Ropes & Gray's Private Investment Fund Update: February 2012

The following summarizes recent legal developments of note affecting the private investment fund industry:

Regulatory Matters

Regulatory Reporting Obligations

The Department of Treasury, through the Federal Reserve Bank of New York (the "NY Fed") and the U.S. Department of Commerce, through the Bureau of Economic Analysis (the "BEA"), require U.S. residents to file certain regulatory reports.[1] Although these reports have been required by the NY Fed and the BEA for several years, historically there has been both widespread non-compliance by the private investment industry, and lack of enforcement by the regulatory authorities. However, in connection with implementations of Form SLT by the NY Fed, the NY Fed and the BEA have taken a renewed interest in certain older regulatory filings. While the NY Fed and the BEA have informally confirmed that they do not intend to penalize reporters for past violations, future compliance with these regulatory filings will be taken more seriously and U.S. residents should review these filings to determine the extent to which these reports may be required by entities in their structure. Brief descriptions of these filings are set forth below.

Form SHC. The NY Fed generally requires U.S. resident end investors and U.S. resident custodians to report information regarding foreign securities[2] (1) that a U.S. resident safe-keeps for itself or for its U.S. resident clients, or that are held with a foreign-resident custodian and (2) that are entrusted to the safekeeping of a U.S. resident custodian, on the Treasury International Capital Form SHC ("Form SHC"). **Form SHC is filed every five years. Data as of December 31, 2011 must be reported no later than March 2, 2012.** Certain transactions specified in the Instructions to Form SHC (including letters of credit, derivative contracts, loans and loan participation certificates and direct investments[3]) are exempt from reporting on Form SHC. Form SHC is a three-part report. Schedule 1 to Form SHC requires the U.S. resident report basic identifying information about itself. Schedule 2 to Form SHC requires information regarding foreign securities, the safekeeping of which is not managed by a U.S. resident custodian, to the extent the total fair value of such foreign securities equals or exceeds $100 million. Schedule 3 requires information regarding foreign securities that are entrusted to a U.S. resident custodian. Schedule 3 only must be filed for each U.S. custodian that holds foreign securities for the U.S. resident reporter that equals or exceeds $100 million (e.g., no Schedule 3 must be filed if two U.S. custodians each hold $60 million of foreign securities for a U.S. resident reporter).

A copy of Form SHC and the Instructions are available here.

Form S. The NY Fed generally requires U.S. residents who engage in transactions directly with foreign residents that result, in the aggregate, of $50 million or more of cash being exchanged for long term

[1] "Residency" is determined by country of legal organization with respect to partnerships and trusts, by country of incorporation with respect to corporations and by tax residency with respect to individuals.
[2] Reportable securities include foreign equities, short-term debt securities, long-term debt securities and asset-backed securities. A security is a "foreign security" if the underlying issuer is a foreign resident. Foreign securities may be traded or issued in the United States and in foreign countries and may be denominated in any currency.
[3] Direct investments are reported on the Direct Investment Surveys, discussed below.

securities[4] in any calendar month, report such transaction on the Treasury International Capital Form S ("Form S"). Reportable transactions include primary and secondary transactions, as well as capital contributions made by U.S. resident investors to foreign funds and capital contributions made by foreign resident investors to U.S. resident funds. Certain transactions specified in the Instructions to Form S (including interest and dividend payments, transactions conducted through a U.S. resident intermediary, capital commitments and direct investment transactions[5]) are exempt from reporting on Form S. Form S is a monthly report that must be filed no later than fifteen (15) calendar days following the last business day of the month with respect to which the Form S is required to be filed.

A copy of Form S is available here and the corresponding Instructions are available here.

Direct Investment Surveys. The BEA generally requires U.S. resident entities to file direct investment surveys with the BEA if such U.S. resident entities meet or exceed certain thresholds of foreign direct investments ("Direct Investment Surveys"). Direct Investment Surveys must be filed when (1) a foreign investor directly and/or indirectly owns 10% or more of the voting securities of a U.S. resident entity or (2) a U.S. resident investor directly and/or indirectly own 10% or more of the voting securities of a foreign entity. [6] In addition, direct Investment Surveys must be filed if the U.S. subsidiary or foreign subsidiary has certain financial values that meet or exceed specified thresholds. Direct Investment Surveys require information regarding direct financial transactions between the parent entity and the subsidiary entity and selected financial data and operating history of the subsidiary entity. Direct Investment Surveys must be filed quarterly, annually and every five years. Quarterly Surveys must be filed within thirty (30) calendar days after the close of the first three calendar quarters and within forty-five (45) calendar days after the close of the last calendar quarter. Annual and Quinquennial Surveys must be filed by May 31 after the close of the reporting year.

More information on Inward Direct Investment Surveys is available here and information on Outward Direct Investment Surveys is available here.

Penalties for Failure to Report Form S, Form SHC and the Direct Investment Surveys. Failure to report Form S, Form SHC or the Direct Investment Surveys can result in a civil penalty of at least $2,500 and at most $25,000, with respect to each instance of noncompliance. Willful failure to report can result in criminal penalties, including a fine of at most $10,000 and imprisonment for no more than one year. An officer, director, employee, or agent of an entity who knowingly participates in the willful failure to report can also face these criminal penalties. Penalties for failure to file are applicable only to the U.S. resident entity or individual with the obligation to file Form S, Form SHC or the Direct Investment Surveys.

Investment advisers of private equity funds should carefully review their operations and the operations of the funds they manage to determine whether they are subject to Form SHC, Form S and the Direct Investment Survey filing requirements.

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[4] A long-term security is a debt or equity security with either no stated maturity or with an original maturity exceeding one year. Long term equity securities include limited partner interests, limited liability company interests, corporate shares and equity interests in funds and equivalent investment vehicles. Long term debt securities include bonds and notes, convertible bonds and debt with attached warrants, asset-backed securities and floating rate notes.

[5] Direct investments are reported on the Direct Investment Surveys, discussed below.

[6] While limited partnership interests are not a "voting security" because limited partner interests do not carry voting rights, investments made by a general partner into a limited partnership are considered to be direct investments and must be reported (provided the requisite financial thresholds are met).

New York City Considering an Attack on Carried Interest in the Context of the Unincorporated Business Tax ("UBT")

New York City's audit team is focusing on the treatment of carried interest in the context of the UBT. Very generally, unlike most jurisdictions, New York City imposes a direct tax on unincorporated entities (e.g., partnerships) with a presence in New York City. While management companies classified as partnerships for tax purposes pay this tax on their management fee income, historically many New York City managers earned carried interest through separate vehicles and took the position that the carried interest was exempt from the UBT. In addition to protecting the carried interest from tax, because the management company generally incurs the majority of a manager/carry expenses, this arrangement also concentrated the management/carry expenses (and hence the deductions) in the entity subject to UBT.

Unlike the proposed U.S. federal legislation, New York City does not appear to be focused on treating the carried interest as taxable income for UBT purposes. Instead, the City appears to be focused on shifting expenses from the management company/partnership to the carried interest vehicle. Such a shift has the effect of increasing a management company's UBT (because it has fewer deductions) without a corresponding offset in the related carry vehicle (which does not benefit from the deductions because it is not subject to the UBT). It is unclear whether New York City actually has the authority to make such an argument. **Private equity funds that maintain an office in New York City should be aware of this examination position being taken by New York City auditors.**

FINRA Proposes Rule Requiring Investor Disclosure and Notice Filings for Private Placements

The Securities and Exchange Commission ("SEC") recently solicited a second round of comments on the Financial Industry Regulatory Association ("FINRA") proposal imposing new disclosure and filing requirements for private placements. FINRA Rule 5123 (the "Proposed Rule") would (i) require that placement agents registered as brokers-dealers (member firms) provide private placement investors with detailed information about the intended use of proceeds and the amount and type of offering expenses and offering compensation; and (ii) require member firms and their associated persons to provide to FINRA information about their private placement activities, including any private placement memorandum ("PPM"), term sheet, or other disclosure document within 15 calendar days after the initial sale of securities, and to file any material amendments to a disclosure document used in an offering within 15 days after the date such document is provided to any investor or prospective investor.

Exemptions. The Proposed Rule would exempt from its obligations several types of private placements based on either the type of purchaser or the type of offering. Exemptions include offerings sold solely to any one or more of the following: institutional accounts, qualified purchasers ("QPs") as defined in Section 2(a)(51)(A) of the *Investment Company Act of 1940* (the "1940 Act"), qualified institutional buyers ("QIBs") as defined in Rule 144A of the *Securities Act of 1933* (the "Securities Act"), investment companies as defined in Section 3 of the 1940 Act, entities composed exclusively of QIBs, banks, and employees and affiliates of the issuer. Additionally, exemptions include offerings made pursuant to Rule 144A or Regulation S under the Securities Act, offerings filed with FINRA under Rules 2310, 5110, 5121, or 5122, and offerings of certain exempt securities, subordinated loans, variable contracts, modified guaranteed annuity contracts, modified guaranteed life insurance policies, non-convertible debt, preferred securities, commodity pool securities, and securities issued in conversions, stock splits, and restructuring transactions with an existing investor for no additional consideration.

FINRA will announce the effective date of Rule 5123 within 90 days of SEC approval. The effective date will be no later than 180 days following SEC approval. **Upon effectiveness, this rule will apply to private equity funds that are raised using a placement agent that is a registered broker-dealer and such fund relies on the Section 3(c)(1) exemption from the definition of investment company under the 1940 Act.**

The text of the proposed rule is available here and the corresponding SEC release is available here.

FinCEN to Require Investment Advisers to Establish AML Programs

In a speech delivered to the American Bankers Association/American Bar Association Money Laundering Enforcement Conference on November 15, 2011, James H. Freis, Jr., Director of the Financial Crimes Enforcement Network ("FinCEN"), reported that FinCEN is working on a regulatory proposal that would require investment advisers to establish anti-money laundering ("AML") programs and report suspicious activity.

FinCEN proposed rules in 2003 requiring investment advisers to establish AML programs, but it withdrew the proposed rules in November 2008. Since then, there have been significant changes to the regulatory framework for investment advisers and Freis noted that FinCEN was ready to revisit the proposal with recent industry changes in mind.

There is nothing private equity funds need to do at this time with respect to these proposals (although we would note that existing law makes it a criminal offense to participate knowingly or recklessly (including willful blindness and conscious avoidance) in the transfer of funds that are proceeds of certain criminal activities; consequently, AML procedures in some form may be useful prior to the adoption of this proposal). Ropes & Gray will notify you of any further developments.

New HSR Rules and Form in Effect

In August, the much-anticipated final Hart-Scott-Rodino ("HSR") premerger notification rules took effect, completing a rule-making process started by the Federal Trade Commission and Department of Justice in August 2010; a new HSR form was also released. The final rules provide greater transparency into the holdings of private equity funds and master limited partnerships, in particular, while reducing the filing burden in other areas.

The New Disclosure Requirements. Under the rules, acquiring persons will now have to report the minority and controlled investments of "associates" – entities under common management with, but not controlled by, the acquiring person – to the extent that they derive revenues in the same industry as the target. This new disclosure requirement particularly impacts master limited partnerships and private equity funds. Additionally, the rules create a new class of documents to be included in each HSR filing, consisting of Confidential Information Memoranda ("CIM"), materials prepared by investment bankers, consultants or other third party advisors, and synergy or efficiency documents. Finally, in a departure from the Census reporting concepts currently embodied in the HSR form, parties must now supply 10-digit NAICS product codes and revenues for each product manufactured outside of the U.S. which is sold into the U.S. at the wholesale or retail level or which is sold directly to customers in the U.S. Formerly direct sales of foreign-manufactured products were not reported and sales of foreign-manufactured products made through a controlled U.S. establishment of the filer were reported only at the wholesale or retail level.

Changes That Reduce the Burden. The rules also make the HSR form easier to complete in a couple of key respects, most notably with the elimination of the need to provide statistical base year (formerly 2002) revenue data and to supply information about products which have been added or deleted since the base year. Parties will no longer have to provide links or hard copies of SEC filings but will instead identify public filers and provide their Central Index Key numbers. Further, full names and addresses of subsidiaries will not be needed but rather parties will supply only the name and city and state of U.S. entities and the name and city and country of all foreign entities deriving revenue in the U.S. Certain other minor modifications have also been made, many of which address omissions from the FTC's 2005 rule-making relating to unincorporated entities.

The new HSR form is available here and the instructions to the form are available here.

The Securities and Exchange Commission Updates

SEC Examination Matters

The SEC has been conducting broad based inquiries into the activities of some private equity firms in an effort to uncover possible instances of fraud. Previously these inquiries targeted hedge funds, but recently the SEC has widened its scrutiny to mutual funds and private equity funds. These inquiries include extensive and wide-ranging document requests for, among other things, formation and offering documents, lists of investors, commitment amounts by investor, information about capital calls, lists of investments, communications with investors, financial statements and all civil complaints and arbitration demands relating to a fund. While the SEC has confirmed this is not a full industry sweep and declined to provide guidance as to factors that it examines to determine whether to launch an investigation, it has suggested there are no set "performance thresholds" or financial guidelines that would trigger such an investigation.

The SEC has also been making more narrow examination requests on private equity firms, focusing on compliance with the custody rule under the Advisers Act. Although the examination request letters have sought certain general information about the advisers, the examinations appear narrowly focused on compliance with the custody rule (as opposed to a general audit of a registered investment adviser). The requests have sought information regarding qualified custodians used, information regarding securities not maintained with a qualified custodian and information regarding the registrar or recordkeeper responsible for any uncertificated securities. They have also sought information regarding private funds advised by the advisers that appears designed to allow the staff to ensure custody rule compliance with respect to both interests in the ultimate portfolio company and interests in each intermediate holding entity between the private fund and the ultimate portfolio company.

Additionally, the Office of Compliance Inspections and Examinations intends to commence letter inspections of many newly registered private equity funds and hedge funds shortly after the March 30th registration deadline. Finally, sources at the SEC have confirmed that SEC plans to target private equity funds' general partners who engage in certain inappropriate practices, including payouts of breakup fees that are disproportionately allocated to one fund over another, breaches of fiduciary duties with respect to maintaining investments in funds that lack prospects for investment returns and promises of excessive returns during fund formation. More information on these matters can be found in "Senior SEC Officials Discuss Asset Management Examination and Enforcement Initiatives and Priorities for 2012," which is available here.

SEC Charges Investment Advisers with Compliance Failures

On November 28, 2011, the SEC charged three investment advisers for failing to implement compliance procedures as required by Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder. While these cases represent extreme compliance failures, they evidence the SEC's interest in adviser compliance matters.

Each of the three investment advisers charged with compliance failures, OMNI Investment Advisors Inc., Feltl & Company Inc., and Asset Advisors LLC, failed to fully adopt and implement written compliance policies and procedures. Two of the three advisers—OMNI Investment Advisors, Inc. and Asset Advisors LLC—had previously received warnings from SEC examiners about their compliance deficiencies.

According to the SEC, the charges correspond to an initiative within the SEC Enforcement Division's Asset Management Unit "to proactively prevent investor harm by working closely with agency examiners to ensure that viable compliance programs are in place at firms." For more information, please see the SEC's press release, which contains links to the related SEC orders.

Upcoming Deadlines

February 14, 2012: Date by which an investment adviser registering with the SEC is required to register.

March 2, 2012: Date by which an end-investor filing Form SHC with the Federal Reserve Bank of New York is required to file.

March 30, 2012: Date by which an investment adviser is filing as an exempt adviser with the SEC is required to register.

March 31, 2012: Date after which an investment adviser must collect information regarding investor's beneficial ownership for purposes of Form PF.

Other Developments

TIC Form SLT Reporting Requirements
September 9, 2011

Applicability of Large Trader Rules to Private Equity Advisers
September 26, 2011

Proposed Rules and Guidance Regarding Federal Reserve Oversight of Nonbank Financial Companies
October 20, 2011

Proposed Volcker Rule and the Effect on Private Fund Sponsors and Investors
October 20, 2011

SEC Adopts Reporting Obligations for Advisers to Private Funds on New Form PF
November 1, 2011

[Another Milestone for the AIFMD – Time for Non-EU Private Equity Advisers to Take Stock?]
November 29, 2011

[SEC Releases Guidance on Whether Entities Related to a Registered Adviser Need to Register]
January 20, 2012

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