Legal Risk Management Tip
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PRACTICAL CONSIDERATIONS FOR PRIVATE FUND MANAGERS IN A CHANGING REGULATORY ENVIRONMENT

It is no secret that the signing of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act") in July 2010 ushered in an unprecedented regulatory regime affecting the entire financial services industry.[1] What is less discussed is how the new legislation will affect individual market participants, particularly advisers to private funds,[2] and what exactly will be required once all provisions of the Act take effect. This article provides practical guidance for fund managers that previously have been exempt from registration as an investment adviser on the registration process and what to expect once under the oversight of the Securities and Exchange Commission ("SEC") or various state regulatory agencies.

Registration as an Investment Adviser: Who, Where, and When

Who Must Register. The Act significantly alters the scope of advisers required to register under the Investment Advisers Act of 1940 (the "Advisers Act") by eliminating the private adviser exemption contained within Section 203(b)(3) on which many advisers to private funds have relied to avoid registration with the SEC.[3] Although the Act provides for several new exemptions from registration,[4] due to the relatively narrow scope of such exemptions, most advisers to private funds that have been relying on the private adviser exemption will be required to register with the SEC or with the states under the registration provisions of the Act.

Where to Register: SEC or State Regulators. Below is a basic and very general synopsis of those advisers and money managers who must register under the Act and with which regulatory authority they must register.

- Advisers to private funds that also manage any separate accounts and have assets under management ("AUM") over $100 million must register with the SEC.[5]
- Private fund advisers that also have separately managed accounts and AUM between $25 million and $100 million must register with state in which the adviser maintains its principal office and

[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111th Cong. (as signed into law by the President, July 21, 2010) [hereinafter Dodd-Frank Act].
[2] "Private Fund" is defined in the Act as an issuer that would be an investment company, but for either Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act of 1940. *Id.* § 402.
[3] *Id.* § 403. The "private adviser exemption" contained in Section 203(b)(3) of the Advisers Act enabled many managers to hedge funds and private equity funds to avoid registration if the manager: (1) had fewer than 15 clients (with each fund counting as a single client) during any 12 month period; (2) did not hold itself out to the public as an investment adviser; and (3) did not serve as an adviser to a registered investment company (i.e. mutual funds). 15 U.S.C. § 80b-3(b)(3).
[4] In broad overview, the new exemptions from federal registration provided by the Act include exemptions for "foreign private advisers," Commodity Trading Advisors registered with the Commodity Futures Trading Commission who advise private funds, advisers solely to "venture capital funds," "mid-sized private fund advisers," and "family offices." *See* Dodd-Frank Act §§ 403, 407-409.
[5] Dodd-Frank Act § 410.

place of business, if the adviser is required to be registered in its home state and if registered, would be subject to examination.[6]

- Advisers whose only clients are private funds must register with the SEC if such advisers have AUM of more than $150 million.[7]
- Advisers with AUM of less than $25 million or who are otherwise exempt from SEC registration must register with (or claim an exemption from registration in) the state(s) in which the adviser has a place of business or more than 5 clients.
- Non-U.S. advisers with any separate accounts, or with fund assets over $150 million, must register with the SEC *unless* the adviser has (1) no place of business in the U.S.; (2) less than $25 million in AUM from U.S. clients and U.S. fund investors; (3) fewer than 15 U.S. clients and fund investors; and (4) does not hold itself out to the public as an adviser.[8]
- "Family offices" and advisers solely to "venture capital funds" (both terms to be defined by the SEC) are exempt from SEC registration.[9]

When to Register. Most of the provisions of the Act are set to take effect one year after enactment, which means that all advisers required to be registered under the Act must do so by July 21, 2011.[10] Advisers may, however, register prior to that date subject to SEC rules and guidance to be released prior to the effective date of the registration provisions.[11]

Reporting and Recordkeeping Fundamentals

Required Records and Reports to Maintain. Section 404 of the Act provides the SEC with the authority to require private fund advisers to maintain records, file reports, and upon request or examination, produce records regarding those private funds. The Act requires registered advisers to private funds to maintain certain records pertaining to the private funds managed by the adviser and that such records will be treated as the adviser's own records and must be available for inspection by the SEC.[12] Such records must include a description of:

- amount of 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 whereby certain investors obtain more favorable rights than other investors;
- trading practices; and

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[6] *Id.* Note that because the new minimum AUM threshold of $100 million is drafted to apply only to an adviser that otherwise would be subject to registration in its home state, if such an adviser is exempt under state law (or if its home state does not require registration or subject advisers to examination), the adviser would be required to register with the SEC.

[7] *Id.* § 408. As a practical matter, the scope and utility of this "Mid-Sized Private Fund Adviser Exemption" is relatively vague, since such advisers are still subject to the recordkeeping requirements of the Act and the SEC is given the authority to require registration and examination of advisers to mid-sized private funds taking into account "the size, governance, and investment strategy of such funds to determine whether they pose systemic risk." *Id.*

[8] *Id.* § 403.

[9] *Id.* §§ 407, 409.

[10] *Id.* § 419.

[11] *Id.*

[12] *Id.* § 404.

- such other information as the SEC (in consultation with the newly created Financial Stability Oversight Council (the "FSOC")) determines is necessary and appropriate in the public interest and for the protection of investors or for the assessment of systemic risk.[13]

Why Records Must Be Maintained and Produced. The SEC must make available to the FSOC, an inter-agency body created under the Act to identify and monitor systemic risks to the financial markets,[14] copies of all "reports, documents, records, and information filed with or provided to the SEC by an investment adviser" regarding a private fund as the FSOC considers necessary for assessing systemic risk.[15] Although the Act contains provisions for protecting the confidentiality of certain information pertaining an adviser's clients and any proprietary information ascertained by the SEC as a result of reports required to be filed by private fund advisers, concerns remain as to the effect of inadvertent leaks of such information, especially that information which will be shared among multiple regulators.

Duration of Private Fund Record Retention. The Act provides the SEC with rulemaking authority to determine the period for which these records must be maintained "as necessary and appropriate in the public interest and for the protection of investors, or for the assessment of systemic risk."[16] Unfortunately, this means that the information regarding private funds could potentially be subject to different holding periods than the existing retention requirements of the Advisers Act, which could complicate matters for advisers that manage private funds in addition to other types of accounts.

Other Compliance Considerations

Compliance and Disclosure Obligations. Advisers to private funds that will be required to register with the SEC will be subject to, among other requirements, Rule 206(4)-7 under the Advisers Act (the "Compliance Program Rule"). Rule 206(4)-7 imposes various obligations on SEC-registered advisers, including: designating of a Chief Compliance Officer; having written policies and procedures that are reasonably designed to prevent violations of the federal securities laws; and performing annual reviews and testing of such policies and procedures.[17] Additionally, advisers registered or required to be registered under the Advisers Act must prepare and deliver to clients a written disclosure statement containing the information required by Form ADV Part 2. Notably, Form ADV Part 2 (referred to as the "Firm Brochure") has been recently revised by the SEC to require detailed disclosures on Part 2A of the adviser's business practices, investment strategies, fees, conflicts of interest, and more in a narrative, plain English format.[18] Although the instructions to the revised Part 2A provide that the Firm Brochure need not be delivered to clients that are SEC-registered investment companies,[19] no mention is made as to whether and to what extent the delivery requirements apply to private funds, or how private fund advisers may meet the delivery requirements of the firm brochure. More specific guidance on this and other matters is expected from the SEC prior to the effective date of the registration requirements imposed by the Act.

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[13] *Id.*
[14] *Id.* § 112.
[15] *Id.* § 404.
[16] *Id.*
[17] Compliance Procedures and Practices, 17 C.F.R. § 275.206(4)-7 (2010).
[18] Amendments to Form ADV, Advisers Act Release No. 3060, 75 Fed. Reg. 49,234 (August 12, 2010), *available at* http://sec.gov/rules/final/2010/ia-3060fr.pdf.
[19] *See* INSTRUCTIONS TO PART 2A OF FORM ADV: PREPARING YOUR FIRM BROCHURE 1 (2010), *reprinted in* Amendments to Form ADV, Advisers Act Release No. 3060, 75 Fed. Reg. 49,234 app. C at 49,289 (August 12, 2010).

Additional Custody Requirements. The SEC recently amended Rule 206(4)-2 under the Advisers Act (the "Custody Rule") governing the treatment by registered investment advisers deemed to have custody of client funds or securities.[20] The amended Custody Rule imposes various obligations on advisers with custody, including the obligation to undergo an annual surprise examination by an independent public accountant and the requirement that advisers have a reasonable basis, after due inquiry, for believing that the qualified custodian maintaining such funds or securities sends an account statement, at least quarterly, to each client (or to each investor in a limited partnership or other pooled investment vehicle), identifying the funds and securities held in the account and setting forth all transactions in the account during that period.[21] The amended Custody Rule provides that the custodial account statement delivery requirement does not apply and the independent verification provision of the Custody Rule will be deemed to have been satisfied with respect to a limited partnership, limited liability company, or other pooled investment vehicle that: (1) is subject to an annual audit by an independent public accountant that is registered with, and subject to inspection by, the Public Company Accounting Oversight Board ("PCAOB"); (2) its audited financial statements are prepared in accordance with generally accepted accounting principles and are distributed to all limited partners (or members or other beneficial owners) within 120 days of the end of its fiscal year; and (3) upon liquidation such audited financial statements are distributed promptly after completion of the audit.[22]

Importantly, and perhaps indicative of the significance placed on safeguarding client assets over which an adviser has custody, the Dodd-Frank Reform Act creates a new Section 223 of the Advisers Act that requires investment advisers to "take such steps to safeguard client assets over which such adviser has custody, including, without limitation, verification of such assets by an independent public accountant, as the [SEC] may, by rule, prescribe."[23] This opens the door for the adoption of additional custody requirements by the SEC, and although the full impacts of the latest revisions to the Custody Rule have yet to be seen, further revisions are possible that may have a significant impact on advisers to private funds required to register by virtue of the new legislation.

Should you have any questions or require assistance with the registration, reporting or compliance processes, please do not hesitate to contact us at (619) 298-2880 or e-mail info@jackolg.com.

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[20] Custody of Funds or Securities of Clients by Investment Advisers, 17 C.F.R. § 275. 206(4)-2 (2010).
[21] *Id.* § 275. 206(4)-2(a).
[22] *Id.* § 275. 206(4)-2(b)(4). For additional information on the amendments to the Custody Rule, see the January 2010 JLG Legal Tip available at http://www.jackolg.com/CM/Custom/Legal-Risk-Management-Tip-January-2010.pdf.
[23] Dodd-Frank Act § 411.