

Private Equity: Regulatory Arbitrage?

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Roughly two years removed from the apex of the financial crisis, the dust has settled, and the industry is grappling with the realities of regulatory reform. While controls designed to reduce systemic risks posed by hedge funds and proprietary trading desks have dominated the headlines, some interesting and far-reaching reforms are impacting the private equity space. However, the precise nature of the reforms differs substantially by domicile, meaning that private equity managers should weigh carefully the impact of regulatory changes across the globe. Key decisions, such as where to pursue clients and where to establish an operational base, are likely to be impacted.

North America

In the U.S., the Dodd-Frank Wall Street Reform and Consumer Protection Act has significant implications for both private equity funds and their investment advisers. Dodd-Frank amended the Investment Advisers Act of 1940 (the "Advisers Act") and redefined exemptions from SEC registration. Going forward, U.S.-based investment advisers, who provide advice solely to private funds, including private equity funds, with \$150 million or more in assets under management will be required to register as investment advisers with the U.S. Securities and Exchange Commission (SEC). This registration will require investment advisers to appoint a Chief Compliance Officer and adopt and implement compliance programs to address applicable compliance requirements under the Advisers Act. The effectiveness of the adviser's compliance program must annually be reviewed and reported upon by the adviser's Chief Compliance Officer.

Dodd-Frank also amended the Advisers Act to permit the SEC to require registered investment advisers to maintain records related to private funds and make periodic reports to the SEC. Dodd-Frank mandated certain records to be maintained for each private fund advised by the adviser, including assets under management, the

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 (a.k.a. "side letters"), trading practices and other information deemed necessary by the SEC. The SEC proposed rules on January 25, 2011, to implement these reporting requirements. The proposed rules, if adopted as proposed, would distinguish between large and small advisers. Large private fund advisers, defined as AUM in excess of \$1 billion, would report quarterly to the SEC. Smaller private fund advisers would report on an annual basis to the SEC. It is expected that these rules will be adopted in final form prior to the one-year anniversary of Dodd-Frank's enactment, July 21, 2011.

Perhaps more significantly, on December 30, 2009, largely in response to the Madoff Ponzi scheme, the SEC adopted amendments to Advisers Act Rule 206(4)-2 to modify custody requirements applicable to registered investment advisers who are deemed to have custody of client assets (e.g., cash or securities), including those belonging to pooled investment vehicles (such as private equity and hedge funds). Under amended Rule 206(4)-2, advisers to private funds must generally maintain all client assets with a "qualified custodian." Qualified custodians

are defined as banks, registered broker-dealers and registered futures commission merchants. An investment adviser to a private fund may be exempt from the requirement to maintain securities that are uncertificated, obtained in a private offering and have restrictions on resale if the private fund holding the uncertificated ownership interest undergoes an annual audit, performed in accordance with GAAP, and distributes its audited financial statements to its investors within 120 days of its fiscal year end. This custodial exemption would not be available to the cash portion of the private fund's assets. Given this limited exemption, and the ease and simplicity of relying upon a qualified custodian, most registered investment advisers will look to leverage qualified custodians to satisfy this requirement. In a post-Madoff world, it is also likely that investors will take great comfort from the use of independent custodians by their private funds' advisers.

Europe

Across the pond, the Alternative Investment Fund Manager (AIFM) directive has also laid out new requirements for private equity and hedge fund managers operating in the European Union. Although the directive itself has been approved this January, full implementation will not take place until 2013 at the earliest, as additional details must be ironed out, and member states must codify the directive into law. Firms with aggregate assets of less than €100 million leveraged or €500 million unleveraged will escape the full registration and reporting regime.

For private equity managers, a key provision of the AIFMD is the requirement for each fund managed by an alternative manager to have a single depositary appointed to it. The depositary will be responsible for the safekeeping of financial instruments and face strict liability requirements for physical loss (not decline in asset value). In order to avoid conflicts of interest, the manager cannot act as depositary of its own funds. The AIFMD also requires an independent valuation of AIFs. The manager or the depositary may fulfill this role, but only if each has functionally and hierarchically separated their roles, and they have disclosed their dual roles to the investors in the fund.

The scope and depth of the burdens on the depository are worth detailing further. Depositories must ensure that the sale, issue and redemption of AIF units comply with the AIF's national law and its constitution. They must also ensure that valuation, transactions and income are calculated and applied in accordance with local (i.e., national) law. Moreover, depositories face a "reverse burden of proof," meaning that they are liable for the loss of assets held in custody unless they can prove that "the loss had arisen as a result of an external event beyond its reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary." Under any circumstances, the depository remains liable for losses suffered by the fund or the investors as a result of the depository's negligence or intentional failure to properly perform its obligations. Some observers fear that given these new regulations, many firms will exit the business, rather than expose themselves to the significant downside risks of serving as depositories. This could potentially lead to market share being concentrated in the hands of a few players, arguably increasing the very systemic risk that AIFMD sought to reduce.

Asia

In Asia, while there are no significant regulatory changes with regard to custody at a regional level, that does not mean that all individual markets will see business as usual. In some cases, regulators will react not just to developments in their home markets, but developments across the globe. For instance, the Monetary Authority of Singapore (MAS) notes in its policy consultation review that "as the fund management industry continues to grow and evolve, it is important that the regulatory regime keeps pace with industry and regulatory developments internationally."

With these thoughts in mind, the MAS outlined changes in April of 2010 to "business conduct requirements" mandated for investment managers operating in Singapore. Previously, only Capital Markets Services (CMS) licensed managers were required to meet these guidelines, but now all managers must place their customers' monies and assets with a custodian licensed and authorized in the jurisdiction where the assets are being held. Moreover, fund management companies (FMCs) must

either outsource fund administration to an independent service provider, or ensure that all conflicts of interest are adequately mitigated if fund administration is conducted by the FMC or its related entity. If the FMC itself is conducting fund administration, proper segregation between front- and back-office duties is required.

Global Considerations: Consistency vs. Minimum Requirements

Taken together, what do these regulatory developments mean for private equity managers across the globe? A number of interesting scenarios arise. First, the varying responses by jurisdiction create the potential for regional regulatory arbitrage. Managers nimble enough to do so may choose to relocate their business to another, less restrictive, domicile. However, this approach is unlikely, since so doing might entail setting up new operations, redeploying new talent or hiring locally, and potentially giving up certain clients. More common perhaps will be the dilemma facing private equity managers with an existing global footprint. Meeting the minimum requirements on a region-by-region (or country-by-country) basis will seemingly ensure compliance with local regulations while minimizing business disruption. On the other hand, some global managers have wondered if a level playing field makes more sense for their business model; that is, will uneven regulatory requirements create pitfalls for business and compliance considerations? Furthermore, does abiding by more lenient business standards in one domicile favor those clients over those living in a stricter domicile? And would the increased regulatory burden potentially result in uneven cost structures? These concerns are leading some managers to adopt best practices globally, to ensure equal treatment of clients, and to harmonize compliance activities across the firm.

Second, the varying implementation guidelines by region also create a temporal arbitrage. Thus, even as the world becomes increasingly global, Dodd Frank's private equity adviser registration requirements require compliance no later than July 21, 2011. Arguably, U.S.-based managers will be at a two-year disadvantage in their home market relative to their European peers operating on the Continent, where Level 2 country-level adoption of AIFMD is not expected to take effect until 2013. Dodd-

Frank has carved out a narrow Foreign Private Adviser Exemption, but only for those firms with no place of business in the U.S., fewer than 15 total clients and investors in the U.S., less than \$25 million (subject to SEC revision) attributable to U.S. clients and provided that the firm does not hold itself out generally to the U.S. public as an investment adviser or investment company as defined by the Advisers Act. Meanwhile, non-EU managers seeking to distribute within Europe will need to ensure that their home jurisdiction has a cooperation agreement in place with the European countries where the funds are marketed. While offshore centers such as Jersey, Guernsey and Cayman have expressed their eagerness to do whatever is necessary, it is expected that non-EU fund managers of alternative investments will only be able to apply for an EU-wide passport from January 2015 onward.

Where do these changes leave private equity firms? Clearly the business will get more expensive and more complex, especially in the short term. Private equity managers should seek legal counsel, as well as the advice of custodians, fund administrators and other professional advisors to best understand how to become compliant, and ultimately maintain compliance, with the emerging regulatory landscape. It's worth remembering that it's not just regulators seeking increased transparency and oversight, but investors as well – which means that in the long run, these changes could be a good thing for the industry.

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