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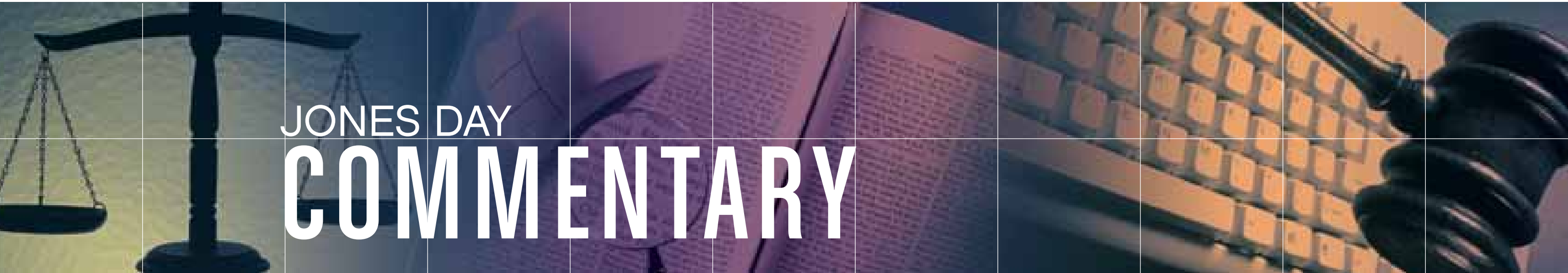

THE WALL STREET REFORM ACT: ITS IMPACT ON ADVISERS TO PRIVATE FUNDS

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Wall Street Reform Act") was formally signed into law on July 21, 2010. Two of its key aspects, the "Adviser Registration Act" and the "Volcker Rule," significantly change the landscape for investment advisers and fund mangers by now requiring many of them to register with the Securities and Exchange Commission (the "SEC") and by limiting the involvement of "banking entities" in the ownership and management of hedge funds and private equity funds.

THE ADVISER REGISTRATION ACT

The Adviser Registration Act broadly expands the requirement for investment advisers to register pursuant to the U.S. Investment Advisers Act of 1940 ("Advisers Act"). The Adviser Registration Act will affect many investment advisers to hedge funds, private equity funds, and real estate funds, but it will generally not apply to family offices or to investment advisers to venture capital funds and small business investment companies that meet SEC regulatory requirements. In effect, the Adviser Registration Act will, absent any of the specific exclusions or exceptions discussed below, require any investment adviser with more than $100 million of assets under management, and any investment adviser to one or more private funds (funds relying on the exemptions under Section 3(c)(1) or 3(c)(7) of the U.S. Investment Company Act of 1940) with more than $150 million of assets, to register with the SEC and become subject to new reporting and recordkeeping requirements as discussed below. Investment advisers (other than certain foreign-based investment advisers) falling below these thresholds will generally be required to register in the state where they maintain their principal place of business.

Elimination of the Private Adviser Exemption. Investment advisers to private funds have historically relied upon the exemption from SEC registration found in Section 203(b)(3) of the Advisers Act (the "Private Adviser Exemption"). The Private Adviser

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Exemption has generally been available to any investment adviser that (i) did not hold itself out to the public as an investment adviser, (ii) had fewer than 15 clients during the preceding 12 month period, and (iii) was not an adviser to a registered investment company. Pursuant to the Private Adviser Exemption and related SEC Rules, a private fund has traditionally been viewed and counted as a single client, even though the fund may have 15 or more investors. Therefore, many advisers to hedge funds, private equity funds, real estate funds, and the like were able to avoid registration, and thus were not subject to most of the rules and regulations applicable to advisers with more than 15 separately managed accounts or to mutual funds and similar pooled investment vehicles typically marketed and sold to the general public. Under the Adviser Registration Act, the Private Adviser Exemption is simply eliminated for U.S.-based investment advisers.

Exclusions and Exemptions. The Adviser Registration Act provides a limited number of exclusions and exemptions from SEC registration for certain investment advisers.

Advisers To Private Funds With Less Than $150 Million of Assets Under Management. The Adviser Registration Act directs the SEC to exempt from registration advisers that provide advice solely to private funds that have less than $150 million of assets under management. However, while investment advisers to private funds with less than $150 million of assets under management may avoid traditional Advisers Act registration, as discussed below, the SEC will, pursuant to the Adviser Registration Act, impose certain new recordkeeping and reporting requirements on those investment advisers.

Venture Capital Funds. Investment advisers that advise solely one or more venture capital funds (as to be later defined by the SEC) will be exempt from registration, but the Adviser Registration Act provides that the SEC shall require those advisers to maintain records and file reports as the SEC determines appropriate.

Small Business Investment Companies. Investment advisers solely to one or more small business investment companies operating pursuant to the U.S. Small Business Investment Act of 1958 will be exempt from investment adviser registration requirements.

Family Offices. The Adviser Registration Act generally exempts family offices from the definition of "investment adviser" and thus any registration or reporting requirements under the Advisers Act. The SEC is left with the task of defining "family office" based upon current exemptive orders and in consideration of the various organizational, management, and employment structures and arrangements used by different family offices.

Foreign Advisers. The Adviser Registration Act provides an exemption for non U.S. investment advisers, but the exemption is very limited and would apply only if the non U.S. investment adviser:

- Has no place of business in the United States;
- Has fewer than 15 U.S. clients and/or investors in private funds it advises;
- Has aggregate assets under management attributable to U.S. clients and investors of less than $25 million (or such higher amount determined by the SEC);
- Does not hold itself out generally to the public in the United States as an investment adviser; and
- Is not an investment adviser to a registered investment company.

Given the very narrow band of non-U.S. investment advisers that might qualify for this exemption, the Adviser Registration Act significantly expands the extraterritorial reach of the Advisers Act. These provisions will likely require non U.S. investment advisers to register with the SEC if they access U.S. investors for their private funds in any meaningful way.

New Records and Reports for Private Funds. The Adviser Registration Act gives the SEC broad authority to require any investment adviser registered under the Advisers Act to maintain records of, and file reports with the SEC, regarding private funds. In addition to other recordkeeping requirements under the Advisers Act, the Adviser Registration Act requires investment advisers of private funds to maintain for each fund a description of:

- The amount of assets under management;
- The 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 and side letters;
- Trading practices; and
- Such other information as the SEC determines is in the public interest and for the protection of investors or for the assessment of systemic risk.

The SEC may vary the types of reports and records it requires based on the size or type of the fund being advised, may prescribe different time periods during which this information must be maintained and filed, and must share the information with the Financial Stability Oversight Council (the "Oversight Council") to the extent requested. The SEC is required to conduct periodic inspections of the records maintained by a registered investment adviser to a fund and may conduct other reviews at any time, although there is no specific mandate as to the frequency of these reviews.

Private fund information provided to the SEC and the Oversight Council will be exempt from disclosure under the Freedom of Information Act and will be afforded certain limited confidentiality, but nevertheless may be disclosed to Congress, federal agencies, self-regulatory organizations, and/or in judicial proceedings brought by the SEC or the U.S. government. Such other recipients will be bound by the same level of confidentiality established for the SEC and the Oversight Council.

The Adviser Registration Act provides special confidentiality protection for "proprietary information of an investment adviser" with respect to research models and methodologies, trading strategies, trading data, computer hardware and software containing intellectual property, and any other information the SEC determines to be proprietary. While Section 210(c) of the Advisers Act has traditionally prohibited the disclosure of client information other than in connection with an SEC enforcement action, the Adviser Registration Act now permits the disclosure of the identity, investments, or affairs of a client to the SEC and Oversight Council "for purposes of assessment of systemic risk."

Custody of Client Assets. The Adviser Registration Act amends the Advisers Act to authorize the SEC by regulation to require registered investment advisers with custody over client assets to engage an independent public accountant to verify such assets.

Adjustment of Investor Standards. Under the Adviser Registration Act, the "accredited investor" net worth standard will be fixed for the next four years at $1 million for a natural person (either individually or jointly with spouse), but will now *exclude* the net worth of such person's primary residence. The new accredited investor threshold became effective immediately and may be modified by the SEC after the initial four-year period. Similarly, the Adviser Registration Act requires the SEC to adjust for inflation the net worth standard for "qualified clients" permitted to pay performance-based fees, incentive allocations, and carried interest distributions to registered investment advisers pursuant to Rule 205-3 of the Advisers Act. While the current net worth threshold of $1.5 million remains in place for the moment, the SEC has one year to adjust the threshold, and then do so for inflation every five years thereafter.

Transition. Except for the new accredited investor standard, which is already effective as noted above, the remainder of the Adviser Registration Act will take effect one year from the date of enactment. While investment advisers subject to the new rules may register at any time, they must be registered and/or meet the new recordkeeping and disclosure requirements by July 2011.

THE VOLCKER RULE

The Wall Street Reform Act also adopted what has become known as the "Volcker Rule," named after Paul Volcker, the former Federal Reserve Chairman and current Chairman of the President's Economic Recovery Advisory Board. The Volcker Rule will become new Section 13 of the Bank Holding Company Act (the "BHC Act") and will, subject to certain exceptions and under certain conditions, prohibit any "banking entity" from:

- Engaging in proprietary trading of any debt or equity security, futures contract, option, derivative, or other financial instrument that may be determined by rule; and
- Acquiring or retaining any equity, partnership, or other ownership interest in or controlling or sponsoring a hedge

fund or private equity fund, including acting as a general partner, managing member, or trustee of a fund; selecting or controlling a majority of the employees, officers, or directors of a fund; or sharing the same name (or variation thereof) with a fund for marketing purposes.

"Banking entities" are broadly defined to include FDIC-insured institutions and their holding companies, foreign-controlled entities treated as bank holding companies under Section 8 of the International Banking Act of 1978, and any of their affiliates or subsidiaries. Similar limitations will be imposed on U.S. and foreign "non-bank financial companies" supervised by the Federal Reserve.

Permitted Proprietary Trading Activities. Certain activities are deemed "permitted activities" to the extent not in conflict with other provisions of federal or state law. These include:

- The purchase or sale of federal, state, and other government obligations;
- The purchase or sale of securities in connection with underwriting or market-making activities on behalf of customers;
- Hedging activities designed to reduce risk in connection with individual or aggregate positions, contracts, or other holdings;
- Investments in "small business investment companies";
- The purchase or sale of securities by a regulated insurance company; and
- Proprietary trading conducted by a foreign banking entity as long as the trading occurs solely outside the United States and the banking entity is not controlled by a banking entity organized within the United States.

All permitted activities under Section 13(d)(1) are subject to limitations and rules to be adopted by the appropriate federal banking agencies, the SEC, and/or the CFTC.

Permitted Private Equity and Hedge Funds Activities. A banking entity is permitted to organize and offer private equity funds and hedge funds, and it may serve as a general partner, managing member, or trustee of such funds; select a majority or controlling group of employees, officers, directors, or agents of such funds; and pay expenses of those funds, *provided that* it does so only for customers of the banking entity and under the following conditions:

- The banking entity provides *bona fide* trust, fiduciary, or advisory services;
- The fund is organized and offered only in connection with the provision of such *bona fide* trust, fiduciary, or advisory services and only to persons that are customers of such services of the banking entity;
- The banking entity does not acquire or retain more than a *de minimis* ownership interest in the fund;
- The banking entity does not guarantee, assume, or otherwise ensure the obligations or performance of the fund;
- The banking entity and the fund do not share the same name (or variation thereof);
- No director or employee of the banking entity has an ownership interest in the fund, except for persons who are directly engaged in providing advisory or other services to the fund;
- The banking entity discloses to investors that any losses of the fund are borne solely by the investors and not by the banking entity; and
- The fund complies with any additional rules of the federal banking agencies, the SEC, or the CFTC designed to ensure that losses in such funds are borne solely by investors in the fund and not by the banking entity.

Investment Limitations. A banking entity may provide "seed" capital to a fund that it sponsors or advises, but must, not later than one year after the date that the fund is established, reduce its equity ownership to 3 percent or less. In no case may the aggregate of all interests the banking entity has in private equity and hedge funds exceed 3 percent of its Tier 1 capital.

Permissible Services and Limitations on Relationships with Funds. Banking entities that meet the requirements of the Volcker Rule and serve as an investment manager or sponsor of a fund may not enter into any "covered transactions" with the fund, as defined in Section 23A of the Federal Reserve Act. This will limit the ability of banking entities to make loans, extend credit, or provide guarantees on behalf of their funds, or to purchase fund assets or securities. The Federal Reserve may grant exceptions to permit a banking entity to serve as a prime broker for its own fund as long as certain conditions are met. Banking entities will also be subject to the restrictions of Section 23B of the Federal Reserve Act, which require that any transactions with their managed or advised funds occur on arm's length terms.

Effective Dates. The Volcker Rule becomes effective on the earlier of (i) 12 months after the issuance of final rules, or (ii) two years after the date of enactment. Once effective, banking entities will have two additional years to comply (with the possibility of up to three one-year extensions). A banking entity may request an extension of up to five years if necessary to comply with any contractual obligations in place as of May 1, 2010, or to make or retain an investment in an illiquid fund.

Rulemaking. The Volcker Rule and Section 13 of the BHC Act will require substantial rulemaking by the federal banking agencies, the SEC, and the CFTC, all of which are mandated to study its provisions and adopt rules on a coordinated basis. Much of the ultimate impact will be determined by these studies and related rulemaking efforts.

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