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Registration Requirements for Private Fund Managers: Compliance Under the Dodd-Frank Act

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Topics to be Covered

- New Registration Requirements
- The Registration Process
- Compliance Plan for New Registrants
- Effects of Registration on Private Fund Advisers
- Other Dodd Frank provisions affecting Investment Advisers

The Dodd-Frank Act

- Dramatic impact on the registration, recordkeeping and reporting requirements for advisers
- Changes “accredited investor” and “qualified client” investor standards
- Limits banking entities ability to sponsor or invest in certain private funds
- Creates a new “systemic risk” regime
- Will require 315 rulemakings and 145 studies by regulators

Private Investment Advisers Registration Act of 2010 (the "Registration Act")

- Signed into law on July 21, 2010
- Expands and contracts the potential universe of types of investment advisers subject to registration with the Securities and Exchange Commission (the "SEC")
  - eliminates the "private adviser exemption"
  - raises the threshold for SEC registration from $25 million in assets under management to $100 million in assets under management

Adviser Registration Requirements

Current Requirement:

All "investment advisers" with assets under management of $30 million or more are required to register with the SEC, unless they qualify for an exemption

Registration Act:

All "investment advisers" with assets under management of $100 million or more are required to register with the SEC, unless they qualify for an exemption

Consequences to Mid-Size Investment Advisers

- Advisers with AUM of between $25 million and $100 million that are required to be registered in their home states and, if registered, would be subject to examination) are precluded from registering with the SEC under the Registration Act, except:
  - Advisers that advise business development companies or SEC registered investment companies, and
  - Advisers that would be required, under the Registration Act, to register with 15 or more states.

Exemptions and Exceptions from Registration – Private Adviser Exemption

Current Private Adviser Exemption:

The private adviser exemption enabled an investment adviser to avoid SEC registration if it:

- did not act as an investment adviser to a registered investment company or business development company;
- had fewer than 15 clients (counting each fund as 1 client); and
- did not "hold itself out" to the public as an investment adviser

Registration Act:

The private adviser exemption will be **eliminated** as of July 21, 2011

Registration Act Exemptions from Registration—Foreign Private Advisers

Registration Act:

A non-US private adviser is exempt from registration if:

1. has no place of business in the US;
2. has fewer than 15 clients and investors in the US in private funds advised by the adviser;
3. has less than $25 million of asset under management attributable to clients in the US and investors in the US in private funds advised by the adviser; and
4. does not hold itself out generally to the public in the US as an investment adviser and does not advise business development companies or SEC-registered investment companies.

Registration Act Exemptions from Registration—Private Fund and Venture Capital Fund Exemptions

- **Private Fund Adviser Exemption** - Advisers that advise solely private funds and have less than $150 million of assets under management in the U.S.
- **Venture Capital Fund Adviser Exemption**- Advisers that advise solely "venture capital funds" (to be defined)

Records and Reports - Both types of advisers above are still required to keep such records and provide to the SEC such reports as the SEC determines necessary or appropriate in the public interest or for the protection of investors

Registration Act Exemptions from Registration—Other Exemptions and Exceptions

- **CTA Exemption** - Advisers registered with the CFTC as commodity trading advisors
- **SBIC Adviser Exemption** - Advisers to small-business investment companies
- **Intrastate Exemption** - Intrastate advisers that do not advise private funds
- **Family Office Exception** - (to be defined, under certain guidelines)

Registration Act – Additional Reporting

- Additional Disclosure: The Registration Act authorizes the SEC to promulgate rules requiring disclosures by registered investment advisers to the SEC, including information about:
  - amount of assets under management;
  - the use of leverage (including off-balance sheet leverage);
  - Counterparty credit risk exposure;
  - trading and investment positions; and
  - trading practices
- SEC Rulemaking Authority: enhanced rulemaking authority to define terms used in the IAA

Registration Act: Effective Dates

- July 21, 2011: Most provisions of the Registration Act become effective, including the elimination of the private adviser exemption, as well as the exemptions from registration under the Registration Act listed above.
- Between July 21, 2011, and July 21, 2013: the studies to be undertaken under the Registration Act must be completed.
- Currently no effective date (subject to SEC rulemaking):
  - the definition of a family office;
  - additional recordkeeping and reporting requirements;
  - Private fund exemption (< $150 million)
  - recordkeeping and reporting requirements for investment advisers that advise VC funds.
- SEC Timeline: http://sec.gov/spotlight/dodd-frank.shtml

Investment Adviser Registration

How to Register

- Fill out Form ADV
- File Part 1
- Hold Part II (File Part 2 after 1/1/10)
- Wait for SEC order

- IARD online registration
  - Register with the IARD
  - Fund account (SEC fees; state fees)
- Log on to complete and submit all filings
- SEC approval will be granted or denied within 45 days
- *Adviser must be fully compliant upon the date of registration*

Form ADV – Part I

- Basic identifying information
- Basis for registration
- Number of employees
- Number of clients
- Types of clients (e.g., individuals, funds, charities)
- Compensation arrangements
- Assets under management
- Types of advisory activities
- Types of non-advisory activities (*e.g., broker*)
- Financial industry affiliations
- Conflicts of interest
- Soft dollars
- Custody
- Identification of control persons
- Prior bad acts
- Private funds
- Affiliated advisers
- Websites (if any)

Form ADV – Part II

- Description of Advisory Services
- Types of Clients
- Types of Investments and Products
- Fees
- Methods of Analysis
- Biographies
- Conflicts of Interests
- Code of Ethics
- Proxy Voting
- Allocation and Trading Disclosure
- Best Execution and Soft Dollar Disclosure
- Privacy Policy
- *Proposed legislation suggests that additional disclosures regarding funds and fund advisers may be required*

State Notice Filing

- State registration requirements for SEC registered investment advisers (requirements differ from state to state):
- Notice Filing - in each state where the adviser has an office and a certain number of clients (numbers vary – but must be at least 6) who are residents of the state.
- Register “investment adviser representatives" - for any representatives of the adviser who annually meet or communicate with more than 10 clients (who fall below certain financial standards) in their offices in such states. Exams may be required.
- Register “investment adviser representatives" - in a state where third party solicitors who have an office in the state and solicit state residents (numbers vary) for the adviser. Exams may be required.

State Registration

- Differs by state
- Same process using IARD
- Additional state questions in Part 1 of the Form ADV
- Some states require filing of Part II now (before the filing implementation date of the new Part 2
- Some states have additional custody and net capital requirements
- Some states require adviser representative examinations
- Not all IAA provisions will apply

Differences in Regulation

Advisers Act Provision	Topic	Unregistered Advisers?
Rule 204-2	Books and Records	No
Rule 204-3	Brochure Delivery	No (but 206)
Section 204A	Insider Trading Procedures	Yes (not state)
Section 205	Contracts	No (but 206)
Rule 205-3	Performance Fees	No (but 206)
Section 206(1)	Fraud	Yes
Section 206(2)	Fraud	Yes
Section 206(3)	Principal/Agency Transactions	Yes
Rule 206(4)-2	Custody	No
Rule 206(4)-3	Solicitor Rule	No (but 206)
Rule 206(4)-4	Disclosure of Adviser Financial and Disciplinary Matters	No (but 206)
Rule 206(4)-6	Proxy Voting	No (but 206)
Rule 206(4)-7	Compliance Officer and written Compliance Procedures	No
Rule 206(4)-8	Anti-Fraud (applicable to investors in the fund)	Yes

Registration Action Plan

Action Plan for Investment Advisers Preparing for Registration

- Preliminary Steps:
  - Review business of the adviser and determine how registration will affect daily operations (disclosure of conflicts, books and records, performance fees, custody, advisory contracts, etc.)
  - Designate CCO
  - Set up account with Investment Adviser Registration Depository ("IARD")
- Implementation:
  - Prepare and implement Compliance Policies and Procedures and Code of Ethics
  - CCO implements Compliance Program
- Registration:
  - Prepare Form ADV Part I and submit to the SEC through IARD
  - Prepare Form ADV Part II (The new Part 2 would be completed and filed for registration after January 1, 2011)

What effect will registration have on private fund advisers?

Investment Advisers Act Rule 206(4)-7

- Adopt and Implement Policies and Procedures
- Designate a Chief Compliance Officer
- Recordkeeping
- Annual Review

SEC Suggested Policies and Procedures

- **Portfolio Management Process** (including allocation of investment opportunities among clients and consistency of portfolios with clients' investment objectives, disclosures by the Adviser and applicable regulatory restrictions);
- **Trading Practices** (including procedures by which the Adviser satisfies its best execution obligation, uses client brokerage to obtain research and other services ("soft dollar arrangements") and allocates aggregated trades among clients);
- **Proprietary Trading** of the Adviser and Personal Trading Activities of Supervised Persons;
- **Accuracy of Disclosures** made to investors, clients and regulators, including account statements and advertisements;
- **Safeguarding of Client Assets** from conversion or inappropriate use by advisory personnel;
- **Books and Records** (The accurate creation of required records and their maintenance in a manner that secures them from unauthorized alteration or use and protects them from untimely destruction);
- **Marketing** advisory services, including the use of solicitors;
- **Valuation** (Processes to value client holdings and assess fees based on those valuations);
- **Safeguards for Privacy** Protection of client records and information; and
- **Business Continuity Plans.**

Additional Policies that may Apply

- Anti-Money Laundering
- Private Placement
- Supervision of Service Providers (administrators, accountants, etc.)
- Anti-bribery and Foreign Corrupt Practices Act
- Regulatory Filings (including 13D, 13G and 13F)

Compliance Manuals

Each policy in the compliance manuals should address the following:

- Identify risks policy addresses.
- Detect, address and prevent violations.
- Designate who will implement the policies.
- Designate who will supervise the policies.
- Designate who will monitor the policies.
- How will the policies be tested?
- How often will the policies be tested?
- Who will test the policies?
- How will the policies be documented?
- Who will be responsible for amending the policies?
- How will policy compliance be documented?
- What other policies does this policy affect this policy?
- What disclosures should be aligned with this policy?

Building a Culture of Compliance

- "Tone at the Top" – Senior management must play an active leadership role in compliance
- Participation and consistency at every level of management
- Communication to and from employees – compliance is everyone's responsibility
- Everyone must be knowledgeable about the compliance program including why the policies are in place and what risks they are meant to address
- Empower the Chief Compliance Officer
- Implementation and training
- Documentation and transparency – "If it isn't written down, it didn't happen"
- Reviews and audits
- Consistent sanctions and rewards

The Chief Compliance Officer

- Sufficient knowledge about the company and the Investment Advisers Act
- Seniority and authorityto implement the procedures
- Sufficient resources to effectively implement and enforce the policies
- Sufficiently independent:
    - Who does the CCO report to?
    - Does the CCO have a financial interest in the company?
    - How is the CCO's salary determined?
    - Does the CCO have other roles in the company?
    - Does the CCO have other conflicts of interest?

Advisory Agreements

- No Assignment without Client Consent
- Fee Disclosure
- No Hedge Clauses – no waiver of rights against the adviser
- Termination
- ADV Delivery (48 hrs. prior or termination right within 5 business days – until 1/1/10)
- Investment Guidelines
- Disclosures: Privacy, Proxy Guidelines, Code of Ethics and Conflicts of Interest
  (§ 205 and Rule 205-3)

Allocation of Trades

- **Formula Required - Fair and Equitable.**
  - No specified methodology (SEC favors objective, mechanical criteria over subjective methodologies).
    - **Pro rata** – based on account size.
    - **Rotational** – clients are provided fair access to opportunities over a reasonable period.
    - **Percentage Allocation** – based on a stated percentage interest client is to receive in issuer (based on market value of client's account).
- **Deviations from formula for:**
  - De minimus reallocations.
  - Priority to clients of the portfolio manager who located opportunity.
  - Client/investment objective differences.
- **Self-Dealing**
  - Offer to client first.
  - Disclosure.
  - Disinterested consent.
- **Favoring Certain Clients**
  - Several SEC proceedings.
  - Disclosure.

Allocation of Trades

- Bunching of Client Orders:
  - Not required.
  - Disclosure.
  - Aggregation (Bunching) and Affiliates.
- Benefiting one client at the expense of another:
  - Contra trades.
  - Different timing (selling or buying ahead).
  - Short sales.

Portfolio Management

- Principal and Agency Cross Transactions
- Process for Identifying and Approving Transactions
- Trade Error Procedures
- Investment Guidelines and Restrictions
- Portfolio Pumping and Window Dressing

Best Execution Defined

- An adviser's obligation to obtain best execution has been defined by the SEC as "to execute securities transactions for clients in such a manner that the clients' total costs or proceeds in each transaction is the most favorable under the circumstances."
- Advisers, as fiduciaries, have an obligation to seek best execution of clients' transactions.
- Soft dollars

Evaluating Best Execution – Factors

- Best execution committee should periodically and systematically review best execution determinations and approve brokers and other service providers.
- Best execution can be based upon a variety of factors, including among others:
  - The value of the research provided (soft dollar arrangements)
  - Execution capability
  - Commission rates
  - Financial responsibility
  - Responsiveness
  - Reputation and Integrity
  - Facilities
  - Financial Services Offered
  - Willingness and ability to commit capital
  - Access to underwriting offerings and secondary markets
  - Reliability in executing trades and keeping records
  - Fairness in resolving disputes The timing and size of particular orders
  - Available liquidity
  - Current market conditions
  - Trading Experience

Code of Ethics

- Rule 204A-1 (Compliance Date February 1, 2005)
- Standards of Conduct
- Require advisory personnel to comply with applicable U.S. Securities Laws
- Provisions designed to prevent the disclosure of inside information (recommendations, holdings, transactions)
- “Access Persons” must report personal securities holdings
- Pre-clearance of IPOs and private placements
- Require Advisory personnel to report violations of the Code
- Signed Acknowledgements
- Provide Code of Ethics to clients upon request

The Custody Rule

- Client assets over which an investment adviser has custody must be held by a "qualified custodian" (e.g., a registered broker-dealer).
- Clients need to be given certain information about the custodian (i.e., name, address and the manner in which the assets are held).
- Clients must receive account statements either from the custodian or from the adviser. If sent by the adviser, there must also be a surprise audit by an independent accountant.

Custody and Private Investment Funds

- General partner, managing members and others who have access to the assets of the private investment funds they operate are deemed to have custody, and thus must comply with the revised Custody Rule.
- If a private investment fund's assets are maintained with a qualified custodian and the fund is audited at least annually and audited financial statements are provided to investors within 120 days of the end of the fund's fiscal year, (180 days for fund of funds) there is no need for the custodian or adviser to provide periodic account statements to the investors.
- If the audit approach is not followed or the adviser otherwsie has custody, surprise audits are required

Proxy Voting – Rule 206(4)-6

- Fiduciary Duty to vote proxies in the best interests of clients
  - Adopt and implement written policies and procedures for voting proxies (Identify and resolve conflicts of interest)
  - Describe proxy voting policies and procedures to clients and provide a copy to clients upon request
  - Disclose to clients how they may obtain information about how the adviser voted
- Exceptions (foreign securities)
- ERISA

Privacy Rules and Regulations for Investment Advisers

- Under the Gramm-Leach-Bliley Act, the SEC adopted regulations which require:
- Establish a Privacy Policy - All regulated institutions must clearly, conspicuously, and annually disclose their policies for collecting and sharing customers' nonpublic, personal information. Such policies should describe:
  - information that is collected;
  - information that is disclosed to affiliates and non-affiliated third parties; and,
  - persons within the financial institution who receive such information;
  - how the information of former customers is shared;
  - procedures to protect the security and confidentiality of information; and,
  - disclosures required by the Fair Credit Reporting Act.

Privacy Rules and Regulations for Investment Advisers

- Delivery of Privacy Policy - This notification—written or electronic—must be provided to:
  - "Consumers" (those who do not have an ongoing relationship with the firm, as customers do), with certain exceptions, before this information is shared with non-affiliated third parties; and
  - "Customers" when they establish a relationship with a financial institution and annually thereafter.
- Provide an Opportunity to "opt out" - Both consumers and customers must be given notice of procedures and a reasonable means to prevent their financial institutions from transferring their nonpublic, personal information to a nonaffiliated third party.
- Establish prohibitions on account information disclosures - All financial institutions may not disclose account numbers for credit card, deposit, or transaction accounts to any non-affiliated third parties for use in phone, mail, and email marketing.
- Administrative, technical and physical safeguards

Definition of an "Advertisement"

- An "Advertisement" includes
  - any written communication addressed to more than one person;
  - any notice or announcement in any publication, or by radio or television which offers any analysis, report, or publication regarding securities; or
  - any graph, chart, formula or other device for making securities decisions, or any other investment advisory services regarding securities.

Advertising Rules

- Testimonials
- Past Specific Recommendations
- Graphs, Charts, Formulas, and other Devices
- Presentation of Performance Information*
- Actual and Model Results
- Calculating Composites
- Manner of Selection of Accounts
- No Untrue Statements of Material Facts or Statements that are otherwise False or Misleading
- Disclosure of all Material Information

Books and Records – Rule 204-2

- In general, under the Advisers Act all required books and records must be maintained and preserved in the adviser's office for two years after the last entry date and three additional years in an easily accessible place
- Records for performance must include background and calculations and must be retained for 5 years after the date of last use (grandfathering for new registrants?)
- The fund's records are considered to be part of the adviser's records
- No specific format required, but electronic records must be preserved to prevent alteration or destructions

Books and Records

- Business Accounting Records
  - Journals and ledgers.
  - Order and trade tickets.
  - Bank statements and checks.
  - Bills and statements.
  - Balance sheets and financial statements.
  - Custodial records, if applicable.
- Adviser Related Records
  - Communications to and from clients.
  - Advisory agreements (and all other advisory-related agreements).
  - Adviser's publications and recommendations.
  - Adviser advertisements (with basis for advertising performance).
  - Personal and proprietary security transaction records
  - Retain records.

Anti-Money Laundering – Legal Provisions Applicable to Investment Advisers

- Statutes
  - International Money Laundering Abatement and Anti-terrorist Financing Act of 2001 (Title III of U.S.A. Patriot Act, Public Law 107-56).
  - Bank Secrecy Act (31 U.S.C. §5311-5355 (Chapter 53)) (as amended by Title III of USA Patriot Act).
  - Federal Criminal Money Laundering Statutes (18 U.S.C. 1956-1957).
- Regulations:
  - USA Patriot Act Regulations - Final, Interim and Proposed:
    - Financial Crimes Enforcement Network; Anti-Money Laundering Programs for Unregistered Investment Companies, 31 CFR Part 103 (Proposed Rule).
- Financial Crimes Enforcement Network; Special Information Sharing Procedures To Deter Money Laundering and Terrorist Activity, 31 CFR Part 103 (Final Rule).
  - OFAC Regulations (31 C.F.R. 500-598).
- Principal Regulators
  - SEC
  - Treasury
  - FinCEN
  - IRS
  - OCC
  - SROs: FINRA, CFTC

Proposed Rule for Registered Advisers and Private Investment Funds

- On September 18, 2002, the U.S. Treasury Department's Financial Crimes Enforcement Network (FinCEN) released a set of proposed rules under the USA PATRIOT Act which would expand the application of the USA PATRIOT Act to registered investment advisers and a wide range of unregistered investment companies. FINAL RULES HAVE NOT YET BEEN ADOPTED.
- The rules will require each adviser and fund which is subject to the Act to:
  - Develop internal policies, procedures and controls;
  - Designate an Anti-Money Laundering Compliance Officer;
  - Provide for independent and periodic testing of the anti-money laundering program; and
  - Establish an ongoing training program.

Business Continuity Plans

- No specific requirement under the Advisers Act (yet)
- Fiduciary duty requires that client assets and transactions are reasonably safeguarded from foreseeable delay or harm
- Disclosure (not insurance)
- Key man and successor provisions
- Essential for compliance with other fiduciary duties: privacy, custody, insider trading, code of ethics and books and records

SEC Examinations

- First inspection is typically within the first year of registration (every 1 to 4 years thereafter, depending on risk ratings)
- The purpose of the inspection is to determine whether an adviser is conducting activities:
  - In accordance with the Advisers Act
  - Consistent with disclosures made to clients
  - With adequate systems and compliance policies and procedures
- Deficiency or no finding letter or referral to the SEC Division of Enforcement

Other Significant Implications of the Dodd-Frank Act to Investment Advisers

- Requires the SEC to adjust for inflation $ amounts used in the qualified client test under Section 205(e) of the Advisers Act.
- Volcker Rule: certain banking entities are banned from acquiring or retaining any equity, partnership or other ownership interest in or sponsoring a hedge fund or private equity fund (subject to exceptions)
- Accredited investor definition under Reg D (effective July 21,2010): net worth of an individual is calculated by excluding the value of the primary residence (and the SEC to must periodically review and adjust the AI standard for natural persons)
- The SEC is precluded from defining the term "client," for purposes of Sections 206(1) and (2) of the Advisers Act, to include an investor in a private fund managed by an investment adviser if that private fund has entered into an advisory contract with such investment adviser.

Thank you

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