fund sponsors will be subject to the new registration and reporting requirements. The Private Fund Act exempts from registration sponsors that advise only “venture capital funds” and also those sponsors that both solely advise private funds and that have assets under management in the United States of less than \$150 million. Each exemption will be more particularly defined by rules issued by the SEC. While exempt from registration, these sponsors will nevertheless be subject to such recordkeeping and periodic reporting requirements as the SEC may determine appropriate in the public interest and for the protection of investors.

The manner in which the SEC defines the scope of the venture capital exemption will be of great interest to the private fund industry. Some anticipate that these rules will be subject to considerable public comment, but that “venture capital fund” will ultimately be defined narrowly by the SEC to prevent sponsors of hedge funds, buy-out funds and similar private funds who do not exclusively provide capital to early-stage and smaller companies from availing themselves of the exemption.

The Private Fund Act also exempts from registration advisers to “family offices” (to be defined by further rulemaking), certain foreign private advisers, and investment advisers who solely advise small business investment companies.

Regulation D Amendments

Currently, many individual investors in private funds satisfy the accredited investor standard of Regulation D under the Securities Act with a personal net worth in excess of \$1 million. The Private Fund Act immediately amends the definition of “accredited investor” to exclude the value of an investor’s primary residence from the \$1 million net worth test. (The amount of any indebtedness secured by the primary residence may be excluded from the net worth calculation up to the value of the residence for purposes of this test.) The SEC is required by the Private Fund Act to make future adjustments to this and other aspects of the “accredited investor” definition as the SEC may deem appropriate for the protection of investors and the public interest.

The current accredited investor annual income test of \$200,000 in each of the two most recent years, or \$300,000 for a couple, is not affected by the Private Fund Act, but will be subject to review and future adjustment.

In addition, the Private Fund Act instructs the SEC to issue rules barring certain “bad actors” from offering or selling securities pursuant to Rule 506 of Regulation D. Persons barred would include persons who have been subject to proceedings or examinations of the SEC in connection with a prior offering or sale of securities or otherwise subject to discipline or conviction related to activities involving the offer or sale of securities.

As a result of the Private Fund Act, sponsors of private funds must evaluate the extent to which they are impacted by the new rules and whether they will have to register under the Advisers Act or otherwise modify their practices and operations. In the short term, private fund sponsors must update the “accredited investor” disclosure in their subscription materials and other portfolio company investment documentation.

We will continue to monitor the implementation of these laws and regulations as well as other effects of the Dodd-Frank Act on the private equity and venture capital industry.

Bass, Berry & Sims PLC's Private Equity and Venture Capital Subgroup is comprised of corporate and tax attorneys who monitor and advise on developments in the corporate and securities laws, tax rules and other trends relating to private equity and venture capital funds, their sponsors and the private issuance of securities. If you have any questions regarding the issues addressed in this *Corporate and Securities Law Alert* or if you would like to set up a meeting with us and your management team regarding these developments, please feel free to communicate with your regular contacts in our Corporate and Securities Group or any of the attorneys in our Subgroup listed below.

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