WAGE AND PRICE CONTROLS IN PRIVATE EQUITY? PROPOSED SEC RULES WOULD APPLY INCENTIVE COMPENSATION LIMITATIONS TO PRIVATE EQUITY FIRMS

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To Our Clients and Friends:

The Securities and Exchange Commission ("SEC") and several other federal agencies have approved proposed rules aimed at governing incentive compensation practices at a broad range of banks and other financial institutions, including private equity firms. The proposed rules implement Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), which prohibits certain compensation arrangements that are seen as excessive or as encouraging inappropriate risk. The SEC's version of the proposed rules, passed by the SEC in a 3-2 vote, covers both registered and unregistered investment advisers (including private equity firms) having $1 billion or more of consolidated assets ("IAs"). Unless the scope of the proposed rules is narrowed, the proposed rules (other than the deferral provisions of the rules, which would apply only to very large IAs) could apply to a significant number of private equity firms.

SCOPE AND IMPACT OF THE PROPOSED RULES

The SEC's version of the proposed rules limits compensation practices at covered IAs, as follows:

- Prohibitions. Each IA is prohibited from establishing or maintaining incentive-based compensation arrangements for "covered persons" that encourage inappropriate risk by providing (i) excessive compensation or (ii) compensation that could lead to a material financial loss by the IA. A "covered person" means any executive officer, employee, director or principal shareholder (*i.e.*, a 10% or greater owner).

  The proposed rules specify six factors to consider when determining whether compensation is excessive, including whether compensation arrangements are in line with industry practice. So, for example, it is possible that a private equity firm that has industry-standard compensation arrangements—a 20% carry allocated among investment professionals, and salaries and bonuses paid out of its 1.5% to 2.0% management fees—could take the position that its compensation arrangements are consistent with industry practice and, therefore, should not be deemed excessive. Under the rules as currently written, however, industry practice is only one of the factors that may be considered in determining whether compensation is excessive—leaving considerable leeway for regulators to second-guess a private equity firm's decisions concerning compensation arrangements.

- Reporting. Each IA must submit a brief annual report to the SEC describing the structure of its incentive-based compensation arrangements and the policies and procedures governing such arrangements. IAs are not required to disclose the compensation of particular individuals, however. The annual report must explain why the IA believes that those arrangements comply with the prohibitions against excessive or risky compensation.
- Three-Year Deferral of Incentive-Based Compensation by Very Large IAs. IAs having $50 billion or more in "consolidated assets" must defer for at least three years at least 50% of the annual "incentive-based compensation" for executive officers (including the chief investment officer and chief legal officer, among others). During the deferral period, the deferred amount must be adjusted (down) for (poor) performance during the deferral period. This deferral requirement appears to apply to annual bonuses paid to employees of the IA, but does not appear to apply to carried interest arrangements (since they are not "annual" compensation).
- Definition of Consolidated Assets. "Consolidated assets" means the IA's "total assets" as reflected on the balance sheet for the IA's most recent fiscal year end. Under GAAP as currently in effect, certain IAs, including private equity firms, are required to consolidate their affiliated funds if the limited partners of those funds do not have the right to remove the funds' general partner(s) without cause by a vote of a majority in interest (or less).

  We do not believe that any private equity firm currently has a balance sheet showing total assets of $50 billion or more (the trigger for the deferral requirement). However, a private equity firm that is required to consolidate its associated funds could become subject to the proposed rules as its assets under management rise, absent (i) a change in the GAAP consolidation rules, which are under discussion, or (ii) a change in the SEC's proposed rules, such as a change in the definition of consolidated assets so that (notwithstanding what GAAP might require generally for private equity firms) for purposes of these rules consolidated assets are deemed to include only the firm's risk assets (assets owned by the private equity firm) and not assets under management by affiliated funds. As noted below, the SEC has asked for comments on this question.

- **Definition of Incentive-Based Compensation.** "Incentive-based compensation" means "any variable compensation that serves as an incentive for performance." The deferral requirement for larger IAs applies only to "annual" incentive-based compensation. Therefore, as noted above, the deferral requirements appear not to apply to private equity carried interest arrangements (since they do not constitute annual compensation), even if those arrangement are subject to vesting, as is typical. (Vested equity, including partnership interests, is not considered incentive-based compensation under the proposed rules.)

- **Policies and Procedures.** Each IA must develop and maintain specified policies and procedures governing incentive-based compensation that are consistent with the restrictions of Section 956 of the Dodd-Frank Act. In addition, each IA having $50 billion or more in total consolidated assets must have in place a process for the board of directors (or a committee thereof) to review and approve incentive-based compensation for covered persons who individually have the ability to expose the IA to losses that are substantial in relation to the IA's size, capital or overall risk tolerance.

POINTS FOR POSSIBLE COMMENT

The SEC has specifically requested public comment on various aspects of the proposed rules, including on:

- the proposed definition of "incentive-based compensation;"

- whether the SEC should clarify that any specific forms of compensation are not incentive-based compensation;

- the proposed method of determining asset size for investment advisers, and whether the determination of total assets should be further tailored for certain types of advisers, such as private equity funds or hedge funds;

- whether there are additional factors that should be considered in evaluating whether compensation is excessive or could lead to material financial loss; and

- whether it would it be prudent to mandate deferred incentive-based compensation for certain types of covered financial institutions but not require such deferral for other institutions (*e.g.*, investment advisers) based on the business risks inherent to that business or other relevant factors.

WHAT'S NEXT?

After each of the federal agencies tasked with implementing Section 956 of the Dodd-Frank Act has approved a version of the proposed rules, the proposed rules will be published in the *Federal Register*, and open for public comment for 45 days after publication.

We anticipate that there will be a great deal of public comment on the proposed rules, including from private equity firms. The rules were intended in part to address situations where employees at financial firms were perceived to have exposed their institutions to long-term risks in exchange for near-term fees to the institutions (and large near-term bonuses to the employees), leading to excessive risk taking and even, possibly, the risk of adverse impacts on the financial system should those institutions find themselves in material distress. In the case of private equity firms, by comparison, because those firms negotiate their funds' carried interest and management fee arrangements with sophisticated third party investors, there is a market check on excessive compensation. In addition, private equity firms and funds do not raise systemic risk concerns. Finally, the compensation arrangements at private equity firms and funds do not present the perceived problem that drove much of this rulemaking, namely financial institutions taking long-term risks but being compensated currently with no adjustment if the risk fails to pay off in the long run. Private equity is different because private equity professionals receive the bulk of their income in the form of carried interest distributions, consisting primarily of a share of the realized gain from the sale of long-term investments.

Following public comment, which we expect will suggest modifications to the rules in light of the points noted above, final rules will be adopted by the various agencies. The final rules applicable to IAs will become effective six months after they are adopted by the SEC in final form and published in the *Federal Register*.

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Please contact any of the undersigned if you have questions about these proposed executive compensation rules.

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