

# An Overview of the Dodd-Frank Act and Its Effect on Hedge/Private Fund Managers

July 27, 2010

Michael S. Caccese (Partner, Boston)

Nicholas S. Hodge (Partner, Boston)

Rebecca O'Brien Radford (Partner, Boston)

George J. Zornada (Partner, Boston)

[www.klgates.com](http://www.klgates.com)

## Overview

- Dodd-Frank really marks the start of the next stage of the policy-making process
  - It will require 315 rulemakings to implement, plus there are 145 studies required for regulators, on some of the most complicated and contentious issues
- Congress retains a vested interest in the outcome of these rulemakings and studies
  - Congressional committees will exercise their oversight responsibilities (especially hearings) in ways intended to influence regulators' rulemaking
  - There will be follow-up legislation, both for technical fixes for the Act's myriad of inconsistencies, errors and gaps and for substantive modifications
- This process will take years to play out

## Overview (cont.)

The Act will have a profound affect on the regulatory regime governing investment advisers and private funds

- Among other things, the Dodd-Frank Act:
  - Dramatically reshapes the registration, recordkeeping and reporting requirements for advisers
  - Changes the “accredited investor” and “qualified client” requirements
  - Limits the ability of banking entities to sponsor or invest in certain private funds through the “Volcker Rule”
  - Raises the potential for additional regulation of large funds and fund complexes under a new systemic risk regulatory regime
  - Mandates that the Government Accountability Office and Securities and Exchange Commission conduct a number of studies on issues affecting private funds and their advisers
  - Creates immense uncertainty pending rulemaking and agency guidance
- Private adviser provisions were effective on July 21, 2011



# Adviser Registration, Recordkeeping and Reporting

## I. Adviser Registration and New Exemptions

The Act rescinds the “private adviser exemption” effective July 21, 2011

- Many advisers to private funds currently rely on private adviser exemption to remain unregistered
  - Section 203(b)(3) of the Investment Advisers Act of 1940 (Advisers Act) exempts an adviser that
    - during any rolling 12-month period had fewer than 15 clients,
    - does not serve as adviser to a registered investment company or business development company (BDC) and
    - does not hold itself out to the public as an investment adviser
  - Generally, a fund counts as a single client
- Most advisers that rely upon the private adviser exemption will be required to register either with the SEC or state regulator(s) because of the limited scope of the new registration exemptions in the Dodd-Frank Act

## I. Adviser Registration and New Exemptions (cont.)

The Act raises the minimum AUM for federal registration to \$100 million

- Prohibition on federal registration applies to advisers:
  - If required to be registered as an investment adviser in the state in which it has its principal place of business and, if registered, would be subject to examination
  - With AUM between \$25 million and \$100 million
    - SEC may increase these amounts by rule
  - If not required to be registered in a state, the minimum AUM for federal registration is \$25 million
- Does not apply:
  - To advisers to registered investment companies or BDCs
  - To advisers that would be required to register with 15 or more states and
  - To advisers with their principal office and place of business outside of the United States

## I. Adviser Registration and New Exemptions (cont.)

### Issues and Concerns with New AUM Requirement

- Unclear whether current registrants that no longer qualify must de-register and register with one or more states
  - Will SEC provide some form of “grandfathering” relief?
  - “Qualified Professional Asset Manager” or “QPAM” status is dependent on SEC registration
- Shifts significant regulatory burden to states
  - SEC Chairperson Schapiro has said advisers with less than \$100 million in AUM account for:
    - 40% of SEC-registered advisers, or
    - 4,000 registrants
  - SEC Commissioners and staff (among others) have expressed concern about whether states have sufficient resources and expertise to handle new responsibility

## I. Adviser Registration and New Exemptions (cont.)

- “Mid-Sized” Fund Advisers Exemption
  - Requires that SEC shall provide an exemption for an adviser solely to private funds with aggregate AUM in the United States of less than \$150 million
  - The Act mandates that SEC require these advisers to “maintain such records and provide to the [SEC] such annual or other reports as the [SEC] determines appropriate”
  - “Private fund” is defined for the Act’s private adviser provisions as one that would be an investment company but for the exceptions in Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940

## I. Adviser Registration and New Exemptions (cont.)

- Questions raised by “mid-sized” fund adviser exemption
  - Scope and usefulness is unclear
    - Act requires SEC to “take into account the size, governance and investment strategy of [funds managed by these advisers] to determine whether they pose systemic risk”
    - Further, SEC must “provide for registration and examination procedures” for such advisers commensurate with the level of systemic risk they and their funds pose
    - Not clear how this assessment and subsequent procedures will limit usefulness of this exemption
    - Also not clear with respect to applicability to foreign private advisers
  - Unavailable for advisers with other clients such as separate account clients

## Additional Exemptions

- Foreign Private Adviser
- Venture Capital Fund Adviser
- SBIC
- Family Office
- Registered CTA

## I. Adviser Registration and New Exemptions (cont.)

The Act creates a number of new exemptions from registration

- “Foreign Private Adviser” Exemption
  - Provides an exemption from registration for a “foreign private adviser”
  - “Foreign private adviser” defined to mean an adviser that:
    - Has no place of business in the United States
    - Has, in total, 15 or fewer clients and investors in the United States in private funds it advises
    - Has aggregate AUM attributable to United States clients and investors of less than \$25 million or a higher amount determined by the SEC by rule, and
    - Neither:
      - Holds itself to the public in the United States as an investment adviser or
      - Serves as adviser to a registered investment company or a BDC

## I. Adviser Registration and New Exemptions (cont.)

- Issues and questions relating to foreign private adviser exemption:
  - Requires look through of funds to U.S. investors
  - No time limit on calculating U.S. clients as with private advisers exemption (rolling 12-month period)
    - Unclear whether 15 clients includes former clients and, if so, how far back one must look and if one must include clients that were former clients before the effective date of the new exemption
  - No definition of assets under management
  - Status of prior SEC staff no-action guidance on provision of services to a U.S. adviser by foreign affiliates without registration is still valid
- If required to register, a non-U.S. adviser with a principal office and place of business outside of the United States could do so federally without regard to the increased minimum for federal registration



Changes to Accredited Investor and  
Qualified Client Standards, Adviser  
Reporting; Private Fund General  
Provisions

## I. Accredited Investor Standard

- Exclusion of Primary Residence from Net Worth
  - Until last week a natural person was an accredited investor if he or she:
    - Has an individual net worth, or joint net worth with his or her spouse, including any net equity in a primary residence, that exceeds \$1 million at the time of the purchase of securities (Net Worth Test), or
    - Has an individual income in excess of \$200,000 (or joint income with that person's spouse in excess of \$300,000) in each of the two most recent years and a reasonable expectation of reaching the same income in the current year (Income Test)
  - **The value of a natural person's primary residence now is excluded from the determination of whether that person meets the Net Worth Test**

## I. Accredited Investor Standard (cont.)

- SEC Study of “Accredited Investor” Definition
  - The Act requires the SEC to review the “accredited investor” definition as it applies to natural persons
  - The SEC cannot, however, in the initial review and for four years after the enactment of the Act, increase the \$1 million level of the Net Worth Test. Thus, the initial review will likely focus on the Income Test
  - The SEC may also use the occasion to make other changes to the “accredited investor” definition

## I. Accredited Investor Standard (cont.)

- Subsequent Reviews of Definition
  - Apart from the initial review, the Act requires the SEC to review the “accredited investor” definition as it applies to natural persons:
    - No earlier than four years after enactment of the Act, and
    - Every four years thereafter
  - In this subsequent review, the SEC could propose additional changes to the definition, including an increase in the \$1 million level of the Net Worth Test

## I. Accredited Investor Standard (cont.)

- Issues and Questions Raised by the Changes
  - Exclusion of primary residence was effective *immediately* upon enactment of the Act, impacting almost all ongoing private placements
  - Will particularly affect smaller advisers that manage private funds with significant investments by natural person accredited investors that are not “qualified purchasers” (*i.e.*, 3(c)(1) funds)
  - Current investors who are no longer “accredited investors” as a result of the changes are not able to make additional investments in funds in which they are currently invested
  - Requires as a practical matter supplemental information on investors

## II. Qualified Client Changes

- The Act requires the SEC to adjust any dollar amount used for determining “qualified client” status for inflation:
  - Within one year of the Act’s enactment, and
  - Every five years thereafter
- The Act’s change applies only “if the SEC uses a dollar amount test” to determine qualified client status, which it currently does (see Rule 205-3 under the Advisers Act)
- Any adjustment that is not a multiple of \$100,000 must be rounded to the nearest multiple of \$100,000

## II. Qualified Client Changes (cont.)

- Issues and Questions Resulting From Change
  - Unclear whether an adviser may continue charging a performance fee or incentive allocation with regard to an investor that is no longer a “qualified client” as a result of the initial or a subsequent adjustment but was one when he or she initially invested in a private fund
  - Generally, not an issue for 3(c)(7) “qualified purchaser” funds because “qualified purchasers” are automatically “qualified clients”

## II. Recordkeeping and Reporting Requirements

- The Dodd-Frank Act provides the SEC with authority to require records and reports regarding private funds
- The Act requires records to include the following:
  - AUM and use of leverage, including off-balance sheet leverage
  - Counterparty credit risk exposure
  - Trading and investment positions
  - Valuation policies and practices
  - Types of assets held
  - Side arrangements or side letters
  - Trading practices, and
  - Such other information as the SEC (in consultation with the Financial Stability Oversight Council) determines is necessary and appropriate in the public interest and for protection of investors or for the assessment of systemic risk

## II. Recordkeeping and Reporting Requirements (cont.)

- SEC may issue rules requiring advisers to private funds to maintain and file reports containing information SEC deems necessary and appropriate
  - Reporting requirements may vary based on type or size of private funds advised
  - Unclear what these rules will require or what record maintenance period and requirements will be imposed
- SEC may share information with FSOC, a body created to assess systemic risk in the financial system generally, as the FSOC considers necessary to assess systematic risk
- SEC and CFTC (after consultation with FSOC) must jointly promulgate rules to establish the form and content of reports to be filed with SEC and CFTC by dual registrants

## II. Recordkeeping and Reporting Requirements (cont.)

- Confidentiality of Information
  - Dodd-Frank Act provides SEC, FSOC and other agencies receiving materials or reports required by the Act with broad FOIA exemption
  - “Proprietary information” ascertained from records and reports may not be revealed by SEC or staff except:
    - With approval from SEC
    - In the course of a public SEC hearing, or
    - In response to a request or resolution from either House of Congress

## II. Recordkeeping and Reporting Requirements (cont.)

- “Proprietary information” is defined to mean:
  - Investment or trading strategies of an adviser
  - Analytical or research methodologies
  - Trading data
  - Computer hardware or software containing intellectual property
  - Additional information the SEC determines is “proprietary information”

## II. Recordkeeping and Reporting Requirements (cont.)

- Treatment of Filed Reports
  - SEC can require advisers to file reports on private funds
  - The SEC “may not be compelled to disclose any report or information contained therein” except:
    - To Congress upon an agreement of confidentiality
    - In connection with a request from another federal agency or self-regulatory organization
    - Pursuant to a court order in an action brought by the United States or the SEC
  - Any other federal agency or SRO that requests and receives information must treat it with the level of confidentiality established for the SEC under the Act

## II. Recordkeeping and Reporting Requirements (cont.)

- The Dodd-Frank Act requires the SEC to report annually to Congress on how it is using information obtained regarding private funds
- SEC's new Division of Risk, Strategy and Financial Innovation will likely use the information contained in the reports

## II. Recordkeeping and Reporting Requirements (cont.)

- Concerns and issues regarding recordkeeping and reporting
  - New recordkeeping and reporting rules could be onerous, particularly for smaller advisers to private funds
  - Always a risk of information leaks when information is provided to government agencies, particularly when shared among other agencies or with Congress

### **III. Potential Application to Private Equity Managers**

- The SEC will have to apply the Advisers Act and the systemic risk/recordkeeping provisions of the Act to PEF managers, although the SEC has little experience in regulating PEF managers
- Likely areas of regulatory focus:
  - Insider trading and personal trading
  - Marketing materials and performance presentation
  - Compliance with new AI, QC rules, solicitation rules
  - Allocation of investment opportunities among funds and in co-investment structures
  - Transactions with affiliates
  - Calculation of carried interest, clawbacks, etc.
  - Differences in releases from capital commitments
  - Leverage

## I. Provisions Focused on Private Funds

- SEC Review of Short selling:
  - The SEC is required to study the state of short selling, with particular attention to the impact of recent rule changes and the incidence of the failure to deliver shares sold short, *i.e.*, “naked” short selling, and to report on within 2 years
  - The SEC is also required to study and report on within 1 year the feasibility, benefits and costs of
    - requiring public reporting of real time short sale positions of publicly listed securities or, alternatively, providing such reports only to the SEC and FINRA, and
    - conducting a voluntary pilot program in which public companies would agree to have trades of their shares marked as “short,” “market maker short,” “buy,” “buy-to-cover” and “long” and reported in real time through the consolidated tape
- The GAO is required to study the feasibility of forming an SRO to oversee private funds and to issue a report within one year of enactment

## II. General Provisions

- Whistleblowers: Dodd-Frank provides powerful monetary incentives for individuals who know of a securities violation to contact the SEC and provide assistance in the investigation and prosecution of wrongdoing creates significant new protections for these whistleblowers.
- Dodd-Frank authorizes the SEC to impose fiduciary duties on broker-dealers when they provide "personalized investment advice about securities to a retail customer" after conducting a study.
  - The SEC is empowered to require them to "act in the best interest of the customer without regard to the financial or other interest of the broker-dealer" and to disclose "any material conflicts of interest."
  - There are 3 votes on the Commission to implement this duty, which will impose disclosure requirements on placement agents regarding the compensation that they receive from fund managers

The background of the slide is a solid dark blue color. Overlaid on this background are several white dotted lines that form a complex, abstract pattern of curved and intersecting paths, primarily concentrated in the upper right quadrant.

## The “Volcker Rule” as Applied to Private Funds

## I. The “Volcker Rule” Prohibition

- The “Volcker Rule” prohibits any “banking entity” from:
  - Proprietary trading
  - “Sponsoring” or investing in “hedge funds” or “private equity funds”
- What are hedge funds and private equity funds (“Covered Funds”)?

## I. The “Volcker Rule” Prohibition (cont.)

- What is a “banking entity”?
- What is not a “banking entity”?

## I. The “Volcker Rule” Prohibition (cont.)

- What does it mean to “Sponsor” a Covered Fund?
  - Serving as a **general partner**, managing member or trustee of a Covered Fund;
  - Selecting or **controlling** in any manner a **majority of the directors**, trustees or management of a Covered Fund; or
  - Sharing with the Covered Fund **the same name**, for corporate, marketing, promotional or other purposes

## II. Exceptions to the “Volcker Rule” Prohibition

### ■ The “Covered Fund Exception”:

- The Covered Fund is organized and offered in connection with *bona fide* trust, fiduciary or investment advisory services only to customers of such services
- No guarantee of the Covered Fund’s Performance
- No name sharing with the Covered Fund
- No director or employee of the banking entity may have an ownership interest in the Covered Fund, unless ...
- Specific disclosures are made
- No ownership interest in the Covered Fund by the banking entity other than a Permitted Ownership Interest

## II. Exceptions to the “Volcker Rule” Prohibition (cont.)

- Permitted Ownership Interests In the Covered Fund Exception:
  - A seed investment up to one year
  - De minimis longer term investments (not more than 3% of the Covered Fund)

## II. Exceptions to the “Volcker Rule” Prohibition (cont.)

- De minimis Investments in Third-Party Covered Funds
  - Some have speculated that a banking entity could make a De Minimis Investment in a Covered Fund the banking entity did not sponsor or manage
  - Under the wording of the Act, this does not appear to be the case

## II. Exceptions to the “Volcker Rule” Prohibition (cont.)

- Prohibited Transactions
  - Notwithstanding the Covered Fund Exception, no transaction or class of transactions is permitted if:
    - material conflict of interest
    - unsafe/unsound exposure to high risk assets or strategies
    - threaten safety and soundness of the banking entity
    - threaten the financial stability of the United States
  - Left to rulemaking by regulatory agencies

### III. Implementation

- Implementation of the “Volcker Rule” will involve numerous agencies
  - SEC
  - CFTC
  - federal banking agencies
  - Federal Reserve Board (FRB)
  - The Act anticipates coordination among the agencies and adoption of comparable rules
    - The Chair of the FSOC (the Treasury Secretary) is charged with coordinating the regulations

## IV. Timeframe

- 6 Months: Study by FSOC on implementation
- 9 Months After Study: Deadline for agencies to start their implementation
- 2 Years from Act's passage (*i.e.*, July 21, 2012)

-or-

12 Months After Agencies Adopt Rules  
(whichever is earlier) = Effective Date

- 3 – 1 year extensions possible



Potential for Systemic Risk  
Regulation of Private Funds and  
Private Fund Advisers

## I. Potential for Systemic Risk Regulation

- The FSOC is charged with identifying and monitoring systemic risks to the financial markets
- It is composed of 10 voting members:
  - 9 serve *ex officio* as the heads of various government agencies
  - 1 independent member appointed by President
  - The Treasury Secretary is the chairman
- Also includes non-voting members in an advisory capacity, including representatives of state regulators

## I. Potential for Systemic Risk Regulation (cont.)

- FSOC by a two-thirds vote can place a U.S. or non-U.S. “non-bank financial company” under Federal Reserve supervision and registration
  - FSOC must assess whether a “non-bank financial company’s” financial distress could pose a threat to the financial stability of the United States
  - “Non-bank financial company” potentially includes a U.S. or non-U.S. private fund or private fund complex
  - The Act requires the Federal Reserve, in consultation with the FSOC, to craft criteria for exempting certain classes or types of non-bank financial companies from supervision by the Federal Reserve
- The target of such a determination is entitled to notice, the opportunity for a hearing before the FSOC and judicial review of the FSOC systemic risk determination

## I. Potential for Systemic Risk Regulation (cont.)

- Non-bank financial institutions designated by the FSOC will be subject to stringent prudential standards developed by the Federal Reserve in consultant with the FSOC or on its own
- These could include, among other things:
  - Risk-based or contingent capital requirements
  - Leverage limits
  - Liquidity requirements
  - Resolution plan and credit exposure report requirements
  - Concentration limits
  - Enhanced public disclosure requirements
  - Short-term debt limits
  - Overall risk management requirements
- A private fund and its adviser may find it very difficult to operate under such conditions



Other Provisions of Dodd-Frank that  
Will Affect Private Funds and  
Private Fund Advisers

## I. Provisions Focused on Private Funds

- Short selling:
  - The SEC is required to study the state of short selling, with particular attention to the impact of recent rule changes and the incidence of the failure to deliver shares sold short, *i.e.*, “naked” short selling, and to report on within 2 years
  - The SEC is also required to study and report on within 1 year the feasibility, benefits and costs of
    - requiring public reporting of real time short sale positions of publicly listed securities or, alternatively, providing such reports only to the SEC and FINRA, and
    - conducting a voluntary pilot program in which public companies would agree to have trades of their shares marked as “short,” “market maker short,” “buy,” “buy-to-cover” and “long” and reported in real time through the consolidated tape
  - The GAO is required to study the feasibility of forming an SRO to oversee private funds and to issue a report within one year of enactment

## II. General Provisions

- Dodd-Frank provides powerful monetary incentives for individuals who know of a securities violation to contact the SEC and provide assistance in the investigation and prosecution of wrongdoing creates significant new protections for these whistleblowers.
- Dodd-Frank authorizes the SEC to impose fiduciary duties on broker-dealers when they provide "personalized investment advice about securities to a retail customer" after conducting a study.
  - The SEC is empowered to require them to "act in the best interest of the customer without regard to the financial or other interest of the broker-dealer" and to disclose "any material conflicts of interest."
  - There are 3 votes on the Commission to implement this duty, which will impose disclosure requirements on placement agents regarding the compensation that they receive from fund managers

# Questions