Regulatory and Case Law Developments Relating to Private Equity Fund Documents

Regulatory authorities (including the Securities and Exchange Commission (the "SEC") and the United States Internal Revenue Service (the "IRS")) have recently proposed and adopted amendments to rules that may affect a private equity fund's subscription documents and other organization documents. This alert highlights several recent regulatory and case law developments affecting private equity fund documents.

Revised "Accredited Investor" Definition

Last month, the SEC adopted an amendment to the "accredited investor" standards to reflect the requirements of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (the "Dodd-Frank Act"). Safe harbor rules provided by Regulation D under the *Securities Act of 1933* allow private placement of interests in private equity funds to "accredited investors." Under the previous rules, with respect to a natural person, an accredited investor is "any natural person who had an individual income in excess of $200,000 in each of the two most recent years or joint income with that person's spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year" or "any natural person whose individual net worth, or joint net worth with that person's spouse, at the time of his purchase exceeds $1,000,000."

Under the amended rule, the net worth threshold remains at $1,000,000; however, calculation of net worth for purposes of the threshold *excludes* the equity value of the primary residence of such natural person as an asset (calculated by subtracting from the estimated fair market value of the property, the amount of debt secured by the property). Therefore, any equity of an investor in his or her primary residence must now be excluded from such investor's net worth calculation.

Furthermore, under the amended net worth standard, indebtedness secured by an individual's primary residence is not treated as a liability (up to the estimated fair market value of the residence) in the net worth calculation, subject to two exceptions. First, such indebtedness may be treated as liability to the extent the amount of debt exceeds the estimated fair value of the residence. Additionally, any increase in such indebtedness shall be treated as a liability in an individual's net worth calculations if such an increase occurs in the sixty (60) days preceding the purchase of the securities in an exempt offering, and such purchase is not in connection with the acquisition of the residence. These revisions are intended to avoid manipulation of the net worth standards by inflating an individual's net worth by borrowing against home equity just prior to participating in an exempt securities offering.

The amended net worth standard will not generally be "grandfathered" into effectiveness, and it will apply to all individuals as of the effective date, subject to one exception. The new net worth standard does not apply to a person's net worth in connection with a purchase of securities in accordance with a right to purchase such securities, so long as (i) the right was held on July 20, 2010, (ii) such person qualified as an "accredited investor" on the basis of net worth at the time the person acquired such right and (iii) such person held securities of the same issuer, other than the right, on July 20, 2010.

The amended "accredited investor" standard will become effective as of February 27, 2012. **Private equity funds should revise their subscription documents to ensure that the definition of "accredited investor" and the net worth standard are updated in accordance with the amended rule.**

The final adopted rule may be found here and the corresponding SEC press release is available here.

Revised "Qualified Client" Definition

Private equity fund managers registered with the SEC are generally prohibited from charging performance and incentive fees/allocations pursuant to Section 205(a)(1) of the *Investment Advisers Act of 1940* (the "Advisers Act"); however, an exemption in Rule 205-3 permits the charging of such fees/allocations to an investor if the investor is a "qualified client." The SEC has issued an order to raise the thresholds qualified clients must meet in connection with the charging of performance and incentive fees / allocations. It is worth noting that this change will not affect funds relying on Section 3(c)(7) of the Advisers Act.

Under the previously existing rules, a qualified client included "(i) a natural person who or a company that has at least $750,000 under the management of an investment adviser immediately after entering into an advisory contract with the investment adviser, and (ii) a natural person who or a company that the investment adviser reasonably believes has a net worth (together, in the case of a natural person, with assets held jointly with a spouse) of more than $1,500,000 at the time an advisory contract with the investment adviser is consummated." Under the SEC's order, the $750,000 and $1,500,000 dollar amounts have been increased to (i) $1 million and (ii) $2 million, respectively.

The SEC also provided that the dollar amount tests will be adjusted for inflation every five years and that the value of an individual's primary residence will be excluded from calculation of net worth, similar to the change to the definition of accredited investor described above.

Additionally, the SEC has proposed transitional rules that generally provide that the changes in the standards described above will apply only on a going forward basis. The transitional rules provide that if a private equity fund manager was previously exempt from registration with the SEC under Section 203 of the Advisers Act (including Section 203(b)(3), the "fifteen client" exemption) and subsequently registers, the prohibition on charging performance and incentive fees/allocations in Section 205(a)(1) of the Advisers Act does not apply to existing investors, and allow for additional investments by investors who invested prior to the effective date of the revised standards, even if such investors would not otherwise qualify under the revised standards.

The revised "qualified client" definition is already effective. **Prior to raising a new fund, private equity funds should revise their subscription documents to ensure that the definition of "qualified client" is updated in accordance with the SEC's order, and should analyze performance and incentive fees / allocations in accordance with the revised definition. With respect to existing private equity funds relying on Section 3(c)(1) of the Advisers Act, while not yet formally adopted, there is every expectation that these transitional rules will be passed.**

The order approving the changes is available here and the corresponding SEC release is available here.

Forms PF and ADV Requirements Relating to Investors in Funds

Form PF includes several reporting requirements that may require advisers to collect information they had not previously collected, including information about the types of investor invested in a fund and affiliations among investors.

Types of Beneficial Owners. Form PF requires advisors to report the concentration of a fund's beneficial owners by type of investor. Reporting this information may require advisers to collect additional data about a fund's investors in order to classify each investor as a member of a specified group. These groups include: (i)

individuals that are U.S. persons (including their trusts), (ii) individuals that are not U.S. persons (including their trusts), (iii) broker-dealers, (iv) insurance companies, (v) investment companies registered with the SEC, (vi) private funds, (vii) non-profit entities, (viii) pension plans, (ix) banking or thrift institutions, (x) state or municipal government entities (and their pension plans), (xi) sovereign wealth funds and foreign official institutions, (xii) investors that are not U.S persons whose beneficial ownership is unknown and cannot reasonably be obtained, and (xiii) any other type of owner not listed. Form ADV requires a similar but shorter list of investor types (funds of funds and non-U.S. investors).

With respect to fund interests issued before March 31, 2012, advisers may respond to this question using good faith estimates of beneficial ownership, based on data currently available to the adviser. For fund interests issued on or after March 31, 2012, the adviser should collect data that would allow it to identify each of the fund's beneficial owners as a member of one of the specified groups and report such information on Form PF. **Prior to raising a new fund, private equity funds should revise their subscription documents to ensure that all required information about beneficial ownership will be obtained by the funds.**

A copy of Form PF is available here and the adopting release is available here.

New FATCA Reporting and Withholding Requirements

Private equity funds may have to update their subscription documents and fund agreements to include certain representations and covenants to comply with the *Hiring Incentives to Restore Employment Act,* enacted March 18, 2010 (the "HIRE Act") and recently released regulations promulgated thereunder (currently in proposed form). The Foreign Account Tax Compliance ("FATCA") provisions of the HIRE Act are generally designed to require certain U.S. persons' direct and indirect ownership of non-U.S. accounts and certain non-U.S. entities to be reported to the IRS, and impose a withholding tax if there is a failure to provide required information or otherwise comply with FATCA's requirements.

In particular, FATCA imposes a 30% withholding tax on certain payments made by a fund to foreign financial institutions ("FFIs") (and certain other non-US persons) unless certain exceptions apply, as described below. FFIs are broadly defined and include foreign entities engaged primarily in the business of investing, reinvesting or trading in securities or similar interests. These include private equity funds, funds of funds, non-U.S. mutual funds and hedge funds. Payments subject to the withholding tax generally include U.S. source payments of interest, dividends, rents, certain payments with respect to derivative instruments that are treated as "dividend equivalent payments" and other gains, profits and income, as well as any gross proceeds from the sale of any property that can produce U.S. source interest or dividends (potentially including the proceeds of the sale or other disposition of an interest in an FFI).

The 30% withholding tax will not apply if (i) the FFI enters into an agreement (a "FATCA Agreement") with the Internal Revenue Service to undertake certain due diligence, reporting, withholding and redemption responsibilities, (ii) the FFI is a deemed compliant FFI (an FFI that complies with certain procedures to ensure that the FFI does not maintain U.S. accounts or is a member of a class of institutions for which the IRS has determined compliance is unnecessary), or (iii) certain other limited exceptions apply.

This withholding tax is currently scheduled to be phased in beginning with payments made on January 1, 2014 (although it may be necessary to enter into the FATCA Agreement by June 2013 to minimize the risk of being withheld on). Private funds that fall under this new regulatory regime should consider updating their

subscription materials and fund agreements to include representations and cooperation covenants from investors with respect to withholding, reporting and compliance obligations under FATCA to ensure the 30% withholding tax will not apply to the fund.

Limited Partner Access to Books and Records

A recent Delaware supreme court decision (*Parkcentral Global, L.P. v. Brown Investment Management, L.P.*) involving a hedge fund structured as a limited partnership addressed the general partner's obligation to disclose the names and addresses of other partners upon request by a limited partner. In this case, the court affirmed the lower court's ruling and required the hedge fund general partner to provide to a requesting limited partner the list of other partners, reasoning that none of the *Delaware Revised Uniform Limited Partnership Act* (the "DRULPA"), the explicit terms of the partnership agreement nor federal privacy rules entitled the general partner to withhold the list of partners. §17-305 of DRULPA entitles limited partners to access partnership records if they make a reasonable demand for a purpose reasonably related to their interest as a limited partner, but the statute also provides that the general partner may establish reasonable standards governing the right to access information and under 17-305(f), that the rights of a limited partner to obtain information may be restricted in the partnership agreement. However, the court also stated in dictum that if the general partner wished to bar access to the names and addresses of partners, it could have done so explicitly in the partnership agreement under §17-305(f) of DRULPA.

While some private equity fund managers have traditionally included a provision restricting access in their subscription materials and partnership agreements, managers that do not have such provisions should consider including them in future materials. Conversely, when investing in funds with partnership agreements that contain such provisions, prospective investors should carefully consider their contractual rights to receive information from the fund in light of the *Parkcentral* decision.

A copy of the decision from the court is available here.

Privacy Notice Reminder

As a reminder, in order to comply with one or both of SEC Regulations S-P and the Federal Trade Commission "Privacy of Consumer Financial Information" regulations, a private equity fund manager is required to notify investors of its policies and practices regarding non-personal information annually. **Accordingly, this is a reminder to provide a privacy notice to your individual investors on an annual basis.**

Please contact your Ropes & Gray LLP advisor to discuss incorporating these changes into your existing and future investor subscription materials.