Davis Polk
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SEC Rules and Regulations

SEC Proposes Private Fund Systemic Risk Reporting Rule

On January 26, 2011, the SEC and the CFTC (the "**Commissions**") jointly released proposed new rules under the Commodity Exchange Act and the Investment Advisers Act of 1940 (the "**Advisers Act**") to implement certain provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**"). The proposed SEC rule 204(b)-1 would require investment advisers registered or required to register with the SEC under the Advisers Act and that advise one or more private funds (i.e., 3(c)(1) or 3(c)(7) funds) ("**private fund advisers**") to file Form PF with the SEC for the purposes of reporting systemic risk information to the SEC. Under proposed CFTC rule 4.27(d), private fund advisers that are also registered with the CFTC as commodity pool operators ("**CPOs**") or commodity trading advisors ("**CTAs**") would also file Form PF, in which case the filing would be a filing with both the SEC and CFTC.

As discussed further in the ***July 14, 2010 Investment Management Regulatory Update***, under the Dodd-Frank Act, effective July 21, 2011, an adviser to private funds will be required to *maintain* records and reports for each private fund that it advises. Section 404 of the Dodd-Frank Act also directs the SEC to issue rules requiring each investment adviser to a private fund to *file* reports containing information the SEC deems necessary and appropriate in the public interest, for investor protection or for the assessment of systemic risk by the Financial Stability Oversight Council (the "**FSOC**"). Section 406 of the Dodd-Frank Act requires that such rules be issued jointly by the Commissions, after consultation with the FSOC, and establish the form and content of such reports to be filed by private fund advisers that are also registered with the CFTC. The joint proposed rules would implement this statutory mandate by requiring the filing of new Form PF.

According to the proposing releases, the information reported on Form PF and shared with the FSOC would generally remain confidential; however, both Commissions would be allowed to use Form PF information in examinations, investigations and enforcement actions.

Form PF Reporting

Form PF has four sections. Section 1 would be required to be completed by all filers, while Sections 2, 3 and 4 would be required only of large private fund advisers advising hedge funds, liquidity funds and private equity funds, respectively. For these purposes, the proposal defines "hedge fund," "liquidity fund," and "private equity fund" as follows:

Hedge Fund. The proposed rule would define "hedge fund" as "any private fund that (a) has a performance fee or allocation calculated by taking into account unrealized gains; (b) may borrow an amount in excess of one-half of its net asset value (including any committed capital) or may have gross notional exposure in excess of twice its net asset value (including any committed capital); or (c) may sell securities or other assets short." The proposal instructs that the fund should not net long and short positions in calculating its borrowings. In addition, the proposal stipulates that the fund should include any borrowings or notional exposures of another person that are guaranteed by the fund or that the fund may be obligated to satisfy.

Under the proposal, a commodity pool that would be an investment company but for sections 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 (the "**Investment Company Act**") is treated as a hedge fund for Form PF purposes.

Liquidity Fund. The proposed rule would define "liquidity fund" as any private fund that "seeks to generate income by investing in a portfolio of short-term obligations in order to maintain a stable NAV per unit or minimize principal volatility for investors." The Commissions acknowledge that, defined in this way, liquidity funds can resemble money market funds, which seek to maintain a stable NAV, typically at $1 per share, and which are registered under the Investment Company Act. The proposal explains that the definition was designed to capture all potential substitutes for money market funds because the Commissions believe that such substitutes pose systemic risk that the FSOC, in its assessment of systemic risk in the U.S. financial system, will want to monitor.

Private Equity Fund. The proposed rule would define "private equity fund" as "any private fund that is not a hedge fund, liquidity fund, real estate fund, securitized asset fund or venture capital fund and does not provide investors with redemption rights in the ordinary course."

- The proposal would define "real estate fund" as "any private fund that is not a hedge fund, that does not provide investors with redemption rights in the ordinary course and that invests primarily in real estate and real estate related assets."
- The proposal would define "securitized asset fund" as "any private fund that is not a hedge fund and that issues asset backed securities and whose investors are primarily debt holders."
- "Venture capital fund" under the proposal would be as defined in proposed rule 203(l)-1 under the Advisers Act, an SEC rule proposed in November 2010 that would define a venture capital fund as a private fund that invests in equity securities of qualifying portfolio companies for the purpose of providing business expansion and operating capital, and which satisfies other specified criteria. For more detail on rule 203(l)-1's proposed definition of "venture capital fund," please see the Davis Polk Client Memorandum ***SEC Proposes Rules Implementing New Exemptions from Advisers Act Registration Under the Dodd-Frank Act***.

Large Private Fund Advisers

The proposed rule would adopt the following thresholds for "large private fund advisers" (i.e., private fund advisers who would be required to complete Sections 2, 3 or 4 of Form PF):

- For purposes of Section 2, any private fund adviser that, with its related persons, collectively had at least $1 billion in hedge fund assets under management as of the close of business on any day during the reporting period;
- For purposes of Section 3, any private fund adviser that advises one or more liquidity funds and, together with its related persons, had at least $1 billion in combined liquidity fund and registered money market fund assets under management as of the close of business on any day during the reporting period; and
- For purposes of Section 4, any private fund adviser that, with its related persons, collectively had at least $1 billion in private equity fund assets under management as of the last day of the reporting period.

In the SEC's estimation, approximately 4,450 advisers would be required to file all or part of Form PF, of which 200, 80 and 250 would be large hedge fund advisers, large liquidity fund advisers and large private equity fund advisers, respectively. In order to determine if an adviser is a large private fund adviser for purposes of Form PF, with respect to any type of private fund, the adviser would aggregate together:

- assets of managed accounts advised by the adviser's firm that pursue substantially the same investment objective and strategy and invest in substantially the same positions as the adviser's private funds of that type (i.e., parallel managed accounts); and
- assets of that type of private fund advised by any of the adviser's "related persons," which would be defined generally as: (i) all of the adviser's officers, partners, or directors; (ii) all persons directly or indirectly controlling, controlled by, or under common control with the adviser and (iii) all of the adviser's employees (other than employees performing solely clerical, administrative, support or similar functions). The proposal would permit, but not require, the adviser to file a consolidated Form PF reporting the private fund assets managed by itself and its related persons.

Additionally, if the adviser's principal office and place of business is outside the U.S., the adviser could exclude any private fund that during the last fiscal year was neither a U.S. person nor offered to, or beneficially owned by, any U.S. person. The proposal also clarifies that (i) to prevent duplicative reporting, only one adviser would be allowed to report information on Form PF for any fund, which adviser would be the adviser that completes the information on Schedule D of Form ADV for that private fund, and (ii) advisers who are exempt from SEC registration under the Advisers Act would not be required to file Form PF.

Frequency of Reporting; Implementation Period

Frequency of Reporting. Under the proposed rule, large private fund advisers would be required to file Form PF within 15 days of the end of each calendar quarter, and any other private fund adviser would be required to file annually on or before the due date of its Form ADV annual amendment (currently 90 days after the end of its fiscal year). A newly registering adviser would be required to submit its initial Form PF within 15 days of the end of its first full calendar quarter following its registration with the SEC.

Implementation Period. The compliance date for Form PF reporting under the SEC/CFTC joint proposal, if adopted, would be December 15, 2011, at which time large private fund advisers would be required to file a report 15 days after the end of the next quarter (i.e., January 15, 2012) and smaller private fund advisers would be required to file 90 days after the end of their first fiscal year-end occurring on or after the compliance date (i.e., March 31, 2012 for advisers with a December 31 fiscal year-end).

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Information Required to be Reported on Form PF

Section 1 (all private fund advisers). All filers would complete Section 1 of Form PF. Subsection 1a would require identifying information about the adviser such as its name, the names of any related persons whose information is reported on the Form PF, and total and net private fund assets under management in the aggregate and by private fund type.

Additionally, the adviser would be required to complete subsection 1b for each private fund it advised (excluding feeder funds in master-feeder structures) which would require reporting for each such fund: (i) gross and net assets, (ii) aggregate notional value of derivative positions, (iii) borrowings, (iv) concentration of the investor base and (v) monthly and quarterly performance information.

Subsection 1c would require the reporting of information about hedge funds managed by the adviser, including: (i) their investment strategies; (ii) percentage of fund assets managed using algorithms; (iii) significant counterparty exposures; and (iv) trading and clearing practices.

Section 2 (large private fund advisers with at least $1 billion in hedge fund AUM). Subsection 2a would require reporting, on an aggregate basis, of certain information about hedge funds managed by the adviser, including: (i) market value of assets invested (on a short and long basis) in different types of securities and commodities; (ii) duration of fixed income portfolio holdings; (iii) interest rate sensitivity of the funds' assets; (iv) turnover rate of the adviser's aggregate portfolios during the reporting period (for purposes of determining frequency of trading activity) and (v) geographic breakdown of investments held by the funds.

Subsection 2b would require additional information about any hedge fund advised by the adviser that had a NAV of at least $500 million as of the close of business on any day during the reporting period (a "qualifying hedge fund"). The proposal would require that the adviser identify its qualifying hedge funds by aggregating parallel managed accounts, parallel funds and funds that are part of the same master-feeder structure, and treat any fund managed by any of its related persons as if it were managed by the filing adviser. For each qualifying hedge fund, the form would require reporting of: (i) exposure to different types of assets; (ii) portfolio liquidity; (iii) concentration of positions; (iv) collateral practices with significant counterparties; (v) identities of and clearing relationships with the three central clearing counterparties to which the fund has the greatest net counterparty credit exposure; (vi) the fund's monthly value at risk ("VaR") metric, if regularly calculated by the adviser during the reporting period; (vii) monthly breakdown of the fund's secured and unsecured borrowing and its derivative exposures; (viii) information about the value of collateral and letters of credit supporting the fund's secured borrowing and derivatives exposures, and the fund's types of creditors; (ix) breakdown of the term of the fund's committed financing; and (x) investor composition and liquidity (e.g., the percentage of the fund's NAV that is subject to side pocket or gating arrangements, in the latter case, by time period).

Section 3 (large private fund advisers advising a liquidity fund and with at least $1 billion in combined liquidity fund and registered money market fund assets). Section 3 would require reporting of certain information about each liquidity fund managed by the adviser, including: (i) NAV per share calculation methodology; (ii) whether the fund has a policy of complying with certain provisions of rule 2a-7 under the Investment Company Act; (iii) portfolio information (e.g., for each month of the reporting period: NAV, NAV per share, market-based NAV per share, weighted average maturity, weighted average life, seven-day gross yield, daily liquid assets, weekly liquid assets, assets with a maturity of greater than 397 days, amount of assets invested in different types of instruments broken down by maturity, and information about each open position that is 5% or more of the fund's portfolio); (iv) secured and unsecured borrowing of the fund; (v) whether the fund has a committed liquidity facility in place; (vi) concentration of the fund's investor base; (vii) gating and redemption policies; (viii) investor liquidity; and (ix) an estimate of the percentage of the fund assets purchased using securities lending collateral.

Section 4 (large private fund advisers with at least $1 billion in private equity fund assets). Section 4 would require reporting of certain information about each private equity fund managed by the adviser, including: (i) the outstanding balance of the fund's borrowings and guarantees; (ii) the leverage of the portfolio companies in which the fund invests, including the weighted average debt-to-equity ratio of controlled portfolio companies; (iii) the maturity profile of all portfolio companies' debt; (iv) whether the fund and/or its portfolio companies experienced any event(s) of default; (v) the identities of the institutions providing bridge financing to the fund's controlled portfolio companies and the amount of such financing; (vi) certain additional information if the fund invests in any financial industry portfolio company (e.g., the fund's percentage beneficial ownership of such portfolio company), (vii) whether any of the adviser's related persons co-invests in portfolio companies; and (vii) a breakdown of the fund's investments by industry and geography.

Format for Reporting

According to the proposal, Form PF would be filed electronically through an online platform. The SEC has not yet designated such a system, but noted the possibility of certain efficiencies if the Investment Adviser Registration Depository (the "**IARD**") were used for this purpose. Currently, the IARD is used by registered investment advisers to file electronically Form ADV.

Comments on the joint proposal are due by April 12, 2011.

- See a copy of the SEC proposal
- See a copy of the factsheet
- See a copy of the Q&A
- See a copy of the SEC press release

SEC Proposes Changes to Accredited Investor Definition to Implement Dodd-Frank Amendments

On January 25, 2011, the SEC proposed amendments to rules under the Securities Act of 1933 (the "**Securities Act**") to implement Section 413(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**") which amended the accredited investor definition for natural persons.

Private funds typically rely on Regulation D under the Securities Act to offer their securities in private placements without registration under the Securities Act. Under Rule 506 of Regulation D, funds can privately sell their securities to "accredited investors" in unregistered transactions under the rationale that such investors have the financial sophistication and expertise to understand the risks of such an investment and thus do not need the protection afforded by registration. Prior to the enactment of the Dodd-Frank Act, an individual investor qualified as an "accredited investor" by having (i) individual net worth (or joint net worth with his or her spouse) in excess of $1 million or (ii) annual income in excess of $200,000 (or joint annual income with his or her spouse in excess of $300,000) for the past two years and the reasonable expectation of meeting the same level of income in the current year.

Effective July 2010, the Dodd-Frank Act tightened the definition of "accredited investor" by expressly excluding the value of the investor's primary residence from the $1 million net worth calculation. Pursuant to SEC guidance issued shortly after the passage of the Dodd-Frank Act, any indebtedness secured by such residence may also be excluded from the net worth calculation, up to the residence's fair market value. However, if the indebtedness exceeds the value of the residence, the excess is considered a liability and must be deducted from the individual's net worth. See the ***August 16, 2010 Investment Management Regulatory Update*** for a discussion of this previous SEC guidance.

The Dodd-Frank Act authorizes the SEC one year after the date of enactment to review and adjust the definition of "accredited investor" for natural persons. (In addition, the Dodd-Frank Act requires the SEC to review and adjust the definition of "accredited investor" for natural persons four years after the date of enactment and every four years thereafter.) The SEC's proposal implements the Dodd-Frank Act's amendments to the accredited investor definition by amending certain rules under the Securities Act (including those in Regulation D) to conform generally to the changes made by the Dodd-Frank Act and the subsequent SEC guidance described above. The proposal would also make certain technical amendments to Form D to conform to the changes made under the Dodd-Frank Act.

Specifically, the proposal would amend the definition of accredited investor for individuals to provide that the net worth standard be a net worth in excess of $1,000,000, excluding the value of the investor's primary residence, "calculated by subtracting from the estimated fair market value of the property the amount of debt secured by the property, up to the estimated fair value of the property." The SEC indicated that the purpose of the new language is to exclude an investor's net equity in the primary residence, reducing the net worth measure by only the amount that the primary residence contributed to an investor's net worth prior to the changes made by the Dodd-Frank Act. The SEC indicated that it preferred this approach over two alternative approaches it considered, which were (i) to exclude the fair market value of the residence without netting out the secured indebtedness of the property and (ii) to exclude *both* the fair market value of the primary residence and all indebtedness secured by the primary residence in the net worth calculation.

The SEC also noted certain issues that it had preliminarily decided under the proposal, but were subject to further comments. These issues included (i) the definition of "primary residence" (which the SEC chose not to define in this proposal), (ii) concerns of asset inflation and of abuses involving the incurrence of a mortgage in order to invest the proceeds in securities and (iii) the need for transition rules to facilitate subsequent follow-on investments by an investor disqualified by the changes effected by the Dodd-Frank Act.

- See a copy of the SEC proposal
- See a copy of the SEC press release

Industry Update

Office of the New York City Clerk Notifies Fund Managers Regarding Lobbyist Registration Requirements for Fund Managers that Seek Business from New York City Pension Plans

On December 29, 2010, the Office of the City Clerk of the City of New York (the "**City Clerk**") issued a letter to managers of the funds in which the New York City pension funds have invested stating that placement agents and other parties that attempt to influence the determinations of the boards of trustees of New York City's five pension plans must register as lobbyists and be in compliance with the city's lobbying laws by January 1, 2011. The letter, signed by Patrick Synmoie, counsel to New York City Clerk Michael McSweeney, referred to an opinion issued by the New York City Law Department Corporation Counsel, Michael Cardozo (the "**Law Department Opinion**"). The letter of the City Clerk stated that the New York City Law Department had opined that "placement agents, other third parties retained by investment firms, and employees of investment firms" are lobbying when they attempt to influence decisions about investments of pensions funds made by the New York City Comptroller, members of his staff, the boards of trustees of the pension funds or retirement systems of New York City or members of their staffs. The letter of the City Clerk stated that failure to file lobbyist or client reports in a timely manner may result in late filing fees and civil penalties, and that a failure to file such reports at all is a class A misdemeanor. The letter further stated that beginning in January 2011, the Office of the City

Clerk will review the activities of parties that, as of January 1, 2011, were attempting to influence investment decisions made by the pension systems of New York City.

The Law Department Opinion, dated as of March 31, 2010, addressed the question of whether placement agents that attempt to influence the determinations of the boards of trustees of New York City's five pension systems (collectively, the "**Funds**") regarding investments made by those Funds are "lobbying" as defined by Section 3-211(c) of the New York City Administrative Code (the "**Administrative Code**").

The Law Department Opinion stated that although the question posed by the City Clerk "focuses on placement agents," the analysis applies "to all third-parties, as well as employees, regardless of the terminology used to identify them, who are retained or employed by investment firms to influence investment decisions made by the Funds." Under Section 3-211 of the New York City Administrative Code, a "lobbyist" is defined as "every person or organization retained, employed or designated by any client to engage in lobbying," and a "client" is defined as "every person or organization who retains, employs or designates any person or organization to carry on lobbying activities on behalf of such client."

The Law Department Opinion stated that "lobbying" is defined in the Administrative Code to include any attempt to influence:

"(iii) any ***determination*** made by an elected city official or an officer or employee of the city with respect to the procurement of goods, services or construction, including the preparation of contract specifications, or the solicitation, award or administration of a contract, or with respect to the solicitation, ***award or administration*** of a grant, loan, or ***agreement involving the disbursement of public monies***,

. . . or

(viii) any determination of a board of commission." Administrative Code §3-211(c)(1)(iii), (viii).

The Law Department Opinion stated that the trustees of the boards of New York City's five pension systems are public officers under Section 3-211(c)(1)(iii) because their duties involve the exercise of sovereign power, a requirement under relevant New York State law. When the boards of trustees invest in real estate investment funds or with private equity firms, the Comptroller enters into limited partnership agreements or contracts pursuant to which management or other investment fees or expenses are paid, according to the Law Department Opinion. The Law Department Opinion reported that the provisions in the limited partnership agreements or in the contracts for the payment of management or other investment fees or expenses involve a disbursement of public monies, and thus, a decision to enter into such agreements or contracts constitutes a determination made by public officers with respect to an "award or administration" of an "agreement involving the disbursement of public monies." The Law Department Opinion stated that placement agents who approach the boards of trustees or individual members of the boards seeking to influence their determinations are engaged in "lobbying" under the Administrative Code. The Law Department Opinion further stated that because the Comptroller makes recommendations to the boards of trustees, even if placement agents do not communicate directly with board members, an attempt to influence the investment recommendations of the Comptroller also constitutes an attempt to influence a determination of the boards of trustees.

The Law Department Opinion concluded that persons that are so "lobbying" are subject to the provisions of the Administrative Code regulating lobbyists, including (i) the filing of statements of registration, periodic reports and fundraising and political consulting reports; (ii) the prohibition on contingent retainer agreements; and (iii) the prohibition on offering or giving gifts to a public servant.

For those persons that are deemed to be "lobbyists," the current deadline for filing a statement of registration is February 15, 2011.

- See a copy of the Law Department Opinion

ILPA Publishes Updated 2011 Private Equity Principles

The Best Practices Committee of the Institutional Limited Partners Association ("**ILPA**"), a not-for-profit association serving institutional investors in private equity funds, released an updated version of its original September 2009 Private Equity Principles (the "**2009 Principles**") in January 2011 (the "**2011 Principles**"). These principles are intended to provide a set of globally recognized industry "private equity preferred terms and best practices."

The 2011 Principles retain the ILPA's proclaimed guiding tenets of (i) aligning interests between general partners ("**GPs**") and limited partners ("**LPs**"), (ii) enhancing fund governance and (iii) providing greater transparency. The 2011 Principles also explicitly acknowledge that funds will need flexibility in adopting these guidelines and that the guidelines should not be seen as a "one-size-fits-all" checklist. In connection with the release of the 2011 Principles, the ILPA has also issued its "Capital Call and Distribution Notice Templates," the first of its series of five standardized reporting templates, which will include templates for annual and quarterly reporting as well as performance metrics.

The 2011 Principles are substantially similar to the 2009 Principles. The main revised components of the ILPA's recommendations include:

- A new appendix setting forth best practice guidelines for carried interest clawbacks that expands its previous recommendations;
- A revised appendix on best practices of Limited Partner Advisory Committees ("**LPACs**") modifying the strong governance role of LPACs set forth in the 2009 Principles; and
- Release of ILPA Standardized Reporting Templates.

Clawback of GP Carried Interest

Continued Recommendation of a European-style Waterfall. The 2011 Principles expand the prior guidelines for clawback of a GP's carried interest by providing a separate appendix on this issue. Like the 2009 Principles, the 2011 Principles continue to advocate a portfolio-wide waterfall (i.e., an all-contributions-plus-preferred-return "European style" waterfall) in lieu of a deal-by-deal "American" model, as this approach tends to minimize excess carry distributions and limit clawback situations.

Modifications to Deal-by-Deal Waterfall. If a deal-by-deal waterfall applies, then the 2011 appendix suggests implementing (i) an NAV coverage test (of at least 125%) to ensure sufficient "margin of error" on valuations and (ii) interim clawbacks triggered at defined intervals and upon specific events (e.g., key-man event, insufficient NAV coverage). In addition, like the 2009 Principles, the 2011 Principles continue to suggest that funds with deal-by-deal waterfalls should minimize clawback situations by (i) returning all realized costs for a given investment with continuous makeup of partial impairments and write-offs, and returning all fees and expenses to date (as opposed to *pro rata* for the exited deal) and (ii) valuing all unrealized investments at the lower of cost or market.

Calculation of Carried Interest. With respect to the calculation of carried interest, the 2011 Principles continue to recommend, like the 2009 Principles, that (i) carried interest should be calculated on the basis of net profits (not gross profits) and on an after-tax basis (i.e., such that foreign or other taxes imposed on the fund are not treated as distributions to the partners) and (ii) no carried interest should be taken on current income or recapitalizations until the full amount of invested capital is realized on an investment. However, the prior recommendation that all clawback amounts be paid back no later than two years following recognition of the liability is replaced with a general recommendation that clawbacks be created so that when they are required they are fully and timely paid. The ILPA also moved away from its prior recommendation that clawback liabilities be disclosed at the end of each reporting period and now recommends annual disclosure as part of audited financial statements.

GP Satisfaction of Clawback Obligations. With respect to liability for GP clawback amounts, as in 2009, ILPA continues to "strongly recommend" imposing joint and several liability on individual GP members to backstop GP clawback amounts and/or the use of an escrow account (generally of at least 30%). In addition, the 2011 Principles suggest a creditworthy guarantee (provided by a substantial parent company, an individual GP member or a subset of GP members) as an alternative if only several liability is provided.

Clawbacks Paid Net of Taxes. Of note is the ILPA's retreat from its original recommendation that all carry clawbacks should be paid gross of taxes paid on prior carried interest amounts. In allowing GPs to repay excess carry net of taxes, the ILPA recommends that current practice be revised to account for the GP's actual tax situation and ability to reduce the tax burden (e.g., through consideration of any loss carryforwards or carrybacks) instead of assuming the highest hypothetical marginal tax rate in a designated location. Moreover, ILPA recommends any tax advances made to the GP should be returned immediately if in excess of the GP's actual tax liability.

Limited Partner Advisory Committees

The 2011 Principles note that the role of the LPAC should neither be direct governance, nor auditor of the fund, but instead to provide a "sounding board" for guidance to the GP and a voice for LPs when appropriate. The 2011 Principles also emphasize that the LPAC is not intended to serve as a representative or proxy for the broader base of LPs and should not replace frequent communications between the GP and all LPs.

The 2011 Principles make explicit the following two new points of emphasis: (i) the LPAC should operate as a committee, and not as a collection of individual members and (ii) regular provision for an *in camera* session should be made so that LPs can speak with a unified voice when appropriate.

Specific amendments to LPAC best practices include:

- ***Action by Written Consent***. A recommendation that, if consented to by the LPAC, the LPAC be able to vote on matters by written consent, particularly with respect to time-sensitive matters of importance such as conflicts.
- ***LP Conflicts of Interest***. A recommendation that each LPAC member consider its own potential conflicts of interest prior to voting and disclose any actual conflicts to other LPAC members during discussions at LPAC meetings. Additionally, the 2011 Principles recommend that GPs should disclose the identities of LPs which they believe may have conflicts of interest with other LPs.
- ***LPAC Meetings***. A recommendation that the right to call for a meeting should require a minority of three or more LPAC members using reasonable judgment and after consultation with the GP.
- ***GP Obligations***. With respect to requests for consent or approval by the LPAC, ILPA no longer recommends that (i) the LPAC could reserve the right to request that the GP send consents or amendments to all limited partners or (ii) the LPAC to have the right to require a conference call to discuss any consent or amendment.
- ***Partnership Expenses***. A recommendation that the LPAC engage with the GP with respect to the allocation of partnership expenses replaces the prior requirement that the LPAC review partnership expenses annually.

The 2011 Principles explicitly recognize that the LPAC has no broad governance role and its formal responsibilities are defined by the LPA.

Amendments and Clarifications to the Principles

In addition to the changes relating to carried interest, clawbacks and the LPAC described above, other key amendments set forth in the 2011 Principles include:

Alignment of Interest Issues

- ***Management Fees***. The 2011 Principles continue to recommend a lower management fee at the end of the investment period and upon the formation of a successor fund, and now suggest that a reduced fee should also apply if a fund's term is extended. Unlike the 2009 Principles, the new recommendations do not require 100% offset of management fees from transaction and other fees received by the GP.
- ***Partnership Expenses***. The 2011 Principles no longer require that GP insurance be borne by the GP, but now recommend that deal sourcing fees should be borne by the GP.
- ***Limited Partner Clawback***. The ILPA now recommends that LP clawback obligations with respect to fund indemnification expenses be limited to a "reasonable" percentage of committed capital (but not more than 25%) and a reasonable time period (e.g., two years after the date of distribution).
- ***Extension of Fund Terms***. The 2011 Principles maintain the prior recommendation that fund extensions be permitted in one-year increments only, but require a new condition that such extensions be approved by a majority of the LPAC or LPs. In addition, absent LP consent, ILPA recommends the GP must fully liquidate the fund within a one-year period following expiration of the fund term.
- ***GP Investments****.* The 2011 Principles contain a new recommendation that the GP not be allowed to co-invest in select underlying deals to avoid "cherry-picking," but rather its entire equity interest be made via a pooled fund vehicle. The 2011 Principles also clarify that the GP's entire commitment should be contributed in cash rather than a management fee waiver (whereas the 2009 Principles had recommended a "high percentage" be contributed in cash).

Governance Issues

- ***For-Cause Removal***. The 2011 Principles continue to recommend a majority vote of LPs to remove the GP for "cause." Moreover, ILPA recommends LPs should be able to remove a GP for cause "before there is irreparable damage to their interest," as opposed to the 2009 Principles' statement of GP removal upon preliminary determination by a court of "cause."
- ***Key-Man Provisions***. The 2011 Principles contain a recommendation similar to that of the 2009 Principles regarding an automatic suspension of the investment period when a key-man event is triggered, with the 2011 Principles specifying that changes to key-man provisions themselves be approved by a *majority* of the LPAC or LPs (a lower threshold than the original recommendation that *any* LPA amendment be approved by a supermajority).
- ***No-Fault Termination***. The 2011 Principles increase the recommended threshold for implementing no-fault termination rights of the LPs. Whereas the 2009 Principles recommended no-fault termination rights (i) upon majority in interest vote of LPs for suspension or termination of the commitment period or (ii) upon a two-thirds in interest vote of LPs for GP removal and dissolution of the fund, the 2011 Principles recommend that such no-fault termination rights kick in only upon two-thirds or three-quarters in interest vote of the LPs, respectively.
- ***Related Person Fees***. Fees charged to the fund or portfolio company for services provided by a GP affiliate, the 2011 Principles recommend, should be reviewed and approved by a majority of the LPAC.

- ***LP Consent to Amend****.* The 2011 Principles recognize that the extent of the majority required to approve amendments to a fund LPA should vary depending on the proposed amendment. The prior version recommended that *any* LPA amendment require the approval of a supermajority in interest of the LPs, whereas the 2011 Principles state that while any amendment should require the approval of at least a majority in interest of the LPs, only certain amendments should require a supermajority, and that amendments that negatively affect the economics of a particular LP should require such LP's consent.

- ***LP Excuse Rights***. The 2011 Principles clarify that although GPs should accommodate applicable LP excuse rights, GPs should properly disclose their policy and process upon such non-pro rata allocation, as well as consider the effect on investment concentration for other LPs.

- ***LP Notification of Auditor Change****.* The 2011 Principles modify the 2009 recommendation that LPs "ratify" any change in the independent external auditor of the fund to mere notification to the LPs of any such change.

- ***Auditors' Review and Verification***. The 2011 Principles continue to recommend that external auditors review and independently verify capital accounts, management fees, partnership expenses and carried interest calculations but, unlike the 2009 Principles, the 2011 Principles no longer recommend that external auditors *certify* that allocations and distributions have been done pursuant to the LPA, or that the capital accounts, carried interest calculations and management fee calculations have been reviewed and certified by the auditor.

- ***LPAC Independent Counsel***. The 2011 Principles recommend that the LPAC be permitted to engage independent counsel at the fund's expense for important matters of fund governance or other matters where the GP's interests may not be entirely aligned with the LPs. This is in limitation of the 2009 proposal that independent counsel be provided upon the request of the LPAC.

Transparency Issues

- ***GP Disclosure***. In contrast to the 2009 Principles' focus on disclosure of information relating to individual principals of the GP (e.g., profit sharing splits among the principals, vesting schedules, individual commitment amounts), the 2011 Principles recommend that GPs provide additional disclosure relating to fund matters, such as immediately disclosing to LPs the occurrence of (i) any material contingency or liability arising during the fund's life and (ii) any breach of the LPA or other fund document.

- ***Capital Calls and Distributions***. The 2011 Principles contain new recommendations that GPs provide quarterly estimates of projected capital calls and distributions with information that is consistent in substance with the newly designed "Capital Call and Distribution Notice Template."

- ***Additional Risk Disclosure***. The 2011 Principles contain a new recommendation that the fund's annual reports include portfolio company and fund information with respect to material risks and how they are managed, including any risk relating to concentration, foreign exchange, leverage, realization/exit risk, change in strategy and reputation risk at the portfolio company level, and extra-financial risks including environmental, social and corporate governance risks.

- ***Financial Reporting***. The 2011 Principles contain a new Appendix C on Financial Reporting with recommendations regarding the information to be included in the fund's annual and quarterly reports and in portfolio company reports. The recommended information is similar in substance to that recommended in the 2009 Principles. The 2011 Principles, however, now recommend that delivery of annual reports to LPs take place within 90 days of fiscal year-end, as opposed to 75 days.

- ***Fund Marketing***. The 2011 Principles no longer specify the types of information to be included in fund marketing materials.

- See a copy of the 2011 Principles
- See a copy of the press release
- See a copy of the FAQ
- See a copy of the 2009 Principles

SEC Publishes Study on the Fiduciary Duty of Investment Advisers and Broker-Dealers

On January 21, 2011, the SEC released its study, mandated by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**"), on the effectiveness of the standards of care required of broker-dealers and investment advisers providing personalized investment advice about securities to retail customers (the "**Study**").

As required by Section 913 of the Dodd-Frank Act, the Study also considered whether there are any regulatory gaps, shortcomings or overlaps that should be addressed by rulemaking. The Study's recommendations are detailed in the Davis Polk Client Memorandum ***SEC Study on the Fiduciary Duty of Investment Advisers and Broker-Dealers***.

- See a copy of the Study

SEC Publishes Study on Enhancing Investment Adviser Examinations

On January 19, 2011, the SEC released its study on Enhancing Investment Adviser Examinations (the "**Study**"), as required by Section 914 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**").

Advisers Examinations: Past Assessment and Future Forecast of Capacity

The Study found a decrease in the number and frequency of examinations over the past six years. The Study attributes this decline largely to the growth in the number of registered investment advisers and their managed assets and the decline in the number of Office of Compliance Inspections and Examinations ("**OCIE**") staff. The Study noted that the SEC anticipates a significant near-term decline in registered investment advisers following the enactment of the Dodd-Frank Act, due to the increased threshold in assets under management for adviser registration with the SEC (generally $100 million for most U.S. investment advisers, effective July 2011). However, the Study noted that the relief on OCIE resources caused by investment advisers deregistering from the SEC would likely be only temporary due to the fact that industry growth rates (forecast at 5% annually) would overtake any future comparative increase in OCIE resources. The Study also notes that the OCIE's resources will also be taxed by the diversion of resources to fulfill new examination obligations imposed on the SEC by the Dodd-Frank Act.

The Study concludes that OCIE is likely to meet serious capacity challenges in the future, which should be met by stable funding that increases in tandem with industry growth. This was further underscored by Commissioner Walter's separate statement, which also cautioned that the Study may underestimate the difficulties faced by the SEC.

Options to Address Capacity Constraints

The Study considers three approaches to strengthen the investment advisers examination regime:

- ***User Fees***. The SEC could impose user fees set at a level to achieve an acceptable frequency of examinations. This would provide scalable resources that keep pace with industry growth, and be directly available to the SEC, facilitating long-term strategic planning and more flexibility by

OCIE. The Study clearly favors this option, and notes its many advantages such as costs, efficiency and consistency over the self-regulatory organizations option.

- ***Self-regulatory Organizations*** ("**SROs**"). SROs could be authorized to supplement the SEC's oversight authority, and relevant experience supports the view that an SRO may strengthen oversight. However, the Study finds many difficulties with this option. First, it notes that SEC resources will still be needed to oversee the SRO, with the attendant danger of underfunded oversight. Second, the design and implementation of such a regime would involve many complicated issues such as the scope of authority, membership and funding of the SROs, including whether a single or multiple SROs would be most appropriate. Commissioner Walter's separate statement supports the SRO option and refers to the benefits of the SRO option that she faults the Study as failing to address.
  - ***Number of SROs***. Despite the potential for multiple SROs to accommodate industry diversity, the Study prefers a single SRO over multiple SROs due to industry "capture," regulatory arbitrage, lack of economies of scale and concerns about inconsistent application of relevant regulations.
  - ***Scope of Authority***. The Study notes that Congress could authorize broad or limited SRO authority. An intermediate approach would be to grant an SRO limited examination authority and limited collateral rule-making authority, while maintaining the SEC as the sole authority for regulatory policy, according to the Study.
  - ***Membership***. The Study stressed that membership in an SRO for investment advisers would have to be mandatory for effective SRO examination. The Study considered whether to cover state-registered advisers in addition to SEC-registered advisers and discussed the difficulties of crafting specific exclusions from membership due to the diverse business lines of many advisers.
  - ***Governance***. The Study indicated that an appropriate governance structure would be needed to prevent the SRO from allowing one particular investment adviser business model to have a competitive advantage over the others. The Study noted that Congress and certain SROs have recently evolved away from the self-governance model largely to address conflict of interest problems.
  - ***Funding***. The Study noted that Congress could assure adequate funding of the SRO by requiring that SROs meet broad functional requirements (such as those currently set forth in the Securities Exchange Act of 1934) or having the SEC approve annually the SRO's budget.
- ***Authorization of FINRA to Examine Dual Registrants***. According to the Study, the third option would be to authorize the Financial Industry Regulatory Authority ("**FINRA**") to examine advisers registered under the Investment Advisers Act of 1940 (the "**Advisers Act**") that are also registered broker-dealers ("**dual registrants**") for compliance with the Advisers Act. Currently, dual registrants are subject to examinations by FINRA under the Exchange Act and OCIE under the Advisers Act. The Study indicated that by combining these two regimes under FINRA, it would free up many resources for the SEC (because dual registrants compose a substantial portion of the market) and would allow for more cost-efficient and effective examinations. The Study cites concerns, however, of the over-extension of FINRA's jurisdiction, loss of opportunity for SEC expertise accumulation and possible inconsistencies between FINRA and OCIE.

  - See a copy of the Study
  - See a copy of Commissioner Walter's statement

SEC Publishes Study and Recommendations on Improved Investor Access to Registration Information about Investment Advisers and Broker-Dealers

On January 26, 2011, the SEC released its Study and Recommendations on Improved Investor Access to Registration Information About Investment Advisers and Broker-Dealers (the "**Study**"), as required by Section 919B of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**").

Overview of Sources of Publicly Available Data Regarding Broker-Dealers, Investment Advisers and Their Associated Persons

Broker-dealers and investment advisers register using two separate systems, which reflect the differences between their regulatory regimes. Broker-dealers and their registered representatives register through the Central Registration Depository ("**CRD**"), the repository of registration and disciplinary information operated by the Financial Industry Regulatory Authority ("**FINRA**"). Electronic public access of certain CRD data is provided through FINRA's BrokerCheck website. Investment advisers and investment adviser representatives register through the Investment Adviser Registration Depositary ("**IARD**") and electronic public access to nearly all information filed through IARD is available through the Investment Adviser Public Disclosure ("**IAPD**") website.

BrokerCheck and IAPD operate in different ways. The data on BrokerCheck is derived from the Uniform Forms that broker-dealers and their registered representatives complete in the registration and licensing process. This data generally includes member information and information regarding their registered representatives and associations. For investment advisers, IAPD displays essentially all of the information of Forms ADV and ADV-E filed through IARD, which forms provide broad disclosure about the investment advisers submitting such forms, including narrative brochures on conflicts of interest and financial and disciplinary information. Investment adviser representative information on IAPD is summarized from various state sources.

Both BrokerCheck and IAPD allow searching by name or registration number. IAPD searches on advisory firms display Part 1 of the firm's Form ADV and any brochures filed. The SEC has recently expanded the required information on Form ADV Part 2A and also has required electronic filing through the IARD. See the ***August 16, 2010 Investment Management Regulatory Update*** for a description of the new rules pertaining to Form ADV Part 2. Links to other databases are provided for dually registered firms and representatives on both BrokerCheck and IAPD.

Near-Term Recommendations

For the near-term, i.e., the eighteen-month implementation period after the completion of the Study mandated by the Dodd-Frank Act, the Study recommends:

- ***Unifying BrokerCheck and IAPD search results***. The Study states that centralizing access to the two databases would help investors to find information about the provider's registration status. Given the time constraints imposed by the Dodd-Frank Act, the Study recommends unifying search results but maintaining the two separate databases. In the longer term, however, the Study recommends (i) collapsing the two systems into a single database or (ii) creating an additional third website that would serve as a search portal to both databases.
- ***Adding a zip code search or other indicator of location function to BrokerCheck and IAPD***. The Study indicates that this would make the two systems more useful for a general search about financial providers. The Study noted that a prominent disclaimer would dispel any appearance of endorsement by the search results.
- ***Adding educational content to BrokerCheck and IAPD***. The Study also recommends that the BrokerCheck and IAPD websites be modified to include educational content. This could take the form of links or definitions of terms that may be unfamiliar to investors.

Intermediate-Term Recommendation: Continued Analysis of BrokerCheck and IAPD

The Study recommends that, following the eighteen-month implementation period, SEC staff and FINRA continue to analyze, with investor testing, the possible expansion of content on BrokerCheck and IAPD, including the method and format of publishing such information. It suggests including more of the CRD information on BrokerCheck, expanding BrokerCheck and IAPD to include historical filings, experimenting with various presentation formats, and the use of hyperlinks on file numbers to information relating to personnel associated with those numbers to provide more transparency on business activities.

- See a copy of the Study

Eileen Rominger Named as New Director of SEC's Division of Investment Management

On January 18, 2011, the SEC announced Eileen Rominger as the new Director of its Division of Investment Management. Rominger will begin in February, replacing Andrew J. "Buddy" Donohue, who left the SEC in November 2010 after serving as head of the Division of Investment Management for four and one-half years.

Rominger has an extensive background in the asset management industry. For the past eleven years, she has worked at Goldman Sachs Asset Management ("**Goldman Sachs**"), most recently as the firm's global chief investment officer. In that position, Rominger oversaw portfolio management teams in eight countries, served as a portfolio manager for fundamental equity portfolios, was the head of the investment committee for the Goldman Sachs Foundation and was a member of two committees in the firm's Investment Management Division: the management committee and the risk committee. Before her tenure at Goldman Sachs, Rominger worked for eighteen years at Oppenheimer Capital as a portfolio manager, managing director and member of the Executive Committee.

"Eileen brings the agency a lifetime of experience in the asset management industry and a strong record of leadership," SEC Chairman Mary L. Schapiro said. Speaking about her upcoming role at the SEC, Rominger said "the investor protection mission of the SEC has never been more important. Retirement and other important financial needs loom large for millions of Americans, even as investment choices increase in number and complexity. I'm honored to have the opportunity to lead the Investment Management Division and its talented staff as they drive their critical agenda of transparency and integrity in the industry."

- See a copy of the SEC press release

Litigation

SEC Charges Charles Schwab Entities and Executives

On January 11, 2011, the SEC charged Charles Schwab Investment Management ("**CSIM**") and Charles Schwab & Co., Inc. ("**CS&Co**") with making misleading statements about the Schwab YieldPlus Fund (the "**YieldPlus Fund**" or the "**Fund**") and failing to establish, maintain and enforce policies and procedures to prevent the misuse of material, nonpublic information. The SEC also brought charges against CSIM and Schwab Investments for deviating from the YieldPlus Fund's concentration policy without the required shareholder approval. On the same day, the SEC filed charges in federal court in San Francisco against CS&Co Executive Vice President Randall Merk and the former chief investment officer for fixed-income, Kimon Daifotis, alleging fraud and other securities law violations related to the YieldPlus Fund. CSIM and CS&Co agreed to settle with the SEC for approximately $119 million, while the case against Merk and Daifotis remains pending.

The YieldPlus Fund is an ultra-short bond fund. At its peak in 2007, it was the largest ultra-short bond fund in the category, with $13.5 billion in assets. During the credit crisis of 2007 and 2008, the Fund experienced a significant decline. The YieldPlus Fund's Net Asset Value ("**NAV**") began to decrease and many investors redeemed their holdings. Few of the Fund's assets were scheduled to mature in the coming several months, forcing the Fund to sell assets in a depressed market in order to raise cash. In an eight-month period, the Fund's assets under management fell from $13.5 billion to $1.8 billion and its NAV decreased by 28%.

According to the SEC, from at least 2006 to 2008, CSIM, CS&Co, Merk and Daifotis made misleading statements about the YieldPlus Fund and failed to warn investors about the risks associated with an investment in the Fund. The SEC claims that CSIM and CS&Co inaccurately described the Fund as a "cash alternative" that generated a higher yield with only a "slightly higher risk" than a money market fund. In addition, the SEC claims that the Schwab entities, Merk and Daifotis failed to adequately explain to investors the differences between the YieldPlus Fund and a money market fund.

The SEC claims that CSIM, CS&Co, Merk and Daifotis also made a number of material misstatements and omissions to investors during the decline of the Fund. These misstatements and omissions were made in a series of conference calls, written materials and other investor communications, according to the SEC. For example, in one conference call, the SEC alleges, Daifotis stated that the Fund was experiencing "very, very, very slight" and "minimal" redemptions, while in reality Daifotis was aware that the Fund had suffered over $1.2 billion in redemptions in the past two weeks. According to the SEC, throughout these communications CSIM and CS&Co expressed confidence in the Fund and told investors that the majority of the Fund's NAV decline represented unrealized losses.

The SEC also claims that the YieldPlus Fund deviated from its concentration policy without obtaining the required shareholder approval. Under Section 8 of the Investment Company Act of 1940 (the "**Investment Company Act**"), a registered fund must include in its registration statement its policy regarding concentration of investments in a particular industry. Section 13(a)(3) of the Investment Company Act requires a registered fund to obtain shareholder approval before deviating from its stated concentration policy. According to the SEC, the YieldPlus Fund had a policy against investing more than 25% of its assets in one industry and deviated from this policy when it invested approximately 50% of its assets in private-issuer mortgage-backed securities without shareholder approval.

Additionally, the SEC claims that CSIM and CS&Co did not have adequate policies and procedures in place to prevent the misuse of material, nonpublic information about the Fund. The SEC claims that, in several cases, the lack of controls allowed Schwab-related funds and individuals to redeem their investments in the YieldPlus Fund during the Fund's decline. For example, the SEC cited the absence of (i) specific policies and procedures governing redemptions by portfolio managers who were advisers to Schwab funds of funds and (ii) adequate information barriers regarding nonpublic and potentially material information about the Fund.

In settling the charges with the SEC, CSIM and CS&Co agreed to pay a total of approximately $119 million in penalties, disgorgement of fees and pre-judgment interest. CSIM, CS&Co and Schwab Investments also agreed to (i) a cease and desist order from committing or causing future federal securities law violations, (ii) correct all disclosures regarding the Fund's concentration policy, (iii) a censure and (iv) retain an independent consultant to assist in the creation of policies and procedures to prevent future misuse of material, nonpublic information.

- See a copy of the SEC press release
- See a copy of the SEC order

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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