The Impact of the Dodd-Frank Act on Private Fund Managers and Other Investment Advisers

Summary of Implications for U.S. and Non-U.S. Fund Managers

Many U.S. and international fund managers previously exempt from registration under the Investment Advisers Act of 1940 (the "Advisers Act") must now, as a result of passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Act"), contemplate registration with the U.S. Securities and Exchange Commission (the "SEC") within the next 10 months.

U.S. investment advisers with assets under management ("AUM") of $100 million or more will need to register; however, if such advisers manage only Private Funds[1] (other than SBICs, defined below) that do not meet the definition of a "venture capital fund," the threshold is raised to $150 million or more of AUM. Advisers which hit these thresholds are required to register under the Advisers Act on or before July 21, 2011, the first anniversary of the enactment of the Act. The relatively low threshold of $150 million of AUM will ensnare many previously unregistered investment advisers to private equity and hedge funds which benefited from the 14-or-fewer-clients exemption now eliminated by the Act.

U.S. advisers having less than $100 million (or $150 million where solely advisers to Private Funds) of AUM will have to register under State "blue sky laws" rather than being able to register with the SEC under the Advisers Act, unless such an adviser would have to be registered in 15 or more States.

An even lower threshold awaits "foreign private advisers," which will be required to register generally if they have $25 million or more of AUM and/or of investments in their sponsored funds attributable to U.S. investors, or more than 15 clients domiciled in the United States. Conversations with the staff of the SEC's Office of International Corporate Finance indicate that it is currently unlikely that the SEC will increase the $25 million threshold (as it is permitted to do by the Act) prior to July 21, 2011. Accordingly, many non-U.S. investment advisers face the prospect of registration with and regulation by the SEC.

Recommendations

A U.S. private fund manager affected by the Act should begin to prepare for registration well in advance of the July 21, 2011 registration deadline so as to accomplish an orderly registration. This advice applies with greater amplitude to non-U.S. managers who will likely have the additional burden (as discussed

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1 Private Funds are defined as entities that would be an "investment company" under the Investment Company Act of 1940, as amended (the "1940 Act"), but for the exceptions set forth in Sections 3(c)(1) and 3(c)(7) of the 1940 Act. For purposes of Title IV of the Act, Private Funds do not include "venture capital funds" (see "U.S. Advisers" below) but for purposes of the Volcker Rule Private Funds do include venture capital funds; as a result, banks are restricted from sponsoring or investing in a larger set of fund types (see "Volcker Rule for Sponsorship of or Investment in Private Funds" below).

further below) of assessing the U.S. regulatory regime with which they may need to comply,[2] assessing the potential exposure of its non-U.S. operations to SEC inspection, as well as weighing the burden of the commercial efficacy of registration and compliance against the commercial impacts of actions to remove its operations from the expanded regulatory reach of the Act.

Managers having multiple funds, complex structures and/or numerous street-name investors or numerous sales personnel should be all the more mindful of commencing planning and assessments now, to provide sufficient planning and implementation time for registration; or, in the case of non-U.S. advisers, potentially to take appropriate actions to avoid the need for registration.

A private fund manager which may be required to register should:

- Identify which entities in the structure provide investment advice and must register as investment advisers.
- If a "mid-sized" adviser (less than $100 million of AUM, or $150 million of AUM limited solely to Private Funds), assess respective "blue sky" obligations.
- If a non-U.S. adviser, identify the current amount of AUM and investments attributable to, and the number of, U.S. investors and project both forward to determine whether registration will be required.
- If a non-U.S. adviser, determine if, via redemption of U.S. investors' interests or otherwise, affirmative actions can be taken to avoid triggering U.S. registration, as well as the commercial and local law implications of any such redemption.
- If a non-U.S. adviser required to register, consider establishing a separate entity to advise U.S. investors only and address, for example, overlapping personnel and data systems.
- If an asset management firm (either U.S. or non-U.S.) that is a "banking entity," examine the terms of the exception from application of the Volcker Rule (discussed below) and begin to assess the steps it must take to comply with the terms of the exception.
- If an asset management firm that falls within the definition of a "banking entity" and will not qualify for the exception therefrom, assess how the Volcker Rule will affect business activities and begin to plan for compliance with the Rules.[3]
- Gather information appropriate to complete Form ADV Part I and prepare the required investor disclosure for Form ADV Part II. Although much of the required information for Form ADV Part I is factual, it must be gathered from a number of sources, so ample time should be allowed for the information-gathering and disclosure preparation.
- Begin work on required Advisers Act compliance policies and procedures, hire (or appoint) a chief compliance officer to oversee their development; consider implementing new compliance programs on a pilot basis prior to registration. Employee training should also be implemented.
- Implement a books-and-records retention system, including e-mail retention, designed to meet Advisers Act requirements and that, in the case of non-U.S. advisers, is distinct from records regarding non-U.S. clients, which to the extent practicable, should be kept beyond the newly permitted reach of the SEC.
- Review internal control structures to determine what changes should be considered prior to any registration. Given the Advisers Act requirement of client consent to a registered adviser's change of

[2] For example, whether or not registered with the SEC, all investment advisers doing business in the United States will be subject to the anti-fraud provisions of Section 206 of the Advisers Act. Additionally, SEC record-keeping rules may spawn issues under EU client privacy policies.

[3] The Volcker Rule provisions will not be effective on July 21, 2011; rather they will have a significantly longer lead-time (up to seven years — see "Volcker Rule for Sponsorship of or Investment in Private Funds" below).

control or "assignment" (as defined in the Advisers Act), appropriate adjustments to the entity's control structure prior to any registration may well need to be made.

- Review the governing documents of private funds or managed accounts to determine which documents should be amended to comply with the Advisers Act.
- Revise offering documents and related materials to ensure compliance with Advisers Act requirements, including particularly advertising rules.
- Analyze the custody arrangements applicable to the managers' private funds or other clients, given the Advisers Act's custody rule requirement that U.S. client assets[4] be held with qualified custodians, and in certain cases, new reporting obligations and SEC audit rights. Many fund managers can avoid many of the custody rule's more onerous provisions by having their funds (including any co-investment or "side car" funds) audited in accordance with U.S. GAAP and audited financials promptly delivered to investors. Non-U.S. advisers may need to anticipate the incongruencies of doing so with local law obligations.
- Review compensation arrangements given that a registered adviser is not permitted to charge performance fees (including carried interest) unless the client falls within the definition of a "qualified client" (*i.e.*, a person who either has at least $750,000 under the adviser's management or $1.5 million net worth, subject to certain look-through rules[5]), or a person who is not a U.S. resident. Because it is not clear whether the SEC will grandfather existing Private Funds from this restriction, it may be necessary to amend compensation structures in certain cases (with investor consent, where necessary).

U.S. Advisers

The Act repeals in its entirety the so-called "Private Adviser Exemption"[6] previously found in the Act and removes "Private Fund" investment advisers from the general exemption for intrastate investment advisers found under Section 203(b)(I). Private equity, real estate opportunity and hedge funds have historically generally relied upon these exemptions to avoid registration under the Advisers Act.

The Act requires that the SEC provide an exemption from the registration requirements for U.S. advisers to Private Funds, provided the adviser's AUM in the United States are less than $150 million and such adviser is solely an adviser to Private Funds.

Additionally, the Act creates new exemptions from SEC registration, including advisers to "family offices" and advisers to "venture capital funds." What is a "family office" and what is a "venture capital fund" will be determined by the SEC by final rule before July 21, 2011. Finally, any investment adviser that solely advises small business investment companies ("SBICs") that are either licensed or are currently applying for licenses under the Small Business Investment Act of 1958 is newly exempted from registration.

As a result of the Act, the number of potential SEC registrants is expected to increase significantly. The responsibility of the States for licensing, monitoring and overseeing all hedge funds and other alternative investment management firms has also been increased significantly from firms having under $25 million of AUM to firms having under $100 million of AUM. This represents a substantial increase in the responsibility (and jurisdiction) of State securities departments and law enforcement officials. But States

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4 See "Non-U.S. Advisers" below for a discussion of "regulation-lite," which would allow non-U.S. client assets to be held by "non-qualified" custodians.

5 A Section 3(c)(7) qualified purchaser fund would also fall within the definition of "qualified client".

6 Any investment adviser that has had fewer than 15 clients during the preceding 12-month period and does not hold itself out to the public as an investment adviser.

will be taking on this increased responsibility at a time when many State coffers are empty and budgets are far from balanced. Where the extra monies for personnel and supervisory infrastructure will come from is unclear; if monies are not forthcoming, an inconsistent and largely nominal oversight of a large number of U.S. advisers may result.

Non-U.S. Advisers

The Act exempts from registration any investment adviser that is a "foreign private adviser," which is defined in the Act as any investment adviser that:

- has no place of business in the United States;
- has fewer than 15 clients[7] and investors domiciled in the United States in private funds advised by the investment adviser;
- has aggregate assets under management attributable to clients in the United States and investors in the United States in Private Funds advised by the investment adviser of less than $25 million (or such higher amount as the SEC may set by rulemaking);[8] and
- neither holds itself out generally to the public in the United States as an investment adviser, nor acts as an investment adviser to any registered investment company.

The SEC has previously permitted a "regulation-lite" approach that registered non-U.S. advisers may observe with respect to their non-U.S. clients (including, non-U.S. funds in which U.S. persons invest). Under the "regulation-lite" approach, a non-U.S. adviser is permitted to treat each non-U.S. fund as its "client" for many purposes of the Advisers Act. As a result, most of the substantive provisions of the Advisers Act would not apply to a non-U.S. adviser's dealings with a non-U.S. fund, even if the investors in the fund included U.S. persons.[9] It is our expectation that the regulation-lite approach will be carried forward, but there can be no assurance that certain policies reflected in the Act (for example, as to limited disclosure of investor information for purposes of assessing systemic risk — see "Confidentiality and Potential Client Information Disclosure" below) would not interdict the regulation-lite approach.

It should be noted that while U.S. banks and bank holding companies[10] are excluded from the definition of an investment adviser, non-U.S. banks and indeed U.S. branches or agencies of non-U.S. banks are not

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7 Traditionally, a "person" is counted as a single client if it was a corporation, partnership, trust or other entity that receives investment advice based on its investment objective rather than the individual investment objectives of its own beneficial owners. In December 2004, the SEC adopted a new Rule 203(b)(3)-2 that requires hedge fund managers to register as investment advisers under the Advisers Act, despite open dissents from two of the five Commissioners. The broad exemption enjoyed by U.S. hedge fund managers has always been anomalous. The overwhelming majority of developed international financial markets in which non-U.S. managers are predominantly based have historically required formal registration.

8 But see "Summary of Implications for U.S. and non-U.S. Fund Managers" above.

9 For example, a non-U.S. adviser would not be required to comply with the following rules under the Advisers Act as to non-U.S. clients: (a): Rule 206(4)-7 (the "compliance" rule), (b) Rule 206(4)-2 (the "custody" rule) and (c) Rule 206(4)-6 (the "proxy voting" rule).

10 See Sections 202(a)(11) (A) and 202(a)(2)(A) – (D). As a result, a U.S. branch of a non-U.S. bank that sponsors an ABCP conduit cannot rely on the bank exemption and no longer has the benefit of the foreign private adviser exemption. If its activities as sponsor of an ABC conduit make it an investment adviser, the U.S. branch will need to register under the Advisers Act, in the absence of any other applicable exemption.

excluded, even though U.S. branches of non-U.S. banks are treated equivalently with U.S. banks in other provisions of the Act, including the Volcker Rule.[11]

Record-Keeping and Reporting Requirements

The Act modifies the reporting requirements for various types of advisers. First, the SEC can require any registered adviser to comply with certain additional record-keeping and reporting obligations to the SEC. Importantly, the Act deems the reports of any Private Fund to which a registered adviser provides advice to be the records and reports of that adviser. Among other things, reports will have to be filed with the SEC on:

- the amount of AUM and the use of leverage;
- counterparty credit risk exposure;
- trading and investment positions;
- valuation policies and practices of the fund;
- types of assets held;
- any side arrangements whereby certain investors receive more favorable terms than other investors; and
- any other information the SEC determines "is necessary and appropriate in the public interest and for protection of investors, or for the assessment of systemic risk."

Also importantly, the Act imposes new record-keeping and reporting obligations on advisers exempt from registration. In particular, the SEC is mandated to issue rules requiring unregistered advisers to maintain and provide to the SEC such reports as the SEC deems "necessary and appropriate in the public interest and for protection of investors" but does not otherwise define the requirements for these records and reports.

Confidentiality and Potential Client Information Disclosure

As a general matter, all reports disclosed to the SEC by U.S. or non-U.S. advisers must be treated by the SEC as confidential. This confidentiality, however, is subject to the SEC's obligation to make disclosure to Congress, any self-regulatory organization or any other U.S. federal department or agency for matters within their jurisdictions. Any recipient of these reports will be subject to the same confidentiality requirements as the SEC, and will be exempt from the public disclosure requirements of the Freedom of Information Act.[12]

Prior to the Act, Section 210(c) of the Advisers Act prevented the SEC from requiring an investment adviser to disclose the identity, investments or affairs of its clients, except as may be necessary or appropriate in a particular enforcement proceeding or investigation under the Advisers Act. The Act creates a new exception to this provision, allowing such disclosure "for purposes of assessment of potential systemic risk." While this capability should generally not be of concern to most "mid-sized" U.S. and non-U.S. advisers, larger advisers will need to be mindful of this potential disclosure.

The form and content of the reports to be filed with the SEC are to be specified by the SEC (and the Commodity Futures Tracking Commission).

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11 See "Volcker Rule for Sponsorship of or Investment in Private Funds."

12 Section 552 of Title 5, United States Code.

Other Compliance Requirements

The Act authorizes the SEC to promulgate new rules that require a registered adviser to safeguard any client assets over which that adviser has custody. These steps could include verification of the assets by an independent public accountant. Section 206(4)-2 of the Advisers Act and Rule 206(4)-2 already require examination of those assets by an independent public accountant unless an exemption applies to that adviser. Further, the Act directs the U.S. Comptroller General to conduct a study of the compliance costs associated with the custody rules, and submit a report on its results to Congress on or before July 21, 2013.

Additionally, non-U.S. advisers previously exempted from registration will need to become familiar with Rule 204-3 under the Advisers Act, commonly referred to as the "brochure rule." The brochure rule generally requires every SEC-registered adviser to deliver to each prospective advisory client a written disclosure statement, or "brochure," describing the adviser's business practices and educational and business background. The information required by the brochure rule is included as Part II of Form ADV, the registration form for investment advisers. To comply with the brochure rule, an adviser may deliver either Part II of Form ADV, or another document containing at least the information disclosed in Part II of Form ADV.

Agreements entered into with SEC-registered managers must contain certain mandated provisions. For example, Section 205(a)(2) of the Advisers Act requires each investment advisory contract entered into by an investment adviser to provide that the contract may not be assigned without the client's consent.

"Qualified Client"

Section 205(a)(1) of the Advisers Act prohibits an adviser from receiving any type of advisory fee calculated as a percentage of capital gains or appreciation in the client's account ("performance fee arrangement"). The Advisers Act contains exceptions from this prohibition for contracts with registered investment companies and clients having more than $1 million in AUM, if specific conditions are met; private investment companies excepted from the 1940 Act under Section 3(c)(7) of that Act; and clients that are not U.S. residents.

In addition, Rule 205-3 under the Advisers Act permits investment advisers to charge performance fees to:

(a) clients with at least $750,000 under management with the adviser or more than $1,500,000 of net worth;

(b) clients who are "qualified purchasers" under Section 2(a)(51)(A) of the 1940 Act; and

(c) certain knowledgeable employees of the investment adviser.

Pursuant to the Act, the "qualified client" threshold under the Advisers Act (pursuant to which a registered investment adviser can charge a performance fee) has been changed. With respect to any dollar amount threshold used in determining whether a person is a "qualified client," the SEC shall be required before July 21, 2011, and every five years thereafter, to adjust for the qualifications to reflect effects of inflation on such test.

Volcker Rule for Sponsorship of or Investment in Private Funds

Among the more publicly discussed provisions of the Dodd-Frank Act are those composing the "Volcker Rule." The Volcker Rule provisions prohibit an insured depository institution (a bank), a company that controls a bank, a company treated as a bank holding company under the International Banking Act[13], or

[13] This would include a non-U.S. bank that has a branch or agency in the United States.

any of their affiliates (each of which is termed a "banking entity" by the Act) from sponsoring or investing in a Private Fund or a venture capital fund.[14] An asset manager that is an affiliate of a bank or bank holding company would be deemed a banking entity and subject to the Rule's prohibitions.[15]

Exceptions to this blunt prohibition for a banking entity sponsoring a Private Fund for its customers and for a non-U.S. banking entity are set out below.

The Federal Reserve, other banking regulators, the SEC and the CFTC must issue implementing regulations for these provisions, and the scope and timing of the provisions will depend heavily on the regulatory content to be added. For that reason, the effects of the Volcker Rule on money managers may not be clear for a year or so.

Notwithstanding the general prohibition, a banking entity can invest in or sponsor a Private Fund, if it complies with each of the following requirements:

- The banking entity provides *bona fide* trust, fiduciary or investment advisory services;
- The fund is organized and offered only in connection with the provision of *bona fide* trust, fiduciary or investment advisory services, and offered only to persons that are customers of those services of the banking entity;
- The banking entity does not acquire or retain an equity interest, partnership interest or other ownership interest in the fund except for the purpose of (i) establishing the fund and providing the fund with sufficient initial equity for investment to permit the fund to attract unaffiliated investors or (ii) making a *de minimis* investment; or
- The banking entity must actively seek unaffiliated investors to reduce or dilute the investment of the banking entity so that:
    - Within one year after the date of the establishment of the fund, the investment of the banking entity is reduced, through redemption, sale or dilution, to an amount that is not more than 3% of the total ownership interests in the fund (the banking entity may apply to the Federal Reserve for up to a two-year extension); and
    - The banking entity's aggregate interest in all hedge funds and private equity funds does not exceed 3% of its Tier 1 capital (generally cash, government securities, or other highly liquid assets) or is immaterial to the banking entity ("immaterial" will be defined by federal regulators);
- The banking entity and its affiliates comply with limitations on transactions with the fund under Section 23A and 23B of the Federal Reserve Act;

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[14] The term "sponsoring" is defined broadly to include: serving as a general partner, managing member or trustee of a fund; selecting or controlling a majority of the fund's directors, trustees or management; or sharing the same name or variation of the same name as the fund for corporate, marketing, promotional or other purposes. A Private Fund for purposes of the Volcker Rule includes typical hedge funds and private equity funds and, in contrast to a Private Fund for Advisers Act purposes, includes venture capital funds; see footnote "1." The Volcker Rule permits federal banking regulators, by subsequent rulemaking, to include other entities in the definition of Private Fund as the regulators may determine to be appropriate. The Volcker Rule also permits the Federal Reserve to impose capital requirements and quantitative limits on a nonbank financial company.

[15] Nonbank financial companies supervised by the Board of Governors are not subject to an express prohibition like banking entities, yet they will be subject to additional capital requirements and quantitative limits if they do not comply with the same exceptions as banking entities regarding the sponsorship of or investment in a Private Fund.

- The banking entity does not, directly or indirectly, guarantee the obligations or performance of the fund or of any hedge fund or private equity fund in which the fund invests;
- The banking entity does not share with the fund, for corporate, marketing, promotional or other purposes, the same name or a variation of the same name;
- No director or employee of the banking entity takes or retains an equity interest, partnership interest, or other ownership interest in the fund unless the person is directly engaged in providing investment advisory or other services to the fund; and
- The banking entity discloses in writing to prospective and actual investors in the fund that any losses in the fund are borne solely by investors in the fund and not by the banking entity, and otherwise complies with any additional rules issued by regulators designed to ensure that losses in the fund are borne solely by investors in the fund.

The exception permits U.S. asset management affiliates of banks to continue to manage and provide fiduciary and prime brokerage services to hedge funds and private equity funds. However, because the asset management firm itself will be a "banking entity" for purposes of the provision, any fund it manages will not be permitted to share its name or a variation of its name.

A non-U.S. banking entity will have the ability to sponsor a Private Fund beyond that contemplated by the exemption, provided no ownership interest in the fund is offered for sale or sold to a resident of the United States, and the non-U.S. banking entity is not directly or indirectly controlled by a U.S. banking entity.

It should be noted that the Volcker Rule enables the Federal Reserve to place capital requirements on a nonbank financial company, which could include a money manager or a Private Fund supervised by the Federal Reserve that engages in proprietary trading or invests in or sponsors Private Fund. The provisions also prohibit a banking entity or any of its affiliates from engaging in certain transactions with a hedge fund or private equity fund for which the nonbank financial company serves (directly or indirectly) as investment adviser, or which the company invests in or sponsors (under the exception above).

U.S. and non-U.S. banking entities (and nonbank financial companies subject to the Volcker Rule) should be aware that federal regulators under the Rule can issue rules that relate to internal controls and recordkeeping to ensure compliance with the Rule, and could order the termination of an activity or disposal of an investment when the regulator has "reasonable cause to believe" that it has made "an investment or engaged in activity in a manner that functions as an evasion of the requirements" of the Rule.

The Volcker Rule will be effective upon the earlier of 12 months after the issuance of rules that implement the provisions (which must be issued on or before October 21, 2011) or July 21, 2012. An institution or company subject to a Volcker Rule provision will have approximately two years, and perhaps longer, to achieve compliance with the Rule. This compliance period can be extended for up to three additional years at the discretion of federal banking regulators, resulting in a possible period of seven years in which to become compliant. Additionally, in respect of "illiquid funds" (which generally would include most Private Funds), a banking entity may apply to the Federal Reserve for an extension of up to an additional five years.

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