

A Closer Look

The Dodd-Frank Wall Street Reform and Consumer Protection Act



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The first in an ongoing series

Impact On Alternative Asset Managers

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While past efforts to bring hedge funds under Securities and Exchange Commission (SEC) oversight failed, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank or the Act) will now bring a significant number of advisers to private funds under SEC oversight for the first time, while providing exemptions for smaller and some foreign advisers. For many alternative managers, becoming registered will require significant changes to their operations, controls, staffing, recordkeeping, and disclosures.

All hedge fund and private equity fund advisers that are required to register with the SEC must do so before July 21, 2011, and must be fully compliant with requirements under the Investment Advisers Act of 1940 (Advisers Act). The SEC will draft rules to implement the Act, and will likely require advisers to private funds to file reports containing such information as the SEC deems necessary to protect investors or for the assessment of systemic risk. This *A Closer Look* provides our initial perspective on how Dodd-Frank may likely impact alternative asset managers.

Most hedge fund and private equity fund managers will have to register with the SEC

Advisers to private funds lose their exemption. A significant aspect of the new law is the elimination of the existing “private investment adviser” registration exemption for advisers to private funds. Investment advisers to private funds, including hedge funds and private equity funds, are required to register with the SEC unless they qualify for one of the exemptions provided.

While no conclusive numbers are available, thousands of advisers will likely be impacted. Becoming registered entails significant obligations. Upon registration, advisers must comply with the Advisers Act. This includes providing disclosure to advisory clients of all material conflicts of interest and other information, complying with rules governing trading, ensuring that advertising and performance reporting complies with regulatory rules, implementing codes of ethics governing trading by firm principals and other issues, naming a chief compliance officer, and implementing an effective compliance program. In addition, once registered, advisers become subject to examination oversight by the SEC.

Prior to registration, advisers should undertake a comprehensive review of their operations to identify needed enhancements to controls and disclosures. Important steps include:

- *Identifying conflicts of interest associated with the adviser and its employees*
- *Implementing a tailored compliance program with written policies and procedures and an effective surveillance and testing program*
- *Designating a competent chief compliance officer and ensuring adequate compliance resources*
- *Reviewing existing disclosure documents and identifying needed improvements*
- *Drafting clear and accurate registration documents (Form ADV, Parts I and II)*
- *Ensuring that newly required records will be created and maintained consistent with books and records requirements*

Some advisers are exempt from registration

Certain types of advisers are exempt from registration. These include:

Advisers to venture capital funds: The SEC is directed to define “venture capital fund” within one year of enactment. While exempt from registration, they may be subject to record-keeping and reporting requirements.

Smaller advisers: Advisers solely to private funds with assets under management of less than \$150 million, and other advisers with less than \$100 million in assets under management are not subject to registration with the SEC. For advisers in states that will not be subject to registration and examination, and advisers that would have to register with 15 or more states, the minimum assets under management for SEC registration will be \$25 million. While exempt from registration, they may be subject to record-keeping and reporting requirements.

Foreign private fund advisers: Foreign private fund advisers are exempt only if they do not have a place of business in the US; have fewer than 15 clients in the US (this includes investors in the hedge fund or private equity fund); have less than \$25 million in assets under management in private funds for US clients and investors; and do not hold themselves out to the public in the US as an adviser.

Family offices: Family offices are exempt from registration consistent with the SEC’s current exemptions. The SEC will define the term and in a manner consistent with existing exemptive orders.

Commodity trading advisors registered with the Commodity Futures Trading Commission

(CFTC): Advisers to commodity pools that are currently registered with the CFTC are exempt; however, if the business of the adviser becomes predominately securities-related, the adviser will need to register with the SEC.

The chart below shows the advisers that will and will not need to register.

Who must register with the SEC?

NO	YES
Venture capital fund advisers	Private equity fund advisers (unless eligible for an exemption)
Advisers to separate accounts with <\$100 million AUM	Advisers to separate accounts with >\$100 million AUM
Advisers to private funds with <\$150 million AUM	Advisers to private funds with >\$150 million AUM
	Advisers in states without adviser oversight and >\$25 million AUM Advisers that would have to register with 15+ states and >\$25 AUM may (though are not required) to register
Non-US advisers with no place of business in the US, and <15 clients or investors, and <\$25 million AUM for US clients or investors, and do not hold out as an adviser in US (advisers to a BDC or a registered investment company are not entitled to this exemption)	Non-US advisers with a place of business in the US, or >14 US clients or investors, or >\$25 million AUM for US clients or investors, or that hold out as an adviser in US
Family offices	—
CFTC-registered commodity trading advisers	CFTC-registered commodity trading advisers if business becomes predominately securities-related

It will be critical for advisers to assess accurately whether they will be required to register with the SEC or are exempt from registration. A large number of firms, both in the US and based outside the US with US investors, will be required to register. Even if exempt from SEC registration, advisers will need to accurately assess whether they will be subject to record-keeping and reporting obligations, and they remain subject to the anti-fraud rules (and thus to the SEC's enforcement authority). In addition, state-regulated advisers will need to be alert to state regulatory requirements, including possible new examination strategies.

New record-keeping and reporting requirements

New record-keeping requirements. Dodd-Frank empowers the SEC to require registered advisers to maintain specific information regarding an advised private fund, which will be subject to examination by the SEC. Among other things, advisers will be required to maintain records describing:

- The amount and types of assets under management
- Use of leverage
- Counterparty credit risk exposure

- Trading and investment positions
- Valuation policies and practices
- Side arrangements or letters
- Trading practices

In addition, the SEC, in consultation with the Financial Stability Oversight Council, may require that the firm keep additional information (if it determines it is necessary and appropriate in the public interest for the protection of investors or for the assessment of systemic risk). The Act allows for different reporting requirements for different classes of fund advisers, based on type or size of private fund.

New filing requirements. In addition, the Act states that the SEC “shall” issue rules requiring each adviser to a private fund to file reports containing such information as the SEC deems necessary and appropriate for the public interest, to protect investors or for the assessment of systemic risk.

Short sales. The Act requires that the SEC adopt rules that would require institutional investors to submit reports of short sales (by name and issuer of the security, the aggregate number of shares, and any other information the SEC determines), for public disclosure at least monthly.

Following SEC rulemaking, advisers will be required to create and keep records that will be specific to their business as advisers to private funds. The SEC may craft additional record-keeping and filing requirements to allow the SEC to identify heightened investor protection risks as well as to monitor for systemic risk. As described below, this information will be shared with the Financial Stability Oversight Council.

Examination oversight

Examination cycle. The new law provides that the SEC shall conduct periodic inspections of the records of private funds maintained by a registered adviser.

This would seem to require that the SEC establish a regular inspection cycle or cycles for these advisers. Currently, many advisers are not subject to routine, periodic examinations.

Systemic risk is added as a function of examinations. The law also makes these advisers subject to examinations “at any time or from time to time such additional, special, and other examinations” as the SEC deems appropriate for the protection of investors or for the assessment of systemic risk.

The Act explicitly expands the mission of SEC examinations beyond investor protection to include the assessment of systemic risk. This could allow the SEC to initiate examinations based on a need to evaluate risk to markets, independent of risk to investors. This is a significant new responsibility.

Advisers to mid-sized funds. The SEC is empowered to create examination procedures with respect to “mid-sized funds” (a term that is not defined) that reflect the level of systemic risk posed by such funds, taking into account the size, governance, and investment strategy when determining the systemic risk of such funds.

The SEC could differentiate large advisers and craft systemic risk exam and oversight strategies specific to those firms.

Records to be provided. Dodd-Frank provides that any registered adviser must make available to the SEC “any copies or extracts from records as may be prepared without undue effort, expense, or delay” as the SEC may request. The law further provides that the records of any private fund advised by the adviser are considered records of the adviser (and are thus subject to review in an examination of the adviser).

This effectively eliminates some objections to past document requests from the SEC that required the adviser to copy records, or to extract information from existing records into new documents to be produced for the regulator. It also makes clear that the SEC has access to records and information relating to a fund in an examination of its adviser.

Deadlines, other examinations. The Act states that SEC staff shall provide the firm being examined with written notice (i.e., that the exam has concluded, has concluded without findings, or that the staff requests that the entity undertake corrective action) within six months of the end of the on-site portion of the examination or the receipt of all records requested (similar requirements are imposed for enforcement investigations). Exceptions are made for complex examinations. The Act also provides that the Division of Investment Management shall have examiners.

Most examinations conclude within the time frames specified, and the SEC maintains policies to provide written notice that are consistent with the new law. The Division of Investment Management may perform examinations as part of the disclosure review program, or for other types of oversight.

Relationship with Financial Stability Oversight Council

The Act requires that the SEC make all records and information filed or provided by a registered adviser available to the Financial Stability Oversight Council. This might include, for example, information obtained from an adviser pursuant to an examination, or information that the SEC requires to be filed with the SEC (by rule, as described earlier).

Given the expansion of the SEC's role to include assessment of systemic risk, advisers should expect that the SEC will request and obtain a broader set of information than requested in the past, and that this information will be shared with the Financial Stability Oversight Council. Given that assessment of systemic risk is not an existing function of the SEC's oversight of investment advisers, the new Financial Stability Oversight Council will likely play a key role.

Confidentiality of information provided to the SEC

The Act states that the Financial Stability Oversight Council and the SEC (and any other agency receiving such information from the SEC) are exempt from the Freedom of Information Act with respect to such information, and shall treat “proprietary information” of an adviser as nonpublic and confidential under the Advisers Act. Proprietary information is sensitive, nonpublic information regarding:

- The investment or trading strategies of an adviser
- Analytical or research methodologies
- Trading data
- Computer hardware or software containing intellectual property
- Any other information that the SEC determines to be proprietary

Other provisions of the law protect the confidentiality of materials submitted to the SEC by investment advisers, investment companies, and broker-dealers in response to a regulatory request for use in connection with surveillance, risk assessments, or other regulatory and oversight activities.

Effectively, this allows the SEC to obtain sensitive confidential information from advisers for surveillance or risk assessment purposes (separate or as a part of examinations, investigations, or other inquiries), share it with other regulators, and maintain its confidentiality. This removes a longstanding concern expressed by hedge funds and other managers that sensitive, proprietary information indicating trading strategies and tactics would be made available to the public and to competitors who could use it to their advantage.

New accredited investor and qualified client standards

Accredited investor. Once enacted, and then for four years, the net worth standard is \$1 million, excluding the investor's primary residence. The SEC is also authorized to review the "accredited investor" standard within one year, and periodically, every four years. While authorized to modify the standard, the SEC may not reduce the net worth standard below \$1 million for natural persons, excluding their primary residence. The GAO is also directed to complete a study with recommendations for changes to the standard within three years.

To be deemed accredited, investors now must have at least \$1 million in net worth not including their primary residence.

Qualified client. Within one year and periodically, the SEC must review dollar thresholds for when an adviser can charge performance-based fees, and adjust them for inflation within a year, and every five years. Also, the law clarifies that the Adviser's Act requirements for advisory contracts (including performance fees) do not apply to state-registered advisers.

The current standard (\$750,000 or more in assets under management and at least \$1.5 million in net worth), will be revised for inflation within a year.

An SRO for advisers?

GAO study. The Act requires that the GAO conduct a study of the feasibility of forming a self-regulatory organization to oversee private funds, within one year.

SEC study. Dodd-Frank also requires that, within six months, the SEC study the need for enhanced examination and enforcement resources for investment advisers, and revise its rules and identify regulatory or legislative steps necessary, considering:

- The number and frequency of examinations over the last five years
- The extent to which having one or more SROs to augment the SEC's efforts in overseeing advisers would improve the frequency of inspections of advisers
- Current and potential approaches to examining the advisory activities dually registered or affiliated broker-dealers and advisers

The need for an SRO is again under review. The GAO and the SEC will likely study the need for an SRO in light of the current number of adviser registrants and SEC examination resources, and the fact that many more advisers will be required to register with the SEC; the new focus on evaluating systemic risk; and the new requirement that the SEC shall conduct periodic inspections of the records of private funds maintained by a registered adviser, which apparently mandates routine periodic examinations (as previously described). In addition, many advisers are affiliated with broker-dealers, which already have an SRO that performs regular examinations.

While Dodd-Frank will have significant impact on alternative investment managers, many implementation issues are currently unclear and are subject to the SEC and other agencies' rulemaking processes and various statutorily directed studies. PwC will continue to monitor those developments and provide you with updates, which will all be available on www.pwc regulatory.com.

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