RULES AND REGULATIONS

PAUL BERKOWITZ AND **REBECCA G. DISTEFANO**, OF **GREENBERG TRAURIG**, PROVIDE AN UPDATE ON RECENT US REGULATION RELEVANT TO THE HEDGE FUND INDUSTRY

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Recent financial regulations required under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) and the Jumpstart Our Business Startups Act of 2012 (JOBS Act) directly impact the private fund industry, although it remains to be seen how the newly enacted rules under these statutes will affect and/or change private fund industry practices.

THE VOLCKER RULE PROMULGATED UNDER THE DODD-FRANK ACT

On 10 December 2013, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission issued final rules regulating bank involvement with private funds to become effective 1 April 2014. The Federal Reserve Board has, however, extended the conformance period of what is commonly referred to as the Volcker Rule until 21 July 2015.

The Volcker Rule, which was implemented by Title VI of the Dodd-Frank Act in reaction to the financial crisis, which commenced in 2008, seeks to split banks and securities firms and generally prohibits "banking entities" including insured depositary institutions, bank holding companies and their affiliates from engaging in proprietary trading of securities, or acquiring or retaining any ownership interest in, sponsoring, or having certain relationships with "covered funds," including without limitation hedge funds and private equity funds – in each case subject to certain exemptions and exclusions.

Although the Volcker Rule prohibits banking entities from "sponsoring" a hedge fund or private equity fund, it would not prohibit banking organisations from providing advice to such funds. Sponsorship of a covered fund could include serving as a general partner, managing member or

> "THE VOLCKER RULE... SEEKS TO SPLIT BANKS AND SECURITIES FIRMS"

commodity pool operator of the fund. In response, banking institutions such as Citigroup Inc. announced in the months immediately preceding the adoption of the final rules the divestiture of billions of dollars in private equity and hedge fund assets to comply with new regulations that limit such investments. In addition, as of January 2014, at least one major US bank announced the creation of a Volcker Rule implementation team to prepare for the phase-in of the rule.

WHAT IS A COVERED HEDGE FUND OR PRIVATE EQUITY FUND UNDER THE VOLCKER RULE?

The Volcker Rule defines a "hedge fund" and a "private equity fund" to include any issuer that is exempt from SEC registration under the Investment Company Act of 1940 (the 1940 Act) based on Section 3(c)(1) (100 or fewer beneficial owners) or Section 3(c)(7) (qualified purchasers). It also would include any "similar fund" as determined by relevant regulators. The Volcker Rule definition of a covered fund also includes certain commodity pools and foreign funds. An SEC registered investment company and a business development company are both excluded from the definition of covered fund, among other exclusions.

> "THE FINAL RULE PERMITS FOREIGN BANKING ENTITIES SUBJECT TO THE VOLCKER RULE TO SPONSOR AND INVEST IN COVERED FUNDS OUTSIDE THE US, SUBJECT TO CERTAIN REQUIREMENTS"

OFFSHORE EXEMPTION FOR COVERED FUND ACTIVITIES.

The final rule permits foreign banking entities subject to the Volcker Rule to sponsor and invest in covered funds outside the US, subject to certain requirements. One limitation of the complex offshore exemption is that the ownership interest in a covered fund must be sold pursuant to an offering that refrains from targeting residents of the US as the term US person is defined in SEC Regulation S.

ASSET MANAGEMENT EXEMPTION FOR ORGANISING AND OFFERING A COVERED FUND

Among the more significant exemptions is the asset management exemption that allows banking entities to organise and offer a covered fund in connection with bona fide trust, fiduciary, or investment advisory services to customers. Investments in such funds are subject to de minimis limits; a banking entity may own less than 3% of the total amount or value of each covered fund's outstanding ownership interests and, in an aggregate amount in all such covered funds, less than 3% of the banking entity's Tier 1 capital. At least one major US bank indicated in its January fourth quarter earnings call that it expected to steer clients toward so-called "3 percent funds."

GENERAL SOLICITATION UNDER RULE 506(C) PROMULGATED UNDER THE JOBS ACT

On 10 July 2013, the SEC adopted important amendments to the Regulation D safe harbour from the registration requirements of the Securities Act of 1933. The amendments, effective from 23 September 2013, eliminated the long standing prohibition on general solicitation and general advertising for certain offerings under Regulation D Rule 506, implementing changes were mandated by Section 201(a) of the JOBS Act.

USE OF RULE 506(C) BY HEDGE FUNDS AND OTHER PRIVATE FUNDS

Private equity funds, venture capital funds and hedge funds generally rely on statutory exclusions from the definition of "investment company" that are set out in Sections 3(c)(1) and 3(c)(7) of the Investment Company Act (ICA) to avoid being regulated as an investment company under the ICA. However, these statutory exclusions are not available to a fund if it makes a public offering of securities.

In its adopting release, the SEC confirmed that, under Section 201(b) of the JOBS Act, a private fund engaging in general solicitation in a Rule 506(c) offering does not lose the benefit of these statutory exclusions under the ICA.

ARE HEDGE FUNDS CURRENTLY ENGAGED IN GENERAL SOLICITATION?

Since the implementation of Rule 506(c) there's been debate about whether hedge funds would rush to take advantage of the ability to broadly solicit investors through print advertisements, broadcast and online media. A recent amendment to Form D under the amendments require fund managers to disclose whether they intend to utilise general solicitation. The US media has widely reported that following reviews of Form D filings with the SEC most private fund operators have indicated they have no intention of taking advantage of the rule change to engage in advertising. SEC officials have announced as recently as November 2013 that while approximately 300 Form Ds had been filed between 23 September and 15 November in reliance on general solicitation, the vast majority of the offerings are still conducted under the old regime relying on pre-existing relationships of the issuer of securities or the licensed broker involved in the offering. Although still unclear, and while the reluctance to take advantage of the 506(c) rule may be related to the issues surrounding the need to "verify" the accredited investors' status of purchasers, securities practitioners believe the perceived legal uncertainty, including what activities in the age of social media in fact constitute general solicitation, may be preventing many fund managers from acting at this time. ■

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