SIMPSON THACHER MEMORANDUM

The Impact on Private Equity and Hedge Funds of the Financial Regulatory Reform Bills: A Legislative Update

May 25, 2010

On May 20, 2010, the U.S. Senate passed a comprehensive set of financial regulatory reforms that, if enacted, will represent the most sweeping set of changes to the U.S. financial regulatory system since the Great Depression. The reforms, which are set forth in a bill of more than 1,500 pages called the Restoring American Financial Stability Act of 2010 (S. 3217, or the "Senate Bill") and which come after nearly a year of Congressional hearings and months of stop-and-start legislative negotiations, contain a number of provisions relevant to private funds and their advisers.

In its treatment of private funds, the Senate Bill tracks many of the themes contained in the Wall Street Reform and Consumer Protection Act (H.R. 4173, or the "House Bill") that was passed by the U.S. House of Representatives on December 11, 2009. However, there are significant differences concerning, among other things, the registration of private fund advisers and restrictions on the relationship and activities of banking organizations with private equity and hedge funds. The bills also mandate specific executive compensation and corporate governance practices at U.S. public companies generally and, accordingly, would affect a subset of the portfolio companies of private equity, venture capital and other private funds.

This memorandum reviews the principal provisions of the Senate and House Bills applicable to private funds. Congress will now attempt to reconcile the differences in the Senate and House Bills, on this and other matters, through a formal conference committee process that is expected to culminate in legislation being approved by Congress and submitted to the President for his signature by early July.

A. PRIVATE FUND ADVISER REGISTRATION AND REPORTING REQUIREMENTS

1. *Registration of Investment Advisers to Private Funds*

Under current regulations, many private fund advisers are exempted from registration with the Securities and Exchange Commission (the "SEC"), regardless of the amount of assets under management, in reliance on the "private investment adviser" exemption in the Investment Advisers Act of 1940, as amended (the "Advisers Act").[1] In June 2009, the Obama Administration unveiled a proposal that would require all advisers to private funds—including

1 Section 203(b)(3) of the Advisers Act provides an exemption for a private investment adviser that has had fewer than fifteen clients during the preceding twelve months, (ii) does not hold itself out generally to the public as an investment adviser and (iii) does not act as an investment adviser to any registered investment company or business development company.

private equity funds, hedge funds and venture capital funds—whose assets under management exceed a "modest threshold," to register with the SEC under the Advisers Act.[2] Nearly a year later, Congress has passed two bills that, while not replicating the Obama Administration's original proposal in all respects, represent significant changes to the private investment adviser exemption.

The Senate and House Bills both eliminate the private investment adviser exemption contained in Section 203(b)(3) of the Advisers Act and define a "private fund" as an issuer that would be an "investment company" under Section 3(a) of the Investment Company Act of 1940, as amended (the "1940 Act") but for the exemptions provided in Sections 3(c)(1) or 3(c)(7) of the 1940 Act.[3] However, the bills differ in their treatment of private equity funds.

Most analyses of the financial crisis that began in 2007 do not cite private equity funds as a contributing factor. Hedge funds, while not identified as a principal cause of this crisis, nevertheless raised concerns because, as the Obama Administration's Financial Regulatory Reform proposal put it, "de-leveraging by hedge funds contributed to the strain on financial markets," in part because the government lacked reliable, comprehensive data with which to assess their activities. More broadly, hedge funds are viewed as a part of the "shadow banking system," which refers to financial institutions that are beyond the scope of federal regulations. The federal regulators not only lack the ability to regulate such institutions, even those that are large and highly leveraged, but they lack the authority to require such institutions to provide information regarding their activities. The primary purpose of requiring registration of advisers to private funds appears to be to enable the regulators to obtain information regarding the activities of such funds. In the case of large and leveraged funds, the proposed legislation may also result in regulation as a "supervised nonbank financial company," as discussed below.

Under the House Bill, private equity and hedge fund advisers would be required to register with the SEC if their advisee funds have over $150 million in assets under management. Advisers to "venture capital funds" would be exempt from SEC registration. The House Bill does not exempt private equity funds, but it does require the SEC to assess the "relative risk profile of different classes of private funds as it establishes, by rule or regulation, the registration requirements for private funds."

The Senate Bill would require all advisers to hedge funds to register with the SEC to the extent that their advisee funds have over $100 million in assets under management, a slightly lower threshold for SEC registration as compared to the House Bill. The Senate Bill is more favorable to the private equity community because advisers solely to "private equity funds" would have an express exemption from SEC registration, as would advisers to venture capital funds. However, advisers to private equity funds (a term that the SEC would define) would be

---

2 *See* "Treasury Department Outlines Reforms to U.S. Financial Supervision and Regulation," dated June 23, 2009, *available at* http://www.stblaw.com/content/publications/pub838.pdf (summarizing features of the Obama Administration's initial comprehensive proposal for financial regulatory reform).

3 Section 3(c)(1) of the 1940 Act generally exempts an issuer that has 100 or fewer holders of its securities (other than short-term paper) and that does not engage or propose to engage in a public offering of securities. Section 3(c)(7) of the 1940 Act generally exempts an issuer all the security holders of which are "qualified purchasers" and that does not engage or propose to engage in a public offering of securities.

required to maintain such records and provide the SEC with such reports as the SEC determines are "necessary and appropriate in the public interest."

The Senate Bill's exemption of private equity fund advisers from registration retains the approach contained in the legislation as reported by the U.S. Senate Committee on Banking, Housing, and Urban Affairs (the "Senate Banking Committee"). The Senate rejected a proposed amendment by Senator Jack Reed (SA 3958), which would have, among other things, removed the exemption from registration for advisers to private equity and venture capital funds altogether, more closely aligning the legislation to what the Obama Administration proposed last year.

It is unclear whether the final law will follow the approach of the Senate Bill or that of the House Bill. Even if the Senate's approach is adopted, the SEC might use its authority to define "private equity fund" and to require the maintenance of records and the filing of reports from such funds in a way that results in a similar outcome to what would result from adoption of the registration requirement in the House Bill.

Both the House Bill and the Senate Bill also create a new limited exemption for "foreign private advisers." This foreign private adviser exemption would be available to any adviser that (i) has no place of business in the U.S., (ii) has fewer than 15 clients who are domiciled in or residents of the U.S., (iii) has assets under management attributable to clients in the U.S. and investors in the U.S. in private funds advised by the investment adviser of less than $25 million (such amount may be increased by the SEC), and (iv) neither holds itself out generally to the public in the U.S. as an investment adviser nor acts as an investment adviser to any registered investment company or business development company. Because the exemption is so narrowly crafted, it would significantly expand the extra-territorial application of the Advisers Act, which may, in turn, result in restricted access by U.S. investors to funds managed by non-U.S. advisers.

2. *Reporting and Recordkeeping Requirements*

Advisers of private funds that are required to register with the SEC would be subject, under both the Senate and House Bills, to reporting and recordkeeping requirements that are substantially similar. The Senate and House Bills authorize the SEC to require registered investment advisers to maintain records (for such periods as the SEC prescribes) and file such reports with the SEC as deemed necessary or appropriate in the public interest or for purposes of "systemic risk" assessments made by other governmental bodies, such as the Board of Governors of the Federal Reserve System (the "Federal Reserve") or the Financial Stability Oversight Council, an interagency body that would be created by the legislation to monitor and address systemic risk. All such records would also be subject to periodic and special examination by the SEC.

The records required to be maintained (and made available for SEC inspection and, possibly, subject to SEC filing requirements to be prescribed) by each private fund advised by an investment adviser would include information on the following:

- amount of assets under management;
- use of leverage;
- counterparty credit risk exposure;

- trading and investment positions;
- trading practices;
- valuation policies and practices of the fund (Senate Bill only);
- types of assets held (Senate Bill only);
- side arrangements or side letters whereby certain investors in a fund obtain more favorable rights or entitlements than other investors (Senate Bill only); and
- other information that the SEC, in consultation with the Federal Reserve (House Bill) or the Financial Stability Oversight Council (Senate Bill), determines is necessary or appropriate in the public interest and for the protection of investors or for the assessment of systemic risk.

To the extent that any "proprietary information" of a private fund is contained in reports required to be filed with the SEC, both bills provide for protections from public disclosure under the Freedom of Information Act. The term "proprietary information" is defined to include sensitive, non-public information regarding the investment or trading strategies of the investment adviser; analytical or research methodologies; trading data; computer hardware or software containing intellectual property; and any additional information that the SEC determines to be proprietary.

3. *Supervised Nonbank Financial Companies*

A key feature of the Senate Bill is its proposal to extend prudential regulation by the Federal Reserve to financial institutions that are not currently subject to such regulation but that potentially pose risk to the financial system. The Senate Bill defines a "nonbank financial company" as a company that is substantially engaged in activities that are financial in nature and provides the Federal Reserve with the authority to determine which of such companies are "significant." The Financial Stability Oversight Council would have the authority to subject such a company to regulation by the Federal Reserve (including capital, leverage and liquidity regulation) if the Financial Stability Oversight Council determines that material financial distress at the company would pose a threat to the financial stability of the United States. The Senate Bill does not contain any minimum size requirements for such a designation and it is possible that it could be applied to large private funds, particularly large, highly leveraged hedge funds. In the case of a foreign nonbank financial company, such regulation would be limited to its U.S. activities.

B. THE VOLCKER RULE: RESTRICTING PROPRIETARY TRADING AND INVESTING IN AND SPONSORING OF PRIVATE FUNDS

1. *Origins of the Volcker Rule*

The Financial Regulatory Reform report issued by the Obama Administration in June 2009 did not contain what has come to be known as the "Volcker Rule," a series of proposals that is primarily focused on prohibiting banking organizations from engaging in proprietary trading and from investing in or sponsoring private funds. In fact, of the many governmental, quasi-governmental and private studies that were issued on the causes of and cures for the financial crisis, the Group of Thirty, a group of former senior regulators that is chaired by Paul Volcker, the former chairman of the Federal Reserve who now heads the President's Economic Recovery Advisory Board, was virtually alone in recommending that large banking organizations be prohibited from engaging in proprietary trading activities. The Group of Thirty report stated:

> Recent experience in the United States and elsewhere has demonstrated instances in which unanticipated and unsustainably large losses in proprietary trading, heavy exposure to structured credit products and credit default swaps, and sponsorship of hedge funds have placed at risk the viability of the entire enterprise and its ability to meet its responsibilities to its clients, counterparties, and investors. . . . These activities, and the "originate-to-distribute" model . . . all step away from the general concept of relationship banking, resting on individual customer service, toward a more impersonal capital markets transaction-oriented financial system. What is at issue is the extent to which these approaches can sensibly be combined in a single institution, and particularly in those highly protected banking institutions at the core of the financial system.

The report did not specifically identify such "instances." There appear to be no instances in which private equity investments or sponsorship of private equity funds by a significant banking organization contributed to its financial distress. The "originate-to-distribute" model and exposure to structured credit products was responsible for the failure or severe financial distress of several significant banking organizations; however, those problems had nothing to do with investment in private equity or the sponsorship of private equity funds. Moreover, proprietary trading of other types of financial instruments, far from causing the demise of significant banking organizations, has been a critical source of profits for a number of banking organizations during an otherwise dismal financial environment.

In any case, the Group of Thirty report stated that such activities inherently raise conflicts of interests with clients and, in times of financial stress, client interests tend to be subordinated to the interests of the firm. The report also raised concerns about the risks those activities pose to financial stability when conducted in large, systemically important banking institutions and about the "unfair" competitive advantage such firms enjoy due to a market perception that they are "too big to fail." The report concluded:

> Large, systemically important banking institutions should be restricted in undertaking proprietary activities that present particularly high risks and serious conflicts of interest. Sponsorship and management of commingled private pools of capital (that is, hedge and private equity funds in which the banking institutions own capital is commingled with client funds) should ordinarily be prohibited and large proprietary trading should be limited by strict capital and liquidity requirements. Participation in packaging and sale of collective debt instruments should require the retention of a meaningful part of the credit risk.[4]

[4] Group of Thirty, "A Framework for Financial Stability," at 27-28 (Jan. 15, 2009).

The House Bill, which, as noted above, was passed on December 11, 2009, did not contain a provision equivalent to the Volcker Rule, although it did provide the Federal Reserve with the authority to prohibit proprietary trading by a financial holding company if the Federal Reserve determined that merely imposing more restrictive prudential regulation on such activity would be insufficient to eliminate an existing or foreseeable threat to the safety and soundness of such company or to the financial stability of the United States.

On January 10, 2010, the Obama Administration proposed including a version of the Volcker Rule in the pending financial reform legislation. Although the proposal initially met with skepticism in Congress, it was included in the bill reported by the Senate Banking Committee. The provision gathered momentum as hearings held by Senator Carl Levin brought wide media attention to allegations of financial institutions sacrificing their clients' interests in favor of their own.

2. *The Ban on Proprietary Trading*

The Senate Bill provides that, "subject to the recommendations and modifications" of the Financial Stability Oversight Council, the federal banking agencies shall by rule prohibit proprietary trading by an insured depository institution and by any company that controls or is under common control with an insured depository institution (collectively, "banking organizations"). Proprietary trading is broadly defined to include purchasing and selling of any kind of financial instrument, with exemptions for trading in government securities, market making activities, and facilitating customer relationships (including "risk-mitigating" hedging activities). The legislation also would accommodate investments by insurance companies that are regulated under state insurance law.

The Financial Stability Oversight Council is required to study and issue recommendations regarding these provisions (both those relating to proprietary trading and those discussed below relating to relationships with private funds) within six months of enactment. The Senate Bill incorporates a variety of matters that the Financial Stability Oversight Council is to consider (including conflicts of interest, financial stability, and the cost and availability of financial services) in issuing such recommendations. The considerations to be taken into account are probably less significant than the fact that the Financial Stability Oversight Council is given the authority to modify these prohibitions, which otherwise would go beyond what the Group of Thirty report contemplated inasmuch as they would constitute an outright ban rather than a restriction only of those activities that "present particularly high risks and serious conflicts of interest."

Within nine months of completion of the Financial Stability Oversight Council's study the federal banking regulators are to issue rules implementing these provisions, and such rules are to become effective two years later, with the federal banking regulators retaining discretion to grant extensions of the compliance period to individual companies for up to three additional years. Thus, the total compliance period for a particular company could be more than six years from the date of enactment.

Although nonbank companies are not subject to the ban on proprietary trading, the Senate Bill instructs the Federal Reserve to impose additional capital requirements and to specify quantitative limits on "supervised nonbank financial companies" (discussed above) that engage in proprietary trading or sponsoring and investing in hedge funds and private equity funds.

3. *Sponsoring, Investing in and Engaging in Transactions with Private Funds*

Subject to the modifications and recommendations of the Financial Stability Oversight Council, the Senate Bill would generally prohibit banking organizations from sponsoring or investing in private equity and hedge funds. Furthermore, while banking organizations would not be prohibited from advising or managing private equity or hedge funds, they would be severely limited in the types of transactions that they could engage in while acting as their investment advisers or managers.

During consideration of the Senate Bill, Senators Carl Levin and Jeff Merkley proposed an amendment that would have modified the Volcker Rule provisions in the Senate Bill. While the amendment was withdrawn prior to the Senate vote, all or part of this amendment (SA 4115, or the "Levin Amendment") may find its way into the legislation that emerges from the conference committee. Accordingly, this summary also examines certain provisions of the Levin Amendment that may be important going forward.

Both the Senate Bill and the Levin Amendment define "private equity fund" and "hedge fund" as any fund that is exempt from registration as an investment company under Section 3(c)(1) or 3(c)(7) of the 1940 Act, or a "similar" fund, as jointly determined by the federal banking agencies and, in the case of the Levin Amendment, also the SEC and the Commodity Futures Trading Commission (the "CFTC").

4. *Prohibition on Investing in or Sponsoring Private Funds*

Under the Senate Bill and the Levin Amendment, banking organizations would be prohibited outright from investing in private equity and hedge funds.[5] Unlike the Senate Bill, which is silent on what "investing" means, the Levin Amendment provides that a banking organization may not "acquire or retain any equity, partnership, or other ownership interest" in a private equity or hedge fund.

Both the Senate Bill and the Levin Amendment also prohibit "sponsoring" private equity and hedge funds, which means:

- serving as a general partner, managing member or trustee of the fund;
- selecting or controlling (or having employees, officers, directors or agents who constitute) a majority of the directors, trustees or management of the fund; or
- sharing with the fund the same name (or a variation thereof) for corporate, marketing, promotional or other purposes.

---

5 An exception would exist for investments in "small business investment companies" and for "public welfare" investments by national banks in community and economic development companies and related projects. Also, investment activities conducted solely outside of the United States by a foreign banking organization or other company pursuant to Sections 4(c)(9) or 4(c)(13) of the BHC Act and not controlled, directly or indirectly, by a U.S. company would be exempt. These exemptions would also apply to non-U.S. fund sponsorship activities by such foreign entities.

The prohibitions applicable to banking organizations would not extend to those "nonbank financial companies" supervised by the Federal Reserve by virtue of their having been determined to be systemically important. However, as noted above, the Senate Bill instructs the Federal Reserve to impose additional capital requirements and to specify quantitative limits on "supervised nonbank financial companies" that engage in proprietary trading or sponsoring and investing in hedge funds and private equity funds.

5. Restrictions on Transactions with Advised Private Funds

In addition to prohibitions on investment and sponsorship activities, the Senate Bill also imposes new limitations on other transactions by banking organizations with private equity and hedge funds. Banking organizations could still serve as investment advisers or managers of private equity or hedge funds (on a non-sponsorship basis), but the Senate Bill would greatly limit the range of transactions that could be permissibly entered into with funds while acting, either "directly or indirectly," in such capacities.

Section 23A of the Federal Reserve Act imposes quantitative limits and, in some cases collateral requirements, on "covered transactions" between an insured depository institution and its "affiliates." The term "affiliate" includes companies that control or are under common control with the depository institution (except for the depository institution's subsidiaries). The term "affiliate" also includes funds that are sponsored and advised by the depository institution or its affiliates; funds for which the depository institution or its affiliates acts as a registered investment adviser; and funds for which the depository institution or its affiliates acts as an unregistered investment adviser if the depository institution or its affiliates own more than 5% of the equity of the fund. The term "covered transaction" includes loans and extensions of credit to the affiliate; purchases of investment securities from the affiliate; purchases of assets, including assets subject to an agreement to repurchase; acceptances of securities issued by an affiliate as collateral for a loan to a third party; and issuances of guarantees, acceptances or letters of credit, including endorsements or standby letters of credit, on behalf of the affiliate. Section 23A is intended to protect an insured depository institution from being pressured by its parent company to enter into disadvantageous transactions and to ensure that credit from depository institutions is primarily available to unaffiliated parties.

The Senate Bill prohibits an insured depository institution and any company that controls or is under common control with the depository institution from engaging in any "covered transaction" with a private equity or hedge fund for which such insured depository institution, or any company that controls or is under common control with the depository institution, acts as an investment adviser or investment manager. Although the provision is ambiguous, it appears that for this purpose such a fund is treated as an affiliate.

Section 23B of the Federal Reserve Act complements Section 23A by imposing a qualitative standard on covered transactions between an insured depository institution and its affiliates (as well as upon any transaction in which an affiliate of the insured depository institution is receiving a fee). Section 23B essentially provides that all such transactions must be on arm's length or better terms from the perspective of the insured depository institution. The Senate Bill provides that Section 23B shall apply to any transactions between an insured depository institution and any company that controls or is under common control with the depository institution, on the one hand, and, on the other hand, a private equity or hedge fund for which such insured depository institution, or any company that controls or is under common control with the depository institution, acts as an investment adviser or investment manager.

6. *Certain Features of the Levin Amendment*

There are several provisions of the Levin Amendment that are quite different from the Volcker Rule provisions that are included in the Senate Bill. First, the Levin Amendment contains an "anti-evasion" provision that would authorize federal banking regulators, the SEC or the CFTC, as appropriate, to order certain activities be terminated or investments disposed of if there was reasonable cause to believe that a banking entity (as well as a nonbank financial company supervised by the Federal Reserve) had engaged in such activities or made such investments "in a manner that functions as an evasion" of the Volcker Rule's restrictions, including "through an abuse of any permitted activity." Also, the Levin Amendment would authorize federal banking regulators, the SEC and the CFTC to issue regulations regarding internal controls and recordkeeping requirements on Volcker Rule compliance.

The Levin Amendment, like the Senate Bill, provides the Financial Stability Oversight Council six months to complete its study and provides the federal banking regulators with nine months to issue regulations. However, it provides that the restrictions applicable to banking entities covered by the Volcker Rule would become effective on the earlier of (i) one year after final regulations are issued and (ii) two years after the date of enactment.

The Levin Amendment also contains several transition-related provisions that, if adopted into the final legislation during reconciliation, will be of critical importance to private equity and hedge funds. The key features of these provisions are as follows:

- Upon enactment, a "banking entity," which, as defined by the Levin Amendment, would include an insured depository institution and each of its affiliates, would be prohibited from (i) sponsoring or investing in any private equity or hedge fund that the banking entity did not sponsor or invest in as of May 1, 2010, or (ii) selling, transferring, loaning or otherwise providing any additional capital or assets to a private equity or hedge fund sponsored by the banking entity or in which the banking entity invests, except to the extent necessary to fulfill contractual obligations that were in effect on May 1, 2010.
- Within two years of enactment, the aggregate amount of equity, partnership or other partnership interests in all private equity and hedge funds (other than illiquid funds, as described below) held by a banking entity may not exceed 2% of the Tier I capital of the banking entity.
- Within five years of enactment, there must be total divestiture of any equity, partnership or other partnership interest held in a private equity or hedge fund (other than illiquid funds, as described below).

For "illiquid funds," the Levin Amendment provides for a special four-year transition period. An illiquid fund is defined to mean a private equity or hedge fund that, as of May 1, 2010, was principally invested in or is invested in illiquid assets, and committed to principally invest in illiquid assets, such as portfolio companies, real estate investments, and venture capital investments, and that maintains the investment strategy of the fund that was in place as of May 1, 2010, regarding principally investing in illiquid assets.

During such four-year transition period, a banking entity may take an equity, partnership or ownership interest in, or otherwise provide additional capital to, an illiquid fund only to the extent necessary to fulfill contractual obligations that were in effect on May 1, 2010.

C. CHANGES TO EXECUTIVE COMPENSATION AND CORPORATE GOVERNANCE PRACTICES OF PUBLIC COMPANIES

Set forth below are highlights of the provisions of the Senate Bill and the House Bill relating to executive compensation and corporate governance. The bills each would mandate specified practices in these areas among companies that are subject to their requirements, including companies within the portfolios of private equity, venture capital and other private funds. In some cases the reach of the bills is limited to companies that have listed their securities on a national securities exchange such as the NYSE or the NASDAQ Stock Market, but in other cases it extends to companies that are otherwise subject to specified SEC reporting requirements such as the requirement to deliver to shareholders a proxy or information statement.

- *Compensation Committee Independence; Independence of Compensation Committee Consultants and Advisers* – The Senate and House Bills would require the SEC to issue rules directing the national securities exchanges to prohibit the listing of any security of a company that fails to have a compensation committee comprised entirely of independent members. This prospective legislative mandate tracks the Sarbanes-Oxley requirement that audit committees of listed companies be comprised entirely of independent directors. To the extent that the SEC, in promulgating rules defining "independence" for compensation committee purposes, adheres to the same standards applicable to independence for audit committee purposes, private equity sponsors may be deprived of the opportunity to be represented on the compensation committees of their listed portfolio companies. The bills would also impose additional requirements relating to the retention and independence of compensation consultants and to disclosure regarding the use of such consultants.

- *Annual Shareholder "Say on Pay" and "Golden Parachute" Votes* – Both the Senate and House Bills generally provide for a separate non-binding annual shareholder vote on compensation given to certain executive officers. In addition, to the extent that any "golden parachute"-related compensation is not approved at the annual "say on pay vote," the House Bill, but not the Senate Bill, would require a separate shareholder vote on such golden parachute compensation at any meeting at which shareholders are asked to approve a merger, acquisition or other extraordinary transaction. The Senate Bill also includes a requirement that the exchanges prohibit broker discretionary voting in connection with the election of directors, executive compensation or any other significant matter (as determined by the SEC), which would ensure that discretionary voting by brokers would not be permitted in say on pay or golden parachute votes.

- *Additional Compensation Disclosures* – Under the Senate Bill, the SEC would be directed to issue rules requiring companies to disclose in annual proxy statements a "clear description" of compensation that is being offered to executive officers, including information that shows, graphically or otherwise, "the relationship between executive compensation actually paid and the financial performance of the issuer, taking into account any change in the value of the shares of stock and dividends of the issuer and any distributions." The SEC would also be directed to require companies to make additional disclosure regarding internal pay disparity between the CEO's compensation and median annual total compensation of all employees and regarding whether directors and employees of the companies are permitted to hedge their equity in the companies. There are no comparable provisions in the House Bill.

- *Clawback of "Erroneously Awarded" Compensation* – Under the Senate Bill, the SEC is also directed to require national securities exchanges to prohibit the listing of any security issued by a company that fails to adopt and implement a policy providing for the clawback of "erroneously awarded" incentive-based compensation received by any current or former executive officer on the basis of inaccurate financial statements. There is no comparable provision in the House Bill.

- *Majority Voting Standard* – Under the Senate Bill, public companies would effectively be required to apply a majority voting standard in uncontested elections for directors. If a director were to receive less than a majority of votes cast in such an election, then the director would be required to tender his or her resignation. However, the board of directors may, upon a unanimous vote, decline to accept such resignation, provided that within 30 days after the uncontested election the board publicly discloses the specific reasons why it chose not to accept the resignation and how it determined such a decision was in the best interests of the company and its shareholders. There is no comparable provision in the House Bill.

- *Proxy Access for Shareholder Nominees* – Both the House and the Senate Bills would authorize the SEC to promulgate rules requiring issuers to include in their proxy materials director nominees submitted by shareholders.

- *Disclosure on Dual CEO/Chairman Roles* – Under the Senate Bill, the SEC would be required to promulgate rules requiring public companies to disclose in their annual proxy statements the reasons why they have chosen to either have one person to serve in the dual roles of chairman of the board of directors and chief executive officer or to have different individuals serve in such roles. There is no comparable provision in the House Bill.

D. CHANGE TO INDIVIDUAL ACCREDITED INVESTOR DEFINITION

The Senate Bill contains a provision that adjusts the individual accredited investor test for private placement purposes. Effective immediately upon enactment of the bill, and for four years following the enactment of the bill, the net worth threshold will be $1 million, excluding the value of the investor's primary residence. In addition, the bill also authorizes the SEC to adjust the individual accredited investor thresholds that do not relate to net worth (e.g., the net income test). The bill also requires the SEC, four years after the enactment of the bill and every four years thereafter, to review the individual accredited investor definition and modify the definition as appropriate for the protection of investors. Assuming that this provision is included in the final legislation, private funds and other issuers currently engaged in private placement offerings will need to move rapidly to revise their subscription documents to incorporate the new net worth test for individual accredited investors, distribute new forms of subscription documents to prospective investors and make sure that going forward they only accept subscription documents containing the new test.

Fortunately, the Senate Bill was amended at the last minute, largely in response to lobbying efforts by venture capital investors, to delete a provision that would have required a period of SEC review of all private placement offerings for up to 120 days to determine whether the offerings should be subject to state securities law (or "blue sky") regulation on the ground that they are not of sufficient size or scope. In the view of many commentators, this provision, had it been adopted, would have significantly inhibited capital formation without providing any meaningful investor protections.

* * *

The House and Senate Bills contain important provisions applicable to private funds. While these bills share many of the same features, there are some significant differences, and the legislative terrain is far from settled as the bills undergo reconciliation. Even after the reconciled legislation is enacted into law, many key details will be left to regulators to deal with through the rulemaking process, which itself presents more questions and uncertainties. In the weeks and months ahead, we will continue to monitor legislative and regulatory developments affecting private funds and their advisers.

For more information about the recent legislation and its potential implications, please contact a member of our Financial Institutions or Private Funds groups.

This memorandum is for general informational purposes and should not be regarded as legal advice. Furthermore, the information contained in this memorandum does not represent, and should not be regarded as, the view of any particular client of Simpson Thacher & Bartlett LLP. Please contact your relationship partner if we can be of assistance regarding these important developments. The names and office locations of all of our partners, as well as additional memoranda, can be obtained from our website, www.simpsonthacher.com.

UNITED STATES

New York
425 Lexington Avenue
New York, NY 10017-3954
+1-212-455-2000

Los Angeles
1999 Avenue of the Stars
Los Angeles, CA 90067
+1-310-407-7500

Palo Alto
2550 Hanover Street
Palo Alto, CA 94304
+1-650-251-5000

Washington, D.C.
1155 F Street, N.W.
Washington, D.C. 20004
+1-202-636-5500

EUROPE

London
CityPoint
One Ropemaker Street
London EC2Y 9HU
England
+44-(0)20-7275-6500

ASIA

Beijing
3119 China World Tower One
1 Jianguomenwai Avenue
Beijing 100004
China
+86-10-5965-2999

Hong Kong
ICBC Tower
3 Garden Road, Central
Hong Kong
+852-2514-7600

Tokyo
Ark Mori Building
12-32, Akasaka 1-Chome
Minato-Ku, Tokyo 107-6037
Japan
+81-3-5562-6200

LATIN AMERICA

São Paulo
Av. Presidente Juscelino Kubitschek, 1455
São Paulo, SP 04543-011
Brazil
+55-11-3546-1000