DAVIES

PERSPECTIVE

Effects of Dodd-Frank on Advisers to Private Investment Funds

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1. Introduction

The *Private Fund Investment Advisers Registration Act of 2010*, which comprises Title IV of the recently enacted *Dodd-Frank Wall Street Reform and Consumer Protection Act* ("Dodd-Frank"), significantly alters the regulatory landscape for investment advisers, particularly for advisers to private investment funds (*i.e.*, hedge funds and private equity funds). Specifically, the legislation is expected to result in the registration – either with the U.S. Securities and Exchange Commission ("SEC") or one or more states – of many previously unregistered advisers, including non-U.S. advisers to offshore (or non-U.S.) funds. Further, registered advisers to private funds will be required to comply with extensive recordkeeping and reporting requirements and will be subject to examination by the SEC. Finally, other provisions of Dodd-Frank prohibit or restrict banks from sponsoring or investing in private investment funds, and subject large, systemically important financial firms (which may include hedge funds and private equity funds) to potential supervision by the Board of Governors of the U.S. Federal Reserve System (the "Federal Reserve").

Most of the provisions of Dodd-Frank that affect investment advisers will become effective on July 21, 2011.

2. Background

Investment advisers subject to the *Investment Advisers Act of 1940*, unless exempt from registration (or excluded from the definition of investment adviser), are required to register with the SEC or, for U.S. advisers only, one or more states in the United States.

Advisers are subject to the Advisers Act if (i) they are organized or have a place of business in the United States, (ii) they have U.S. clients (*e.g.*, individuals resident in the United States or funds organized in the United States) or (iii) the funds (U.S. or non-U.S.) they advise sell their securities to U.S. investors. However, non-U.S. advisers to non-U.S. funds that do not sell their securities to persons in the United States are generally not subject to regulation under the Advisers Act.

Investment managers (portfolio managers) to private investment companies, *i.e.*, hedge funds, venture capital funds and private equity funds, are generally considered to be investment advisers under the Advisers Act.

Under current law and SEC regulations, many U.S. and non-U.S. advisers rely on the "private adviser" exemption from registration under the Advisers Act. To qualify for the exemption, an adviser must have had fewer than 15 advisory clients in the preceding 12 months and not hold itself out to the public as an investment adviser. For non-U.S. advisers, only their U.S. clients count towards the 15-client limit and, unless an adviser provides advice to the individual investors in the fund, each fund it advises counts as one client.

3. Dodd-Frank

(a) Private Adviser Exemption Eliminated

Dodd-Frank eliminates the private adviser exemption from the Advisers Act, effective July 21, 2011. Accordingly, as of that date, advisers subject to the Advisers Act will have to be registered with the SEC (or, in the case of U.S. advisers only, with one or more states) unless they are eligible for another exemption from registration. Dodd-Frank does, however, provide for several new, somewhat limited, exemptions from registration under the Advisers Act.

(b) New Exemptions from Registration

(i) Foreign Private Adviser Exemption.

Dodd-Frank amends the Advisers Act to replace the private adviser exemption with an exemption for "foreign private advisers." To qualify for this exemption, the adviser must:

(A) not have a place of business in the United States;

(B) have, <u>in total</u>, fewer than 15 individual clients and investors in the United States in the "private funds" it advises;

(C) have less than US$25 million in assets under management (subject to increase by the SEC) attributable to its clients in the United States and investors in the United States in private funds that it advises; and

(D) neither hold itself out generally to the public as an investment adviser, *e.g.*, advertising as an investment adviser or maintaining a business listing as an investment adviser (we note that fund advisers generally do not do so), nor advise any U.S.-registered investment company or business development company.

A "private fund" is defined in the Dodd-Frank as any issuer that would be an investment company under the U.S. *Investment Company Act of 1940* (the "Company Act"), but for the exception to the definition of "investment company" set forth in sections 3(c)(1)

("100-person fund") or 3(c)(7) ("qualified purchaser fund") of the Company Act. Most hedge funds, venture capital funds, private equity funds, mezzanine funds, real estate funds and other private investment funds rely on one of these two exceptions to qualify for an exemption from registration under the Company Act. Accordingly, non-U.S. advisers to such funds that sell their securities to investors in the United States will have to look through the funds to count their U.S. investors in determining their eligibility for the exemption. However, a non-U.S. fund that does not offer its securities for sale in the United States will be considered a private fund under Dodd-Frank (because it does not need to rely on either the 100-person fund or qualified purchaser fund exception to avoid registration under the Company Act). Thus, a non-U.S. adviser to such a fund should not be required to look through the fund to count any U.S. investors who may have acquired their interests in the fund in secondary market transactions.

Some of the specifics of the foreign private adviser exemption are unclear, including (i) the date or time frame for determining the amount of assets under management and the number of U.S. clients and investors, (ii) the circumstances under which assets will be attributable to U.S. clients and (iii) whether a U.S. investor participating in several funds advised by the same adviser would be counted separately in determining the number of the adviser's U.S. investors. Although not required under Dodd-Frank, it is anticipated that SEC guidance on these and other interpretive matters will be forthcoming.

The foreign private adviser exemption becomes effective on July 21, 2011, but, because of the 15 client/investor threshold and US$25 million asset limitation (unless increased by the SEC), it may be of limited use to non-U.S. advisers. However, non-U.S. advisers may be eligible for the other exemptions from registration added by Dodd-Frank, as discussed below.

(ii) Exemption for Private Fund Advisers

Dodd-Frank directs the SEC to provide an exemption from registration under the Advisers Act for advisers whose only clients are private funds (*i.e.*, 100-person funds or qualified purchaser funds) and who have assets under management in the United States of less than US$150 million.

There is some uncertainty about the scope of the exemption, particularly with respect to its availability to non-U.S. advisers. For example, the statute does not define "assets under management in the United States" or specify how and when it will be tested or whether it refers to the location of the adviser, its clients and investors, or the location of the portfolio investments of the private funds it advises. It is also unclear whether a non-U.S. adviser to clients that are not private funds (*e.g.*, non-U.S. managed accounts or non-U.S. funds not offered in the United States) may avail itself of the private fund adviser exemption with respect to any private funds that it advises. It is expected that the SEC will clarify these and other interpretive issues for this exemption.

Although the statute does not provide a deadline for the SEC to adopt rules implementing this exemption, it is expected that the SEC will do so within the next 12 months.

(iii) Venture Capital Funds

Dodd-Frank also provides an exemption from registration for advisers to solely one or more venture capital funds. The statute does not define "venture capital fund" but rather directs the SEC to do so within the next 12 months. It is anticipated that the SEC will define the term narrowly, thus limiting the availability of the exemption. Additionally, even if not required to register, advisers to venture capital funds will be required to maintain such records and file such reports as the SEC determines to be necessary or appropriate.

The Senate version of the legislation contained a similar exemption for private equity funds, but it was removed during the reconciliation process with the House.

(iv) Small Business Investment Companies

Dodd-Frank provides a new exemption for advisers who advise only one or more small business investment companies licensed by the U.S. Small Business Administration.

(v) Family Offices

Dodd-Frank amends the Advisers Act to exclude "family offices" from the definition of investment adviser. The SEC is directed to define the term "family office" through rulemaking in a manner consistent with the SEC's previous exemptive orders for family offices (*i.e.*, entities formed to manage the affairs of the members of a single wealthy family and that provide a wide range of services in addition to investment advisory services).

(c) Federal/State Responsibility for Regulating Investment Advisers

Currently, under the Advisers Act, an adviser may not register with the SEC (*i.e.*, it must register with one or more states unless exempt from state registration) if it has less than $25 million in assets under management and is regulated by the state in which it maintains its principal place of business (and all states but one – Wyoming – regulate investment advisers). If the adviser has at least $25 million in assets under management, it may register with either the SEC or one or more states and if it has at least $30 million in assets under management, it must register with the SEC.

Dodd-Frank extends the prohibition against SEC registration to advisers with between $25 million and $100 million in assets under management (either of which amounts may be increased by the SEC) unless (i) the adviser is not registered with and subject to examination by a state regulator in the state where it has its principal place of business, (ii) it advises a registered investment company or business development company, or (iii) it would otherwise be required to register with at least 15 states.

Because non-U.S. issuers do not have a principal place of business in the United States, they will have to register with the SEC unless exempt from federal registration, regardless of the amount of assets they have under management. This is unchanged from the current law.

(d) Reporting and Recordkeeping Requirements for Advisers to Private Funds

Dodd-Frank authorizes the SEC to impose reporting and recordkeeping requirements on advisers to private funds. Registered advisers will be required to maintain

and report certain information regarding each private fund they manage, including at least the following: (i) the amount of assets under management and use of leverage, including off-balance-sheet leverage; (ii) counterparty credit risk exposure; (iii) trading and investment decisions; (iv) valuation policies and practices of the fund; (v) types of assets held; side arrangements or side letters; (vi) trading practices; and (vii) such other information that the SEC, in consultation with the Financial Stability Oversight Council ("Council") (the new oversight entity created by Dodd-Frank to monitor systemic risks to the U.S. financial markets) determines is necessary and appropriate for the protection of investors or for the assessment of systemic risk.

Dodd-Frank also amends the Advisers Act to authorize the SEC to require advisers to disclose the "identity, investments or affairs" of their clients if necessary for purposes of assessment of potential systemic risk. It is unclear whether this provision authorizes the SEC to require disclosure of names of and other information related to investors in private funds.

To ensure compliance with the new recordkeeping requirements, Dodd-Frank mandates periodic SEC inspections of private fund records maintained by registered investment advisers and also authorizes the SEC to conduct additional, special examinations. However, the registration and examination procedures established by the SEC for "mid-sized private funds" must reflect the level of systemic risk posed by the funds based on an analysis of their size, governance and investment strategy. Dodd-Frank neither defines "mid-sized" funds nor directs the SEC to do so, but it is anticipated that the SEC will adopt a definition. There is no deadline under Dodd-Frank for the SEC's adoption of the new recordkeeping, examination and reporting rules.

The Dodd-Frank recordkeeping and reporting requirements will be in addition to the existing extensive regulatory requirements for registered investment advisers under the Advisers Act. However, the SEC has historically not required non-U.S. registered advisers to comply with most of the substantive provisions of the Advisers Act (*e.g.*, compliance procedures, custody rule, proxy voting rule, code of ethics, brochure rule, restrictions on charging performance fees) in providing services to their non-U.S. clients. The SEC's policy is based on the premise that non-U.S. clients of a non-U.S. adviser should not expect the full protection of the U.S. securities laws, even if the adviser is registered under the Advisers Act. For the same reason, the SEC considers a non-U.S. fund, rather than its investors, to be the adviser's client. Whether Dodd-Frank will result in any change in the SEC's policy on these matters is uncertain.

All U.S. and non-U.S. advisers, registered or unregistered, must comply with the provisions of the Advisers Act that prohibit fraudulent, deceptive or manipulative conduct by advisers towards clients and prospective clients. Dodd-Frank prohibits the SEC from defining the word "client" for those purposes to include investors in a private fund, provided the adviser has an advisory agreement with the fund. However, the practical effect of this provision may be limited, as advisers (both U.S and non-U.S., whether registered or not) to funds (both onshore and offshore) will continue to be subject to an SEC rule that prohibits advisers from making false or misleading statements to, or otherwise defrauding, investors and prospective investors in the funds they advise. Only the SEC may enforce the anti-fraud provisions of the Advisers Act, as the Advisers Act does not create a private right of action.

The SEC requires non-U.S. registered advisers to comply with most of the existing recordkeeping requirements of the Advisers Act and to be subject to examination by the SEC. Dodd-Frank does not distinguish between U.S. and non-U.S. advisers with respect to its new recordkeeping and reporting requirements and, given the purported purpose of these requirements (*i.e.*, to provide information to assist in the assessment of systematic risk), and the SEC's current recordkeeping requirements for non-U.S. advisers, it would appear very unlikely that any SEC relief from the new requirements for non-U.S. advisers will be forthcoming. However, it is unclear whether the requirements will apply to all funds advised by non-U.S. advisers or only those that have sold their securities in the United States.

Advisers to funds that are exempt from registration (whether as advisers to private funds or venture capital funds, or as foreign private advisers) will be required to maintain such records and file such reports as the SEC determines through rulemaking to be necessary or appropriate in the public interest or for the protection of investors.

(e) Information Sharing and Confidential Treatment of "Proprietary Information."

Dodd-Frank requires the SEC to generally keep confidential the information it collects pursuant to the Act's reporting and disclosure requirements and such information will not be subject to disclosure under the U.S. *Freedom of Information Act*. However, since the rules are designed to help monitor and mitigate systemic risks to the financial markets, the SEC will provide the information it gathers to the Council for the purpose of assessing the systemic risk posed by a private fund. The Council must keep the information it receives confidential in accordance with the same confidentiality standards that govern the SEC.

The SEC may be compelled to disclose the information it collects in certain limited circumstances, including, if it is required, to Congress, to another U.S. federal department, agency or self-regulatory organization or to comply with a federal court order in an action brought by the U.S. government or the SEC.

If the SEC learns of an adviser's "proprietary information" from reports filed pursuant to Dodd-Frank, the SEC must protect that information in the same manner as it would treat information collected during an examination of an investment adviser (*i.e.*, it generally must keep the information secret). Dodd-Frank broadly describes "proprietary information" as sensitive, non-public information regarding: (i) the investment or trading strategies of the investment adviser; (ii) analytical or research methodologies; (iii) trading data; (iv) computer hardware or software containing intellectual property; and (v) any additional information that the SEC determines to be proprietary.

(f) Custody of Client Assets

Dodd-Frank directs the SEC to adopt rules requiring registered advisers to take steps to safeguard client assets over which they have custody, which may include verification of assets by an independent public accountant. It is unclear whether such rules will replace or supplement the existing custody rule under the Adviser's Act. The application of this provision to non-U.S. advisors is also uncertain.

(g) Volcker Rule

Dodd-Frank adopts the so-called "Volcker Rule," which prohibits (subject to limited exceptions) "banking entities" from investing in or sponsoring "hedge funds and private equity funds." For those purposes, hedge funds and private equity funds include 100-person funds, qualified purchaser funds, and any other similar funds as the SEC, the CFTC or the appropriate federal banking authorities may determine. Banking entities include FDIC-insured banks or thrifts, a company that controls an insured bank or thrift, a company treated as a bank holding company (which may include a non-U.S. bank with a U.S. presence) and their affiliates and subsidiaries.

These entities will generally be prohibited from "sponsoring" private funds. That means they may not (i) serve as a general partner, managing member or trustee of the fund, (ii) select or control a majority of the board of directors, trustees or management of the fund, or (iii) share the same names (or a variation of the same name) with a fund for marketing and promotional purposes.

Notwithstanding the general prohibition, banking entities may sponsor a hedge fund or private equity fund if their activities are limited as follows:

- the banking entity provide *bona fide* trust, fiduciary, or investment advisory services as part of its business;
- the fund is organized and offered only in connection with such services and only to customers of such services;
- the banking entity's equity interest in the fund complies with certain *de minimis* criteria (described below);
- the banking entity does not guarantee or otherwise assume or insure the obligations or performance of the fund;
- the banking entity does not share with the hedge fund or private equity 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 has an ownership interest in the fund unless he or she is directly engaged in providing services to the fund; and
- the banking entity makes adequate disclosures to investors that losses suffered by the fund will be borne solely by the investors.

Additionally, banking entities that sponsor or act as investment advisers to these funds may not enter into certain "covered" (*i.e.*, related party) transactions as defined in Sections 23A and 23B of the Federal Reserve Act, including loans, purchases of assets or securities, and guarantees, with those funds. However, the Federal Reserve may permit exceptions for prime brokerage transactions it deems to be consistent with safe and sound operations and conditions of the banking entity.

A banking entity may make and retain an investment in a hedge fund or private equity fund that it organizes and offers provided that the investment is either *de minimis* in amount or made to establish the fund and attract unaffiliated investors. The banking entity is required to actively seek unaffiliated investors to reduce or dilute its investment. Not later than one year after the fund is established, the banking entity's ownership may not exceed

three percent of the total ownership interests in the fund and must be "immaterial" in amount to the banking entity (as defined by the appropriate regulation). In any event, the aggregate total amount of the entity's investments in such funds may not exceed three percent of its Tier 1 capital.

The Volcker Rule prohibitions and limitations on investments in hedge funds and private equity funds do not apply to "non-banking financial companies" regulated by the Federal Reserve (as discussed below). However, the Federal Reserve is required to impose additional capital requirements and quantitative limits with respect to any such investments in private funds by those non-bank financial companies, which may include non-U.S. entities.

The rules implementing the Volcker Rule (including defining the terms used therein) are to be issued jointly by the appropriate U.S. banking authorities, the SEC and the CFTC, and will become effective on the earlier of 12 months from when the rules are issued and July 21, 2012. Thereafter, banking entities will have two years (and up to three additional one-year extensions) in which to divest themselves of prohibited businesses and investments. An additional five-year extension may be granted upon application to the Federal Reserve for investments in "illiquid" funds, which generally may include many private equity funds, and certain currently existing contractual obligations.

(h) Potential Federal Reserve Oversight of Private Funds

Title I of Dodd-Frank authorizes the Council to designate any U.S. or non-U.S. "non-bank financial company" as systemically important such that the company will be subject to supervision by the Board of Governors of the Federal Reserve.

A "non-bank financial company" is a company, other than a bank holding company, that is predominantly engaged in financial activities. A non-bank financial company could include an investment adviser or a hedge fund, private equity fund, mutual fund or other investment fund.

A particular company will be subject to supervision by the Federal Reserve if the Council determines that "material financial distress" at the company, or the nature, scope, size, scale, concentration, interconnectedness or mix of the company's activities, could threaten the financial stability of the United States. In making any such determination, the Council must consider a number of factors, including the degree of the company's leverage, the extent and nature of its off-balance sheet exposures, its importance as a source of credit in the United States and as a source of liquidity for the U.S. financial system, and its inter-connectedness with other significant financial entities. For non-U.S. companies, the Council will generally focus on their U.S. activities, assets and liabilities, and the extent to which they are subject to prudential standards administered and enforced by a comparable non-U.S. regulatory authority. Any company designated by the Council for supervision will be provided with notice, an opportunity for a hearing at which to contest the designation, and judicial review of the Council's determination following the hearing. In exercising these duties, the Council is directed to consult with non-U.S. regulatory authorities to the extent appropriate.

Any private investment fund designated by the Council for regulation by the Federal Reserve will be subject to prudential standards that would include, among other things, the following:

- risk-based capital requirements;
- leverage limits;
- liquidity requirements;
- resolution plan and credit exposure report requirements;
- concentration limits;
- a contingent capital requirement;
- enhanced public disclosures;
- short-term debt limits; and
- overall risk management requirements.

Additionally, if the Federal Reserve determines that any non-bank financial company it supervises poses a grave threat to the financial stability of the United States, it may: limit the company's ability to merge with or acquire another company; restrict the company's ability to offer one or more financial products; require the company to terminate one or more activities; impose conditions on the manner in which the company conducts one or more activities; or, if the foregoing actions are inadequate to redress the threat, require the company to sell or otherwise transfer assets or off-balance sheet items to unaffiliated entities.

Dodd-Frank provides that the Federal Reserve's authority over non-U.S. non-bank financial companies will extend only to their U.S. activities and their U.S. subsidiaries. This appears to be consistent with the Federal Reserve's traditional policy of limiting U.S. regulations of non-U.S. banks to their U.S. operations and activities. However, the complete extent of the Federal Reserve's expanded authority will depend on future rulemaking.

(i) Other Items of Interest

Dodd-Frank includes other items of interest for advisers to private investment funds:

- Accredited Investor Definition: Dodd-Frank directs the SEC to modify the "accredited investor" standard in its rules under the Securities Act of 1933, so that the "net worth" element of such standard excludes the value of a person's primary residence. The change became effective on July 21, 2010, and the SEC, pending issuance of an amended rule, has issued guidance providing that the mortgage debt secured by an investor's primary residence should not be deducted from the investor's net worth except to the extent, if any, the debt, exceeds the fair market value of the residence. Funds should apply the new standard now for new investors and all additional investments by existing investors to ensure a valid private placement exemption for offerings in the United States. In addition, the SEC is authorized to review and make periodic adjustments to the accredited investor standard, as it relates to natural

persons, in light of the economy and is necessary for the protection of investors and the public interest, but may not further change the "net worth" standard for the next four years.

- Disqualification of "bad actors" from reliance on Reg. D: Dodd-Frank requires the SEC to adopt rules within one year to disqualify certain persons (*e.g.*, persons convicted of a crime or subject to a court or administrative order in connection with the sale of a security) from relying on Rule 506 under the Securities Act. Those so-called "bad boy" provisions already apply to offerings made under Rule 505 of Regulation D. Most private fund offerings rely on Rule 506 because it allows an unlimited offering amount and exempts the offering from regulation under U.S. state securities laws. It is unclear whether the new rules will apply only to the issuer (*i.e.*, the fund) making an offering or to its officers, directors, shareholders and/or any placement agents it engages.

- Qualified Client Definition: Any SEC rules that define the term "qualified client" for purposes of the Advisers Act by reference to a dollar amount test will be required to be adjusted for the effects of inflation every five years. The definition is important because registered advisers are generally prohibited from charging performance fees or incentive allocations unless the client is a "qualified client." The current rule requires the client to have either $750,000 under management with the adviser or a net worth of at least $1.5 million. This change should not affect advisers to non-U.S. funds because the prohibition against charging performance fees is inapplicable to advisory contracts with persons not resident in the U.S., and it is the SEC's current policy that such funds are not U.S. residents.

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