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DODD-FRANK ACT SIGNED INTO LAW BY PRESIDENT OBAMA – IMPACT ON PRIVATE FUND ADVISERS OF INVESTMENT ADVISER REGISTRATION AND REPORTING REQUIREMENTS AND THE VOLCKER RULE

PRIVATE CAPITAL AND INVESTMENT GROUP ALERT

This Private Capital and Investment Group Alert provides only general information and should not be relied upon as legal advice. For more information, contact your Patton Boggs LLP attorney or one of the lawyers/authors listed below.

Donald Moorehead
202-457-5212
dmoorehead@pattonboggs.com

Courtney Nowell
202-457-6563
cnowell@pattonboggs.com

Gregg Buksbaum
202-457-6153
gbuksbaum@pattonboggs.com

Kevin Boardman
214-758-3570
kboardman@pattonboggs.com

Alexandra Metzner
202-457-6028
ametzner@pattonboggs.com

WWW.PATTONBOGGS.COM

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), which includes in Title IV the Private Fund Investment Advisers Registration Act of 2010 (PFIAR Act). The PFIAR Act will have a significant impact on advisers to private funds, many of whom will become subject to registration, recordkeeping and/or reporting requirements under the Investment Advisers Act of 1940 (Advisers Act). The provisions of the PFIAR Act will generally become effective one year after enactment, on July 21, 2011. However, the change to the accredited investor standard for individuals described below is effective immediately.

The Dodd-Frank Act also includes in Title VI the so-called "Volcker Rule" which, among other things, limits banks and certain nonbank financial companies in their ability to sponsor or invest in hedge funds and private equity funds. The Volcker Rule will become effective on the earlier of 12 months after date on which final implementing regulations are issued or two years after enactment, on July 21, 2012. Certain transitional periods will apply, as discussed in further detail below.

This Alert discusses the impact on private funds and their advisers of PFIAR Act, the Volcker Rule and certain other provisions of the Dodd-Frank Act.

PRIVATE FUND INVESTMENT ADVISERS REGISTRATION ACT OF 2010

Key Highlights (Discussed in more detail, below)

- ***Elimination of Private Adviser Exemption.*** The "private adviser" exemption from registration currently in the Advisers Act has been eliminated. As a result, advisers to "private funds" (§3(c)(1) and §3(c)(7) funds generally) who have availed themselves of this exemption in the past, whether located in the U.S. or offshore, will be required to register with the Securities and Exchange Commission (SEC), unless they are otherwise able to rely on another exemption from registration or exclusion from the definition of investment adviser under the Advisers Act, as described below or as otherwise provided in the Advisers Act.
- ***Exemption for Foreign Private Advisers.*** A "foreign private adviser" is exempt from registration if it (1) has no place of business in the U.S.; (2) has fewer than 15 U.S. clients or U.S. investors in the adviser's private funds; (3) has less than $25 million of assets under management attributable to U.S. clients or U.S. investors in the adviser's private funds; and (4) does not hold itself out as an investment adviser in the U.S. or advise a U.S. registered investment company or business development company.

- ***Exemption for Private Fund Advisers with Less than $150 Million Assets Under Management.*** Investment advisers to private funds are exempt from registration if they act solely as an adviser to private funds and have assets under management of less than $150 million, but these advisers will be subject to reporting and record-keeping requirements. Investment advisers which have any advisory clients that are not private funds are subject to a lower threshold and will generally be exempt from registration with the SEC only if the adviser has assets under management of less than $100 million.
- ***SEC to Determine Requirements for Mid-Sized Funds.*** The SEC is able to prescribe registration and examination procedures for advisers to "mid-sized" private funds by taking into account the size, governance and investment strategy of such funds to determine whether they pose systemic risk.
- ***No Specific Exemption for Advisers to Private Equity Funds.*** An exemption for investment advisers to private equity funds, which appeared in earlier versions of draft legislation, was not included in the PFIAR Act. Accordingly, advisers to private equity funds will be required to register unless another exemption or exclusion is available.
- ***Exemption for Advisers to Venture Capital Funds.*** Investment advisers who advise solely venture capital funds are exempt from registration, but will be subject to reporting and record-keeping requirements.
- ***Exclusion of Family Offices.*** Family offices are excluded from the definition of "investment adviser" under the Advisers Act, and thus will be exempt from registration, reporting and other requirements applicable to investment advisers.
- ***Exemption for Advisers to Small Business Investment Companies.*** Investment advisers who solely advise small business investment companies (SBICs) are exempt from registration and reporting requirements.
- ***Reporting Information Required.*** Registered investment advisers will be required to report certain information regarding the private funds they manage, including assets under management, use of leverage (including off-balance sheet leverage), counterparty credit risk exposure, trading and investment positions, valuation policies and practices, types of assets held, side arrangements and letters, trading practices and other information.

Effective Date

The provisions of the PFIAR Act will generally become effective on July 21, 2011, the one-year anniversary of its enactment. Investment advisers who are not already registered with the SEC but who will be required to be registered may register with the SEC prior to such date, subject to rules prescribed by the SEC.

Elimination of Private Adviser Exemption

The PFIAR Act eliminates the current "private adviser" exemption under the Advisers Act, which currently provides an exemption from SEC registration for investment advisers who, among other things, have fewer than 15 clients. This exemption has traditionally been relied upon by most advisers to private investment funds, as rules promulgated under the Advisers Act have generally allowed such advisers to count each fund that they advise as a single client, without looking through to the fund's investors. As such, many fund advisers (including managers and advisers of private equity

funds, mezzanine funds, hedge funds, real estate funds and other private investment funds) who have previously avoided registration in reliance on this exemption will now be required to register with the SEC unless another exemption is available.

Foreign Private Adviser Exemption

The "private adviser" exemption discussed above has previously been relied upon as an exemption from registration not only by investment advisers based in the U.S., but also by foreign advisers. The PFIAR Act replaces the "private adviser" exemption in Section 203(b)(3) of the Advisers Act with an exemption for a "foreign private adviser," defined as an investment adviser who:

- has no place business in the U.S.;
- has in total fewer than 15 clients and investors in the U.S. in private funds advised by the investment adviser;
- has aggregate assets under management attributable to clients in the U.S. and investors in the U.S. in private funds advised by the investment advisor of less than $25 million (or such higher amount as determined by the SEC); and
- neither holds itself out to the public in the U.S. as an investment adviser, nor acts as an investment adviser to a registered investment company or a business development company.

The inclusion of language in the definition referring to both "clients" and "investors in the U.S. in private funds" appears to be intended to prevent an adviser from relying on Rule 203(b)(3)-1 promulgated under the Advisers Act, which generally allows a private fund to be considered a single "client" for purposes of Section 203(b)(3), in determining whether it satisfies the definition of "foreign private adviser".

Assets under Management Thresholds

Advisers with Less than $150 Million Assets Under Management

The PFIAR Act exempts from registration requirements advisers who solely advise "private funds" and have less than $150 million of assets under management (AUM) in the U.S. "Private fund" is defined under the PFIAR Act as an issuer that would be an investment company under the Investment Company Act of 1940 (1940 Act), but for the exceptions under Sections 3(c)(1) or 3(c)(7) of the 1940 Act. This definition includes all funds wherever organized or located, whether in the U.S. or offshore jurisdictions, and includes most private equity funds, mezzanine funds, hedge funds, real estate funds and other private investment funds. However, an adviser to a private fund will still be subject to recordkeeping and reporting requirements as determined by the SEC. This exemption is set forth in a new subsection (m) under Section 203 of the Advisers Act.

State Registration vs. SEC Registration

Currently, an investment adviser is generally not permitted to register with the SEC unless it has AUM of at least $25 million. The PFIAR Act expands this prohibition by further prohibiting an investment adviser from registering with the SEC if:

- the investment adviser is required to be registered with the state securities regulator in the state where it maintains its principal office and place of business;
- if registered in such state, the investment adviser would be subject to examination by such regulator; and
- the investment adviser has AUM above $25 million and below $100 million (or such higher amount as may be determined by the SEC).

However, an advisor with AUM above $25 million and below $100 million will still be required to register with the SEC if it advises a registered investment company or business development company. Further, if as a result of this expanded prohibition an investment adviser would be required to register with 15 or more states, then the adviser may (but is not required to) register with the SEC instead of those states.

Mid-Sized Private Fund Advisers

The PFIAR Act also mandates that the SEC prescribe registration and examination procedures for advisers to “mid-sized” private funds by taking into account the size, governance and investment strategy of such funds to determine whether they pose systemic risk, and to prescribe registration and examination procedures for such advisers which reflect the level of systemic risk posed by their funds. This new language, which is set forth in a new subsection (n) under Section 203 of the Advisers Act, does not articulate a dollar size for such funds.

It is unclear if new subsections (m) and (n) under Section 203 are intended to be read together in order to determine if an adviser to “mid-sized” private funds is one who has more than $150 million in AUM or is one who falls below that threshold, but nonetheless, manages one or more funds that pose a systemic risk. Contrast this with the title of new paragraph (2) under Section 203A(a) of the Advisers Act, “Treatment of Mid-Sized Investment Advisers,” which raised the federal registration threshold from $25 million to $100 million, as discussed above. It is likely that a distinction can be made between advisers to “mid-sized” private funds, on the one hand, and “mid-sized investment advisers”, on the other hand – the latter being those who may advise individual clients and investors in addition to or apart from advising “private funds”.

Taken together these provisions of the PFIAR Act can arguably result in some confusion as to the size standards required for registration and how they would work in concert to enunciate a clear standard. We expect that the SEC will need to issue guidance as to how these provisions will fit together and not overlap.

Venture Capital Fund Exemption

The PFIAR Act exempts from SEC registration, but not reporting requirements, advisers who solely advise “venture capital funds.” These advisers will nevertheless be subject to SEC requirements to provide annual or other reports to the SEC as deemed necessary and in the public interest for the protection of investors. The SEC is required to issue final rules defining the term “venture capital fund” within one year following the enactment of the PFIAR Act.

Depending on how the SEC defines the term "venture capital fund" (as it is required to do within one year of enactment), it is unclear whether fund sponsors that manage both venture capital funds and other types of investment funds would be completely or partially exempt from, or would be subject to all, registration requirements. This uncertainty should be of particular importance to venture capital firms that have expanded beyond traditional venture capital investing by doing later-stage investing or engaging in a mix of investment styles within a single fund. To the extent the SEC promulgates proposed rules, affected advisers should comment on these rules.

No Specific Exemption for Advisers to Private Equity Funds

The PFIAR Act does not specifically exempt investment advisers to private equity funds from registration or reporting requirements under the Advisers Act (earlier versions of draft legislation had proposed a registration exemption). However, private equity fund sponsors and managers may be able to avail themselves of the exemption applicable to those who advise solely private funds with less than $150 million of AUM, as discussed above.

Family Office Exemption

The PFIAR Act excludes advisers to "family offices" from the definition of "investment adviser" under the Advisers Act, and thus exempts them from registering with the SEC. Consequently, the SEC is obligated to formulate rules (although no time period is defined for creating these rules) regarding the definition of the term "family office" to provide for an exemption that:

- is consistent with the SEC's previous exemptive policy regarding family offices;
- recognizes the range of organizational, management and employment structures or arrangements in use;
- does not exclude any person who was either not registered before January 1, 2010, or should have been registered on that date, solely because such person provides investment advice to, and was engaged prior to January 1, 2010 in providing advice to:
    - natural persons who are officers, directors or employees of the family office who:
        - have invested with the family office before January 1, 2010; and
        - are "accredited investors" as defined in Regulation D under the Securities Act of 1933 (Securities Act);
    - companies owned exclusively and controlled by members of the family of the family office; or
    - registered investment advisers providing advice to a family office and who identify investment opportunities to the family office, and invest in such transactions alongside such family office on substantially the same terms, but who do not invest in other funds advised by such family office, and whose assets as to which the family office directly or indirectly provides investment advice represents, in the aggregate, not more than 5 percent of the value of the total assets as to which the family office provides investment advice.

Small Business Investment Company Exemption

The PFIAR Act exempts advisers (who are not business development companies) from registration and reporting who solely advise small business investment companies (SBICs), entities that have received notice that they qualify as an SBIC, or affiliated entities of SBICs that have a pending application for an SBIC license.

Advisers Registered with the CFTC

In addition to the existing exemption for an adviser registered with the Commodity Futures Trading Commission (CFTC) as a commodity trading adviser under Section 203(b) of the Advisers Act, the PFIAR Act creates an additional registration exemption for such advisers that also advise private funds. However, if after the enactment of the PFIAR Act, the adviser's business becomes predominately providing securities-related advice, then dual registration with the SEC will be required.

SEC Rulemaking Authority; SEC and CFTC Joint Rulemaking

The PFIAR Act clarifies the SEC's rulemaking authority under Section 211 of the Advisers Act, and permits the SEC to make, issue, amend and rescind rules and regulations defining technical, trade and other terms used in the Advisers Act, except that for purposes of paragraphs (1) and (2) under Section 206 of the Advisors Act (prohibiting certain adviser activities), the term "client" shall include an investor in a private fund managed by an adviser pursuant to an advisory contract.

In addition, the SEC and the CFTC, after consultation with the Financial Stability Oversight Council (FSOC), are required within 12 months of enactment of the PFIAR Act to jointly promulgate rules on the form and content of reports required to be filed with the SEC and the CFTC by advisers that are registered with both agencies.

Records and Reports Required to be Maintained

The PFIAR Act provides for the collection of data from registered investment advisers and their managed private funds, and provides that any records of funds managed by such advisers are considered to be the adviser's records, as well, for reporting purposes.

Fund information that will be required to be maintained and subject to inspection by the SEC includes a description of:

- the amount of assets under management;
- use of leverage (including off-balance sheet leverage);
- counterparty credit risk exposure;
- trading and investment positions;
- valuation policies and practices of the fund;
- types of assets held;
- side arrangements or side letters with investors;
- trading practices; and

- other information deemed necessary or appropriate by the SEC and the FSOC for the protection of investors or for the assessment of systemic risk, which may include the establishment of different reporting requirements for different classes of fund advisers, based on size or type of fund being advised.

This list of items will greatly expand the reportable information that registered investment advisers are currently obligated to report and may, in certain respects, be greeted with some resistance by participants in the private fund community (e.g., with respect to investing positions, side letters, trading practices). We also note that it is unclear from the language of the PFIAR Act the breadth and extent to which records and reports will need to be "described," including whether the identities of investors with side arrangements or side letters will need to be disclosed.

Maintenance, Availability and Examination of Records and Reports

The PFIAR Act provides that the SEC may prescribe rules for the period of time during which a registered investment adviser shall maintain the records of the private funds it manages, and shall issue rules requiring such advisers to file reports containing such information as the SEC deems necessary and appropriate in the public interest and for the protection of investors or for the assessment of systemic risk.

In addition, records of a private fund maintained by a registered investment adviser to such fund are subject to periodic and special examinations by the SEC. The PFIAR Act also affirmatively mandates that the SEC conduct periodic inspections and authorizes the SEC to conduct additional or special examinations as it may prescribe as necessary and appropriate in the public interest and for the protection of investors or for the assessment of systemic risk.

Moreover, registered investment advisers are required to make available any copies or extracts of its private fund records as may be prepared without undue effort, expense or delay, as the SEC may reasonably request.

Information Sharing; Non-Disclosure of Proprietary Information and Confidentiality

All reports and other information filed with or provided to the SEC by a registered investment adviser must be shared by the SEC with the FSOC, as the FSOC deems necessary for assessing systemic risk posed by a private fund. The information filed with the SEC will be kept confidential, except that disclosure will be required to Congress when accompanied by the proper confidentiality agreement, and will also be required to be disclosed to any other federal department or agency or a self-regulatory organization, or pursuant to an order of a U.S. court in an action brought by the U.S. or the SEC, although such information will be exempt from FOIA disclosure. Any such other federal department or agency or a self-regulatory organization is also required to maintain the confidentiality of the reports and information it receives from the SEC.

In addition to the foregoing, the PFIAR Act provides that any "proprietary information" of a registered investment adviser ascertained in required reporting will be subject to the same limitations on public disclosure as any facts collected during an exam by the SEC. "Proprietary information" includes sensitive, non-public information regarding:

- the investment adviser's investment or trading strategies;
- analytical or research methodologies;
- trading data;
- computer hardware or software containing intellectual property; and
- any additional information the SEC determines to be proprietary.

Loosening Prohibition against Disclosure of Client Identity

The PFIAR Act broadens the exceptions to Section 210(c) of the Advisers Act, which in its current form severely limits the SEC's ability to require a registered investment adviser to disclose the identity, investments or affairs of its clients. Specifically, the PFIAR Act amends Section 210(c) by allowing the SEC to require the disclosure of such information for purposes of the assessment of potential systemic risk.

Accredited Investor Standard

Effective immediately (as of the date of enactment), the PFIAR Act revised the net worth standard for determining whether a natural person is an "accredited investor" by excluding the value of the primary residence of such natural person from the $1 million threshold used to make such determination.

The SEC is required to adjust the net worth standard for natural persons under the Securities Act; provided, that during the four-year period beginning on the date of the PFIAR Act's enactment (July 21, 2010), the net worth standard will remain $1 million, excluding the value of such person's primary residence.

The SEC is permitted to review the definition of "accredited investor" as it applies to natural persons to determine whether any requirements for the definition should be adjusted (excluding the $1 million net worth threshold), and accordingly, may make such adjustments as it deems appropriate for the protection of investors, in the public interest, and in light of the economy. For example, such adjustments could include changes to the gross annual income standard (currently $200,000 for individuals and $300,000 for married couples for the previous two calendar years).

Following the initial four-year period following enactment of the PFIAR Act, and no less than once every four years thereafter, the SEC is required to review the "accredited investor" definition in its entirety (including the $1 million net worth threshold) as it applies to natural persons, and may, by notice and comment rulemaking, make such adjustments to any part of the definition as it deems appropriate for the protection of investors, in the public interest, and in light of the economy.

Qualified Client Standard

The PFIAR Act also obligates the SEC, within one year after enactment and every five years thereafter, to adjust the "qualified client" standard contained in the rules promulgated under the Advisers Act to account for inflation. Thus, the $750,000 assets under management and $1.5 million net worth standards determining a client's status as a "qualified client" would be adjusted for inflation no later than one year after the PFIAR Act's enactment and every five years thereafter, in $100,000 increments.

Custody of Client Assets

The PFIAR Act amends the Advisers Act by adding a new Section 223 requiring that registered investment advisers take such steps to safeguard client assets over which the adviser has custody, including without limitation, the verification of these assets by an independent public accountant, as the SEC may, by rule, prescribe. Amendments to the current custody rule under the Advisers Act (Rule 206(4)-3) became effective on March 12, 2010, and were promulgated under Section 206(4) of the Advisers Act, which provides that the SEC shall by rules and regulations define and prescribe means reasonably designed to prevent, acts, practices or courses of business which are fraudulent, deceptive or manipulative. It is not clear what meaningful effect the new Section 223 has in light of the existing Rule 206(4)-3, other than providing further authority for the recent amendments to the custody rules adopted by the SEC.

Comptroller General and SEC Studies

The PFIAR Act directs the Comptroller General of the U.S. to conduct a study of, and submit to Congress, within three years following the date of enactment, a report on (a) the compliance costs for investment advisers to comply with current SEC rules concerning the custody of clients' funds or securities; (b) the costs if rules concerning operational independence are eliminated; and (c) the appropriate financial thresholds and other criteria to qualify for accredited investor status and eligibility to invest in private funds. Within one year following enactment, the Comptroller General is directed to conduct a study and provide a report explaining the feasibility of forming a self-regulatory organization to oversee the private fund industry.

The PFIAR Act also directs the SEC to perform a study within two years following the date of enactment on the state of short selling including the effect of the newer short sale rules and subsequent trading behaviors, and to perform a study within one year on the feasibility of requiring real-time public reporting of short sale positions of publicly listed securities. Finally, the PFIAR Act requires the SEC to report to Congress annually as to how it has used the data it has collected from private funds and their advisers to monitor the markets and protect investors.

THE VOLCKER RULE

The Dodd-Frank Act contains a modified version of the Obama Administration's so-called "Volcker Rule," which prevents banks and nonbank financial companies under the supervision of the Federal Reserve from sponsoring or investing in a hedge fund or private equity fund with more than a de minimis investment. The Volcker Rule also essentially prohibits banks, bank affiliates and bank holding companies from engaging in proprietary trading[1] and requires nonbank financial companies under the supervision of the Federal Reserve engaging in proprietary trading to meet additional capital requirements and quantitative limits.

[1] When used with respect to a banking entity or nonbank financial company supervised by the Board of Governors, proprietary trading means engaging as a principal for the trading account of the banking entity or nonbank financial company supervised by the Board of Governors in any transaction to purchase or sell, or otherwise acquire or dispose of, any security, any derivative, any contract of sale of a commodity for future delivery, any option on any such security, derivative, or contract, or any other security or financial instrument that the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission may, by rule, determine.

General Prohibition and Effective Date

Except to the extent permitted by the new law, a "banking entity"[2] may not acquire or retain any equity, partnership, or other ownership interest in or sponsor a hedge fund or private equity fund.

For this purpose, the terms "hedge fund" and "private equity fund" are defined to include any issuer that would be an investment company, as defined in the 1940 Act, but for the application of the exceptions contained in sections 3(c)(1) and (7) of that Act (a Covered Fund). The definition of Covered Funds also includes such similar funds as the relevant federal regulatory agencies may designate.

The legislative prohibition would generally take effect on the earlier of (a) 12 months after date on which final implementing regulations are issued by the relevant federal regulatory agencies, or (b) July 21, 2013 – two years after the date of enactment of the legislation. Transitional periods are provided to enable banking entities to make divestitures as necessary to comply with the new restrictions (generally two years with three possible one-year extensions by the Federal Reserve) and special transition periods apply to illiquid funds (by application to the Federal Reserve, although no specific time periods are enumerated).

Permitted Fund Activities

Subject to certain conditions (described below), a banking entity will be permitted to organize and offer a Covered Fund, including serving as a general partner, managing member, or trustee of the Covered Fund and select or control a majority of the directors, trustees or management of the Covered Fund (including having employees, officers, directors, or agents who constitute that majority).

This exception applies only if (a) the banking entity provides bona fide trust, fiduciary, or investment advisory services; (b) the Covered Fund is organized in connection with the provision of such services and is offered only to persons who are customers of such services; (c) with certain exceptions described below, the banking entity does not acquire or retain more than a de minimis investment in the Covered Fund; (d) the banking entity does not directly or indirectly guarantee, assume or otherwise insure the obligations of the Covered Fund or of any fund in which the Covered Fund invests; (e) the banking entity does not share with the Covered Fund for corporate, marketing,

promotional, or other purposes, the same name or a variation of the same name; (f) no director or employee of the banking entity takes or retains an equity interest in the Covered Fund except for directors or employees who are directly engaged in providing investment advisory or other services to the Covered Fund; and (g) the banking entity makes adequate disclosures that any losses sustained by the Covered fund will be borne solely by investors in the Covered Fund (collectively, Sponsor Requirements).

[2] In addition to banking entities (i.e., depository institutions and certain of their affiliates), the Volcker Rule would also be applicable to non-bank financial companies that are supervised by the Federal Reserve Board. This category presumably is intended to cover non-bank financial companies that are determined to be systemically significant under other provisions of the legislation and thus subject to enhanced regulation and supervision.

A banking entity is also permitted to invest in SBICs and investments designed to promote the public welfare. This permitted activity is not subject to the same limitations on investing in hedge funds or private equity funds.

In addition, otherwise permitted activities with respect to Covered Funds and SBICs will become prohibited activities if they involve or result in a material conflict of interest between a banking entity and its clients, customers or counterparties; an unsafe or unsound exposure of the banking entity to high risk assets or high risk trading strategies; a threat to the safety and soundness of the banking entity; or a threat to the financial stability of the U.S.

Capital and Quantitative Limitations – 3 Percent Rule

Subject to certain limitations (described below), a banking entity may make and retain an investment in a Covered Fund that it organizes and offers for the purposes of either (a) establishing the Covered Fund and providing the fund with sufficient initial equity for investment to permit the fund to attract unaffiliated investors or (b) making a de minimis investment in the Covered Fund.

The banking entity must actively seek unaffiliated investors to reduce or dilute its investment in the Covered Fund to a de minimis amount. In addition, investments in a Covered Fund must (a) be reduced to 3 percent of the total ownership interests of the fund not later than one year after the Covered Fund is established and (b) be immaterial to the banking entity, but in no case may the aggregate of all interests of the banking entity in all Covered Funds exceed 3 percent of the tangible common equity of the banking entity. The relevant federal regulatory agency may extend the time for meeting the percentage of fund ownership requirement for two additional years.

Limitation on Relationships with Covered Funds

No banking entity that serves, directly or indirectly, as the investment manager, investment adviser, or sponsor to a Covered Fund, or that organizes and offers a Covered Fund, and no affiliate of the banking entity may enter into transactions with the Covered Fund, or funds controlled by the Covered Fund, that would be prohibited under section 23A of the Federal Reserve Act. Similar rules are provided so that the provisions of section 23B of the Federal Reserve Act would also apply.

Notwithstanding these limitations, the relevant federal regulators may permit a banking entity to enter into prime brokerage transactions with a Covered Fund if the following additional conditions are met: (i) the banking entity is in compliance with each of the Sponsor Requirements (described above) regarding a hedge fund or private equity fund organized and offered by such banking entity; (ii) the banking entity provides an enforceable undertaking that such transaction will not be used under any circumstance to avoid losses to any investor in any such fund; and (iii) the Federal Reserve has determined that such transaction is consistent with the safe and sound operation and condition of the banking entity.

Permitted Activities outside Proprietary Trading Ban

The proprietary trading ban is not absolute. Permitted activities that fall outside the prohibition include: (1) the disposition of U.S. government, state, municipal, and Fannie and Freddie Mac obligations, (2) the disposition of any security or other interest in connection with underwriting, market making-related activities (to the extent that these transactions are not designed to exceed near-term

client demands) conducted on behalf of customers, or by a regulated insurance company directly engaged in the business of insurance for the general account of the company, and (3) risk mitigating hedging activities intended to reduce risk for a banking entity, small business investments, and certain "public welfare" investments, along with any other such activity that the appropriate regulator determines would promote and protect the safety and soundness of the U.S. financial system.

Study

The Dodd-Frank Act requires the FSOC to conduct a six month study to review the benefits and problems of various aspects of such a rule and its implementation. After reviewing the study's findings, the appropriate Federal banking agencies and regulators will jointly create and adopt appropriate rules to carry out the legislation.

OTHER PROVISIONS THAT MAY AFFECT PRIVATE FUNDS

Dissolution Authority over Non-Bank Financial Institutions

The systemic dissolution fund that existed in prior versions of the House and Senate bills was not included in the final Dodd-Frank Act, which would have created a $50 billion (Senate version) or $150 billion (House version) systemic dissolution fund to be used for the orderly and complete dissolution of the failed financial company, that would have been funded by fees charged to financial institutions with more than $50 billion in assets and financial companies that manage hedge funds with more than $10 billion in AUM on a consolidated basis.

Instead, the Dodd-Frank Act establishes a resolution authority under the Federal Deposit Insurance Corporation (FDIC) to wind down large, financially-troubled nonbank financial institutions. This will be achieved through the FDIC's ability to liquidate large, systemically significant firms through a Treasury

Department credit line. The Treasury funds would then be recovered through selling off the assets of the dissolved financial firm, similar to a traditional bankruptcy liquidation process.

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We will continue to monitor developments, including the progress of the SEC's and the CFTC's rulemaking and the reporting of studies conducted by the SEC and the Comptroller General, in order to advise our clients and friends from time to time. Please do not hesitate to contact your Patton Boggs attorney or one of the lawyer/authors listed above with any inquiries.

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