

## General Counsel

### Editorial

Once again, we return to the main regulatory focus of this year: the Dodd-Frank Act.

Two months after we dedicated a special feature to the operational impacts of Title VII, we zero in on **Title IV and its consequences on hedge fund and private fund advisers.**

Gone are the days when funds and fund advisers were spared oversight—they now find themselves the direct target of regulators.

In this article, we detail ramifications for operations, as well as the business and financial environment itself.

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## >> **Dodd-Frank Title IV: Operational Impacts on Hedge Fund and Private Fund Advisers**

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"The Dodd-Frank Wall Street Reform and Consumer Protection Act creates a new, more effective regulatory structure, fills a host of regulatory gaps, brings greater public transparency and market accountability to the financial system and gives investors important protections and greater input into corporate governance." These are the words of Mary L. Schapiro, Chairman of the Securities and Exchange Commission of the United States (SEC), commenting on the law commonly known as the Dodd-Frank Act.

On July 21, 2010, the act was promulgated by President Obama in response to the major financial and economic crisis of 2008. This act will have a major influence on market regulations, especially on the asset management industry, by creating new regulators and new regulation requirements.

Many rules still need important precisions, but in coming years, this will affect most company departments: legal entity, corporate governance and organization, operations and IT systems, risk management and internal controls, regulatory, compliance and public reporting.

This article presents the main points of Title IV, named "Private Funds Investment Advisers Registration Act of 2010" ("The Private Fund Act" or "The Registration Act"), and explores its operational impacts.

### **The Private Fund Act has been the most important financial reform...**

Title IV aims to increase the information provided to investors, the quality of reporting to the regulators and the mitigation of systemic risk. It will be effective on July 21, 2011 which marks the 365th day after the passing of the law.

Title IV amends the already existing "Investment Advisers Act of 1940" (Advisers Act) which has been the primary governing act. This Private Funds Act completes "The Volcker Rule" and other new titles passed in July 2010, as it requires new regulations for banks, their affiliates and holding companies, and limits relationships between banks and hedge funds.

For the first time, registration for most advisers will be obligatory either with the SEC or with one or more states of the US. Going forward, private fund advisers will be subject to record-keeping requirements, and compulsory disclosure of certain financial, operational and other information will be mandatory.

The required registration of private fund advisers implies the elimination of the already existing registration exemption according to the "Private Investment Adviser" section defined in the Advisers Act.

### **... changing the regulatory environment and...**

Title I of the act allows the new Financial Stability Oversight Council (FSOC) created by the Dodd-Frank Act to consider a "non-banking financial company" as a potential systemic risk company. Thus the FSOC can monitor the risk linked to the private fund adviser as it deems acceptable.

According to the Advisers Act, the adviser had to register with the SEC if the Asset Under Management (AUM) was more than \$30 million. For a lower amount, the adviser did not have to register expressly with the SEC.

Within the framework of the Dodd-Frank Act, advisers with an AUM over \$100 million will be subject to registration with the SEC. The new regulation forbids registration with the SEC with an AUM between \$25 and \$100 million except if the adviser:

- > Is not registered in the state where the organization is held
- > Has a client that is a registered investment or prospection company
- > Does not have to register in at least 15 states or more

Under the Freedom of Information Act, the SEC will report annually to Congress on how it uses the collected data to protect investors and insure market integrity. The SEC will provide its conclusions to the examined firm within six months following the end of the investigation.

Over the next five years, the SEC's power will increase. The budget will be doubled and market specialists will be recruited to set up a specialized asset management enforcement unit to focus expressly on investigations into hedge funds, private equity firms and managed accounts. In order to abandon the notion of "too big to fail" and protect investors, the SEC has the ability to examine systemic risk periodically or at any time for all institutions. By increasing the SEC's power, the act mandates better quality reports provided by advisers as well.

### ... maintaining some registration exemptions...

The Dodd-Frank Act eliminates the existing "Private Investment Advisers" registration exemption for advisers of private funds, including hedge funds and private equity funds. Therefore, advisers of private funds with an AUM of less than \$150 million are not subject to registration with the SEC.

However, several categories of investment advisers were exempted in the already existing Advisers Act from SEC registration and will still be dispensed with. Foreign private fund advisers are exonerated if they do not have a place of business in the US, if they have fewer than fifteen clients or investors in the US, if they have less than \$25 million in aggregate AUM in private funds for US clients and investors, or if they do not present themselves as investment advisers.

The Dodd-Frank Act allows dispensation for investment advisers who work with only one or more venture capital funds. The law should properly define the term "venture capital funds" by July 21, 2011.

The Registration Act exempts small business investment companies, which are licensees under the Small Business Law of 1958. The law modifies the Adviser Act to exclude family offices built to manage the wealth of one unique rich family from the investment adviser definition. Mid-sized private fund advisers are spared registration also, but the terms still need to be defined by the SEC. In all cases, the regulators can assess if there is any systemic risk linked to the adviser, and can ask for records and further examine the firm.

### ... and impacting the adviser's organization and report...

In order to evince high standards and be prepared for report requests from the SEC, advisers should prepare for registration and subsequent regulatory examination. Advisers should act now and use this as an opportunity to review and upgrade their current control practices, particularly with respect to operational processes, systems and compliance functions. By viewing this new legislative requirement as a chance to improve a firm's compliance and control environment over the long-term, the investments in resources and tools for "support" departments can reap the benefits.

Practically, this registration will be carried out using Form ADV, Parts I and II:

- > Part I contains information about the adviser's education, business and disciplinary history within the last 10 years.
- > Part II includes information on the adviser's services, fees and investment strategies.

The enactment of the registration process may involve increasing the investment risk governance by setting up one or more risk reviews to correlate with the types of business and risks monitored. The company may create one or more independent highly-skilled risk manager functions with the ability to understand, monitor, analyze and alert top management and/or the SEC in accordance with the exposures detected by the adviser. The accurate escalation policies and internal procedures should be documented, implemented and upgraded by the Compliance department.

Advisers will have to report at least the following details for each managed private fund, in a concise and streamlined way:

- > The amount of AUM using leverage, including off-balance sheets. Considering this, the private fund adviser may plan to expand Market Risk and Liquidity Risk departments in line with the monitoring of these risk exposures.
- > The counterparty and credit risk exposure. The firm may consider enhancing the related departments.
- > The trading decisions and the assets held on the books. The historical trading data and book positions will have to be archived in appropriate and secured systems.
- > The valuation policy and practices of the funds. The adviser will have to make sure the relevant valuation documentation is up-to-date and controls are in place.

The act clarifies that there is no "one-size-fits-all" approach with respect to the new regulation. The right solution for any adviser will depend on the business, its operating model, and other factors such as size, investment focus and product set. The topics listed above have to be further explored. Companies that do not attain the mandated quality by the regulator will be fined, and the company's reputation will be at risk of being marred.

### ... but with a calendar still to define.

On July 21, 2011, the act will come into effect, but even if the main directives have been defined, with the continual introduction of new regulations, a list of terms and deadlines in the next couple of years is expected.

The Dodd-Frank Act has been the most important financial reform in a long time and will change the future financial environment. The consequence for the private fund industry is that most firms will have to register with the SEC and improve the quality of reporting and internal controls. This new regulation focuses on protection of the investors trying to avoid systemic risk, abandoning the conventional wisdom "too big to fail" and the practice of entreating help through taxpayer subsidies.

To ameliorate the reports, investment risk areas will have to adapt their organization, their governance, their documentation, their database and tools used, and the indicators produced. This act will most directly impact the "support" departments of private funds. However, the requirements need to be adapted to the specificities of each asset management company.

This new financial act is linked to the global trend of investor protections by augmenting transparency and the quality of reporting and controls, as well as reducing systemic risk. The same goals have been sought in Europe: one need only look to the European alternative funds reform voted on April 30, 2009, the Basel III Agreements, and even to UCITS IV reforms or Solvency II for insurance companies ■