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FINANCIAL SERVICES

US Alternative Investment Management: Dodd-Frank and Foreign Private Advisers

ADVISORY

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Where we are today….

Since the passage of the Dodd-Frank Act in July 2010, the regulatory environment in which the alternative investment management industry operates in the United States has dramatically changed.

- Passage of the Dodd-Frank Act and its provisions addressing adviser registration, the regulation of derivatives, the "Volcker Rule" that largely prohibits proprietary trading by banking entities, and the regulation of entities for systemic risk purposes has had a profound impact on the regulation of the investment management industry.
- Regulatory developments outside of Dodd-Frank also have affected the regulatory environment for alternative investment advisers, including a revised custody rule, new "pay-to-play" provisions concerning political contributions, and amendments to the Form ADV 2 for those already registered.
- The political firestorm which drove passage of the Dodd-Frank Act has not abated and continues to drive comprehensive regulation of the financial services industry.
- One year later, although some have challenged the rulemaking and its many requirements, it seems clear that increased regulation of the financial services industry in the U.S. is here to stay.

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Key provisions of the Dodd-Frank act

Key provisions of the Dodd-Frank Act which have affected the investment management industry include:

- **Registration of Advisers to Hedge Funds and Others** – Title IV of the Dodd-Frank Act eliminated the private adviser exemption on which many U.S.-based hedge, private equity and real estate firms historically relied to avoid SEC registration, introduced new registration exemptions, made changes to the accredited investor standard, and mandated further studies which could have additional effects on the alternative investment industry.
- **Financial Stability** – Many alternative investment management firms will become subject to new recordkeeping and reporting requirements to facilitate a review of their businesses for systemic risk purposes.
- **Derivatives Provisions** – Investment managers participating in derivatives activities also have been affected by the legislation as regulators have gained a much stronger foothold over the OTC derivatives market including clearing, trading, capital, margining, reporting and all record-keeping requirements.
- **The "Volcker Rule"** – The required divestment of proprietary trading and implementation of severe restrictions on private fund activities by banks has already created opportunities for the investment management industry. Final regulations to implement the Volcker Rule were expected by October 2011 although recent reports suggest these regulations will be delayed.

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Key provisions of the Dodd-Frank act: Adviser registration

The Dodd-Frank Act eliminated the "private adviser" registration exemption and requires most U.S. advisers with over $100 million in assets under management to register with the SEC.

The current compliance date is March 30, 2012.

The Act also classified other advisers for registration purposes:

- **Advisers with Between $25 million and $100 million in AUM** – The "Mid-Sized Advisers".
  - Mid-sized advisers *must register* with the SEC if the adviser is not regulated by a U.S. state or if the adviser is not subject to examination by that state.
  - Mid-sized advisers *are prohibited from registering* with the SEC if the adviser is required to be registered in the U.S. state in which it maintains its principal office and place of business and, if registered, is subject to examination in that state.

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Key provisions of the Dodd-Frank act: Adviser registration (continued)

- **Advisers to Venture Capital Funds**
  - In June, the SEC adopted Rule 203(l)-1 under the Advisers Act which exempted from registration any adviser that advises solely one or more “venture capital funds”
  - For purposes of Dodd-Frank, a “venture capital fund” is a 3(c)(1) or 3(c)(7) fund that
    - Holds no more than 20% of the fund’s capital commitments in non-qualifying investments;
    - Does not borrow or incur leverage in excess of 15% of the private fund’s aggregate capital contributions and uncalled committed capital, and any such leverage is for a term not to exceed 120 days;
    - Has been represented to investors and prospects as a fund that pursues a venture capital strategy; and
    - Does not provide its investors with redemption privileges absent exigent circumstances; and
    - Is not registered under the ‘40 Act and is not treated as a business development company
- The SEC’s goal was to distinguish traditional VC firms from those pursuing a broader form of investing and using leverage in their investments.

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Key provisions of the Dodd-Frank act: Adviser registration (continued)

- **Advisers to Family Offices**
  - In June, the SEC also adopted Rule 202(a)(11)(G)-1 under the Advisers Act to define those family offices that are exempt from registration.
  - Under the Rule, an entity is an exempt “family office” if:
    - The entity has no clients other than “family clients”;
    - The entity is wholly owned by family clients and exclusively controlled (directly or indirectly) by “family members” or “family entities”; and
    - The entity does not hold itself out to the public as an investment adviser.
  - Some multi-family offices may now be subject to registration.

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Key provisions of the Dodd-Frank act: Adviser registration (continued)

- **Private fund advisers**
  - New Rule 203(m)-1 under the Advisers Act provides an exemption from registration for advisers to "qualified private funds" with between $100 and $150 million in AUM
  - Must advise exclusively "qualified private funds" – Generally 3(c)(1) or 3(c)(7) funds
  - U.S. and non-U.S. advisers can both rely on the exemption
  - If a non-U.S. adviser:
    - All assets must be qualified private funds; and
    - Total value of those assets cannot exceed $150 million
    - **No limit** on non-U.S. assets
  - Exempt from registration but subject to books and records and some SEC reporting obligations

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Key provisions of the Dodd-Frank act: Foreign adviser registration

- **Foreign Advisers**
  - New Advisers Act Rule 202(a)(30) defines a foreign private adviser. Under the Rule, a foreign private adviser is *exempt* from registration if it:
    - Has no place of business in the United States;
    - Has fewer than 15 clients and investors in the United States in private funds advised by the adviser;
    - Has aggregate AUM attributable to clients in the United States and investors in the United States in private funds advised by the adviser of less than $25 million; and
    - Does not hold itself out generally to the public in the United States as an investment adviser
    - Some foreign advisers may also rely on the Rule 203(m) exemption

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Key provisions of the Dodd-Frank act: Foreign adviser registration (continued)

- For foreign advisers, start with an assessment of the nature and extent of your firm's U.S. business and investor base:
  - Do you hold yourself out to the public in the U.S. as an investment adviser?
  - Do you advise U.S. clients other than private funds?
  - Do you manage $25 million or more AUM for U.S. clients and/or investors in private funds?
  - Do you have a place of business in the U.S.?

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Key provisions of the Dodd-Frank act: Foreign adviser registration (continued)

- Do you *hold yourself out to the public* in the U.S. as an investment adviser?
  - Not a defined term – Interpreted broadly by the SEC
  - Are you identifying yourself as an investment adviser in communications with clients or prospects in the U.S.
  - Does your website, letterhead, or business cards identify you as an investment adviser

- Do you advise U.S. clients other than *private funds*?
  - Private funds are issuers that would amount to an investment company but for Sections 3(c)(1) and 3(c)(7) of the '40 Act – Meaning
  - A fund owned by no more than 100 persons or all of whose investors are qualified purchasers

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Key provisions of the Dodd-Frank act: Foreign adviser registration (continued)

- Do you manage more than $25 million USD in AUM for U.S.-based *clients* and/or *investors in private funds*?
  - *Clients* are natural persons, corporations, general partnerships, limited partnerships, and other entities to which the adviser provides investment advice based upon its investment objectives rather than the investment objectives or any underlying persons or entities.
  - An *investor* in a *private fund* means any person that would be included in determining the number of beneficial owners under 3(c)(1) or 3(c)(7).
  - AUM means *regulatory* AUM – Some assets are no longer excluded.

- Do you have a *place of business* in the U.S.?
  - Under Advisers Act Rule 202(a)(30)-1, a *place of business* is an office where the adviser regularly provides advisory services, solicits, meets with, or otherwise communicates with clients, and any location held out to the public as a place where the adviser conducts such activities.

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Key provisions of the Dodd-Frank act: Adviser registration

Despite the name of Title IV of the Dodd-Frank Act (“Regulation of Advisers to Hedge Funds and Others”), the new registration requirements have affected a number of investment management organizations.

Our clients have been evaluating the application of the new registration requirements, to their businesses, especially those that are:

- Advisers to Hedge Funds
- Advisers to Private Equity Funds
- Advisers to Real Estate Funds
- Advisers to Collateralized Debt Obligation Funds and other similar asset securitization vehicles
- Advisers to Other Collective Investment Entities and Undertakings
- Venture Capital Firms and Family Offices that do not fall within the narrow exemptions issued by the SEC
- Foreign advisers that do not meet the qualifications associated with the new Rule 202(a)(30) “foreign private adviser” exemption

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Key provisions of the Dodd-Frank act: Adviser registration (continued)

Advisers that will be required to register will be required to:

- Develop a compliance program, including developing and implementing policies and procedures reasonably designed to prevent violations of the federal securities laws, conduct an annual review of those policies and procedures, and designate a Chief Compliance Officer;
- Establish, maintain and enforce a Written Code of Ethics, which must apply to the adviser's personnel and must include provisions on standards of business conduct, compliance with the federal securities laws, reporting of personal securities transactions, and reporting violations of the Code;
- Maintain books and records, including substantial records relevant to the adviser's business;
- Follow specific rules when entering into advisory contracts;
- Adopt and Implement a Written Proxy Voting Policy;
- Adopt a policy and procedures concerning political contributions ("pay-to-play"); and
- Disclose significant information about their advisory business, advisory personnel, fee arrangements, industry affiliations and control persons.

Additionally, advisers will have a fiduciary duty with respect to their relationships with clients and will be subject to examination by the SEC.

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Key provisions of the Dodd-Frank act: Financial stability

Many sections of Dodd-Frank Act include provisions designed to ensure the financial stability of the U.S. economy. Although these efforts are not likely to result in the designation of alternative investment firms as systemically important, many advisers, both registered and unregistered, will be required to provide information to the SEC and other U.S. regulators to enable them to conduct their systemic risk monitoring activities.

Specifically, advisers to private funds will be required to retain records and make them available for inspection. These records, specific to each private fund advised by the adviser, will be required to include descriptions of:

- AUM and use of leverage, including off-balance-sheet leverage;
- Counterparty credit risk exposure;
- Trading and investment positions;
- Valuation policies and practices of the fund;
- Types of assets held;
- Side arrangements or side letters whereby certain investors in a fund obtain more favorable rights or entitlements than other investors;
- Trading practices; and
- Other information deemed necessary and appropriate.

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Key provisions of the Dodd-Frank act: Derivatives

The Dodd-Frank Act established a new framework for regulatory and supervisory oversight of the over-the-counter ("OTC") derivatives market in which many alternative investment advisers are engaged.

In general, the new regulatory framework requires:

- The CFTC and the SEC to share regulatory and supervisory authority for OTC derivatives (i.e., swaps and security-based swaps) and to participate jointly in the rule-making process;
- Mandatory clearing for swaps accepted by a clearing entity and designated by the CFTC and SEC as clearable;
- Mandatory execution of cleared swaps on a regulated exchange or swap execution facility;
- Mandatory reporting of cleared and uncleared swaps to a trade repository or the CFTC or SEC;
- Capital and margin requirements with higher requirements to be imposed on uncleared swaps;
- Prohibitions on certain swap activities for insured depository institutions; and
- Public access to swap transaction volume and pricing date.

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Key provisions of the Dodd-Frank act: The “Volcker Rule”

Although applicable only to banking entities, the so-called “Volcker Rule” has the potential to profoundly affect the alternative investment industry from a capital raising and competitive landscape perspective. The Volcker Rule includes two key provisions:

- Banking entities will be generally prohibited from engaging in proprietary trading;
- Banking entities will be generally prohibited from investing in or sponsoring a hedge fund or private equity fund, except for:
  - An allowed de *minimis* investment in a hedge fund up to 3 percent of total ownership interest of a fund, subject to an aggregate limit on all investments in such funds equal to 3 percent of the banking entity’s Tier 1 capital.

The Federal Reserve, Office of the Comptroller of the Currency (“OCC”), Federal Deposit Insurance Corporation, SEC, and the Commodity Futures Trading Commission (“CFTC”) were required to issue final rules to implement the Volcker Rule by October, but recent reports suggest the regulations will be delayed.

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Key provisions of the Dodd-Frank act: Form PF

On January 26, 2011, the SEC and CFTC jointly issued Release No. IA-3145, “Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisers on Form PF.” The proposed rules implement provisions of Dodd-Frank which permit the SEC to collect information from registrants to aid it in assessing systemic risk.

- The proposed rules would require registered investment advisers annually to report a substantial amount of detailed quantitative data, both on an aggregated and on a per fund basis for certain private funds.
- The proposed rules also would require three types of “large private fund advisers” to provide additional information concerning:
  - Hedge funds that collectively have at least $1 billion in assets;
  - Liquidity funds that have combined liquidity fund and registered money market fund assets of at least $1 billion; or
  - Private equity funds that collectively have at least $1 billion in assets.
- The current compliance date is December 15, 2011.

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Key provisions of the Dodd-Frank act: Other provisions

Other Provisions of the Dodd-Frank Act that have affected alternative investment advisers include:

- **Changes to the Accredited Investor Standard** – Investors seeking to qualify as accredited investors are no longer able to count the value of their primary residence when calculating their net worth. These investors will, however, be able to exclude any mortgage debt outstanding on their primary residence when making the same calculation. This change to the accredited investor standard came into force immediately after passage of the Dodd-Frank Act.
- **Compensation Disclosure** – The SEC is required to issue regulations which will require investment advisers, including advisers to alternative investment funds, to disclose their incentive based compensation arrangements and which will prohibit incentive-based compensation that encourages "inappropriate risks."
- **Studies** – The SEC continues to evaluate whether it would be appropriate to form a self-regulatory organization specifically for the oversight of private funds, the impact of short selling on the markets and issues around the reporting of short-selling activities, whether there is a need for additional examination and enforcement resources for investment advisers, and the costs associated with compliance with the Custody Rule.

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The immediate future for the regulatory environment

A combination of factors will continue to contribute to a continued demand for robust financial regulation. Some of these issues include:

- **Political Support and Continued Public Demands for Regulation** – Despite contentiousness around specific provisions of the Dodd-Frank Act, general political support and public demand for strong financial regulation continues;
- **Empowered Regulators** – Regulatory agencies have added substantial numbers of new staff, many of whom have specialized industry knowledge, and have been supported with additional funding. The addition of this new staff, the additional funding, coupled with the remaining factors listed here have resulted in regulatory agencies operating in a previously unseen "empowered" manner;
- **Prolonged Rulemaking Process** – The Dodd-Frank Act requires a number of studies and the promulgation of over 200 rules, the process for which will take at least the next year, with implementation periods extending for years beyond this study and rulemaking process;
- **Continued Weak Economic Environment** – The slow economic recovery has resulted in continued look-backs at the causes of the financial crisis, exacerbating demands for financial regulations designed to prevent future crises.

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How to respond to this new regulatory world

Foreign advisers should assess their U.S. business and operations and determine whether the firm has the framework necessary to respond to growing demands from both regulators and investors.

Some questions to consider when determining your firm's preparedness include:

- Are our professionals knowledgeable and prepared to respond appropriately to the rapidly changing regulatory environment?
- Do we fully understand the new rules and regulations and what is expected of our firm?
- Do we have the proper controls and processes in place to minimize risk within our firm as well as with our service providers and sub-advisers?
- Are we well positioned to respond in comparison to our peers?

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KPMG’s expertise in financial regulation

As an impartial adviser, KPMG and our team of former regulators, supervisors, examiners, and compliance practitioners can provide objective advice to your organization to respond to this new regulatory world.

KPMG can assist your firm in meeting the requirements associated with SEC registration. Our registration assistance services typically consist of the following:

- **Assessment** – KPMG can assist with an assessment of your firm’s registration readiness. This risk assessment process is designed to identify potential risk areas associated with the investment activities of your firm and to identify gaps in your firm’s governance and compliance program(s). During a risk assessment, KPMG will consider the impact of investment adviser regulations on your firm and test the effectiveness of your firm’s compliance and governance programs.
- **Preparation** – Based on the results of the risk assessment, KPMG can work with you to ensure that your firm is fully compliant with the requirements of applicable investment adviser regulations. Preparation activities may include assistance with drafting or modifying compliance policies and procedures and a code of ethics, assistance with determining the availability of required books and records, and assistance with determining the appropriate person in your organization to serve as Chief Compliance Officer.

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KPMG's expertise in financial regulation (continued)

KPMG can help your firm to meet the requirements associated with registration as an investment adviser with the SEC. Our registration assistance services typically consist of the following:

- **Training** – Upon making a determination that your firm is ready for registration with the SEC, KPMG can assist you in developing and delivering training of applicable regulatory requirements so that your employees are knowledgeable of their obligations related to working as part of a regulated entity.
- **Registration** – KPMG can assist you in preparing and filing the forms necessary for registration with the SEC as an investment adviser (Form ADV), including the establishment of an IARD account with the SEC. Preparation of the Form ADV can include assistance in drafting the "plain-English" disclosures required as part of your firm's Form ADV Part 2 filing.
- **Ongoing Support** – KPMG can assist your firm in addressing the large number of questions which inevitably arise during the operation of your firm as a registered entity. KPMG can also provide assistance with annual reviews of your compliance program required by Rule 206(4)-7 under the Investment Advisers Act.

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