

Special Section

# Dow Jones Private Equity Analyst Dow Jones Private Equity News

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## 2012: The Year Dodd-Frank Comes To Town

By Christopher Chung



In private equity lore, 2012 will likely become known as the year that Dodd-Frank arrived.

Next month, private equity investors and hedge fund managers will face the deadline for registration with the Securities and Exchange Commission under the Investment Advisors Act of 1940, and many private equity firms are now getting prepared.

"It runs the entire gamut," said Kerry Burke, a partner in the corporate and securities practices at law firm Covington & Burling LLP. "Some clients who...were ready to go decided they would register early and so are registered now and working the kinks out. On the other side of the spectrum, we have a few clients who are just getting started thinking about it again."

SEC registration comes with a small handful of other regulatory changes general partners must manage in the new year. The commission also finalized rules last October that require additional monitoring at the fund and portfolio-company level that will start sometime this year, depending on firm size. And the Volcker Rule, which will prohibit big banks from owning or sponsoring hedge and private equity funds, was officially proposed in October and will likely get finalized in the next few months.

The Valentine's Day filing deadline for registration is the culmination of a roughly 19-month process set in motion with passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act in July 2010. In November that year, the SEC proposed a set of rules to implement a new requirement that private equity firms come under the

purview of the Advisors Act. For half a year, the commission entertained comments and criticism on the proposed rules, including what types of firms would be exempt and which would not. Last June, the SEC finalized the rules, which let many venture capital firms and the smallest of fund managers off the hook and set a final compliance deadline for this March 30.

"If firms aren't at the stage where they're registered or close, then they don't have much time," said George Ammar, the chief financial officer at Cleveland-based small buyout firm Resilience Capital Partners, which was in the midst of the process as of mid-December. All told, the SEC said it expects to have 750 new registrants by the deadline, and from the commission's perspective, there haven't been any significant roadblocks or issues with the deadline. "We have not been inundated with calls yet," an SEC spokeswoman said in December.

But for firms, it isn't an insignificant burden. It will be an ongoing administrative task and will require firms to have a formally designated compliance officer, a compliance manual and monitoring programs to guard against insider trading, among other things. In many cases, including Ammar's, current executives are being asked to wear the compliance officer hat in addition to their regular duties.

Firms still haven't had some important concerns assuaged, according to Kevin Ford, the head of strategic solution advisory at Regulatory DataCorp., which provides intelligence and other compliance services to banks, investment firms and corporations seeking to insulate themselves from regulatory risk. For example, since fund marketing must now be more transparent, firms must provide historical documents and show how they calculated their internal rates of return. The problem, Ford said, is that valuations can be complex. If some numbers in a firm's marketing materials contradict numbers in its SEC filings for non-fraudulent reasons, will the firm be punished for that?

"People are really taking a hard look at their offering documents to make sure they are within the advertising rules," said Burke, of Covington & Burling.

Additionally, firms worry about confidentiality. The SEC is allowed to share information with certain agencies. "[But] the experience that everyone has had before is Congress will sometimes interpret those laws to mean that Congress can have access to them," Ford said. "Next thing you know they will go into the public record and then your investment strategies are in the public record."

"From our standpoint the biggest issue is that a number of us have to register and that's something that we're not

accustomed to," said Resilience Capital's Ammar. "It's just difficult any time you're going through and having to register with the SEC."

Firms exempt from registration will end up saving time and money, despite still being required to report to the commission by filing and periodically updating the first part of Form ADV.

Some – including the National Venture Capital Association, as well as two out of five SEC commissioners – have criticized this "exempt reporting" standard, which doesn't preclude further encroachment by the SEC if the commission deems it necessary.

Others aren't as worried. "I don't think it's much," said Harry D'Andrea, the administrative general partner at venture firm Valhalla Partners, which will be claiming the venture capital exemption and filing as an exempt reporting firm. "I know sometimes people have a visceral reaction to increased regulation. As long as it's not onerous we're happy to provide whatever information folks think we should be providing."

After the Advisors Act deadline passes, buyout shops will have a new regulatory project to look forward to: the new Form PF, which private equity firms will be required to file once a year, within 120 days of the end of the fiscal year. While smaller firms will be required to provide information at the fund level, firms with at least \$2 billion in assets

under management will be required to answer questions at the portfolio-company level about leverage, bridge financing and financial-industry investments. Firms with over \$5 billion in assets must file Form PF following the first fiscal year ending after June 15, 2012. Firms with under \$5 billion must begin filing following the first fiscal year ending after December 15 of this year.

While the new 42-page form isn't a particularly large burden, GPs say that they have the same concerns: confidentiality and exposure to risk due to the imperfect science of valuing portfolio companies. Firms are seeking guidance on that from the SEC, Ford said. "I suspect no one knows the right answer yet," he said.

Finally, the Volcker Rule, which would prohibit banks from engaging in proprietary trading and from owning or sponsoring private equity funds, will face its own set of problems once it is finalized in the next few months. One important question that will likely be coming out of the Justice Department will be whether break-ups are actually "arm's length," or whether banks have simply created third-party entities to do proprietary trading, said Ford. Currently the rule is expected to become effective by July 21; the commenting period for the rule ends this month.

For now, Feb. 14 looms.

"I think everyone will be ready to go when they need to be," said Burke. ■