

Financial reform: What private fund advisers need to know about the Dodd-Frank Act

A financial reform resource

The recently enacted Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act) is changing the landscape for financial services firms and financial institutions. The Act addresses four major issues: transparency, risk management, accountability and structural oversight. The Act will create new regulators, bring new firms and markets under regulatory oversight, and provide new rulemaking and enforcement powers to regulators. The central elements of the Act focus on regulating the financial services sector; these new regulations will likely mean significant changes in legal entity structures, corporate governance, operations and IT systems, risk management and internal control frameworks, tax planning, regulatory and public disclosures, and legal and compliance demands.

During the coming months, the onus will be on regulatory agencies, such as the SEC and Commodity Futures Trading Commission (CFTC), to define the specific rules implementing the Act's provisions. Registered investment advisers, especially those with large amounts of assets under management (AUM) and who engage in derivatives and other high risk activities, will face increased regulation and scrutiny — namely, registration and examination by the SEC. In addition, even some smaller funds may be required to register. Advisers and funds should be prepared for the enhanced disclosure and reporting requirements that come with the new regulations. In addition, funds that are classified as “major swap participants” (i.e., funds that maintain substantial positions in swaps), may be required to

register with either the SEC or the CFTC and possibly both regulators. The CFTC is expected to place stringent regulation on fund advisers, particularly those managing funds classified as “commodity pool operators.” These potential rules — and those yet to be determined — could have a significant impact on hedge funds, private equity funds and their advisers. The following table provides a summary of the various rulemakings of the Act that apply to private fund advisers, their effective dates, expected impact, action required by advisers/funds and ways Grant Thornton LLP can help.

Stay up to date on financial reform developments

The Dodd-Frank Wall Street Reform and Consumer Protection Act will make sweeping changes to the financial services industry. Many of the specific rules have yet to be shaped by regulators, and firms must stay informed. To help your firm navigate this uncharted territory, Grant Thornton LLP has created the Financial Regulatory Reform Resource Center. For more information about how the legislation will affect your firm, to read about emerging issues and to discuss your needs with a professional in our Financial Services practice, visit www.GrantThornton.com/financialreform.



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Adviser registration requirements (Title IV)	<p>Many investment advisers that are currently exempt will now be required to register with the SEC or their state depending on their AUM and any other available exemptions.</p> <p>There have been no changes under the Act related to registration requirements for advisers to registered investment companies, and business development companies, (i.e. previously registered advisers/funds to these entities will not be able to avail themselves of the AUM thresholds or other any other exemptions).</p> <p>Advisers with \$25-100 million AUM <i>SEC/state registration requirement/prohibition:</i> Investment advisers are prohibited from registering with the SEC unless they would be required to register in 15 or more states.</p> <p>An investment adviser who is state registered and is not subject to state examination requirements would be required to register with the SEC.</p> <p>Investment advisers currently registered with the SEC that fall under state registration requirements and have state examination requirements will be required to de-register with the SEC and register in the state in which they operate their principal places of business.</p> <p>Advisers with \$100-150 million AUM <i>State registration requirement:</i> No requirement to register with the state if registered with the SEC.</p> <p><i>SEC registration requirement:</i> Advisers that solely manage private funds (i.e., they are not advisers to separately managed accounts) and have between \$100-150 million in AUM in the United States are not required to register with the SEC.</p> <p>Advisers with more than \$150 million AUM Required to register with the SEC, unless exempted.</p>	<p>The Act applies to advisers of private equity and hedge funds that are either located in the United States or that are located offshore but accept subscriptions from U.S. investors.</p> <p>The following are exempt from adviser registration under the Act:</p> <ul style="list-style-type: none"> Advisers only to venture capital funds and family offices. Note, however, that the definition for venture capital will be determined by the SEC at a later date. Foreign private advisers who have no place of business in the U.S., have fewer than 15 clients and investors in U.S. private funds, have less than \$25 million in AUM relating to these U.S. clients and investors, and do not hold themselves out to be investment advisers to the public or act as investment advisers to any registered investment company or business development company. CFTC-registered investment advisers unless they become predominately securities related. Advisers to small business investment companies. 	<p>Advisers that currently meet the “private adviser exemption” under the Advisers Act will be required to be registered by July 21, 2011.</p>	<p>The Adviser should ensure that they understand the impact of the Act on their business and, if they are required to be registered, ensure that they are prepared for SEC or state registration and examination.</p> <p>Grant Thornton LLP can help you analyze the Act and state laws to see if you fit within one of the categories of registration or related exemptions.</p> <p>We can perform regulatory readiness reviews to assist advisers in their preparation for registration, assist in drafting documents for compliance with regulations, perform “mock” regulatory examinations/ inspections by identifying potential regulatory gaps, propose/assist in implementing solutions to address these gaps based on best practices.</p> <p>We can evaluate the design and operating effectiveness of compliance controls as well as policies and procedures related to existing and new regulations, governance, trading, custody, and valuation matters.</p>

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Recordkeeping, reporting and examination (Title IV)	<p>Recordkeeping The Act requires a registered adviser to maintain the following records for each private fund it advises:</p> <ul style="list-style-type: none"> • amount of AUM • 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 • trading practices • other information deemed necessary by the SEC <p>Reporting The Act requires each registered investment adviser to file reports containing information the SEC deems necessary or appropriate in the public interest or for the assessment of systemic risk.</p> <p>Examination The Act directs the SEC to conduct periodic examinations of the records maintained by registered advisers and additional examinations that the SEC may deem necessary.</p>	The new recordkeeping, reporting and examination requirements under the Act are applicable to all registered investment advisers.	Effective upon SEC registration. Further, un-registered investment advisers will need to wait for further clarification from the SEC regarding recordkeeping requirements.	<p>The adviser should ensure that it has a system in place to fulfill the new recordkeeping, reporting and examination requirements.</p> <p>Previous regulation also required that registered investment advisers have a Chief Compliance Officer function, which can be outsourced. The compliance officer will be required to monitor the policies and procedures developed by the registered investment adviser.</p> <p>Grant Thornton LLP can provide recommendations for administrators, other service providers and compliance monitoring/surveillance systems.</p> <p>We can perform transactions testing and records review to help the adviser adhere to the new regulations, disclosure and other reporting requirements.</p> <p>Our professionals can assist advisers with remediating issues noted in regulatory examinations, including developing remedial action plans and performing testing to help address any issues.</p>
Capital-raising: Changes to Regulation D (Title IV and IX)	<p>Revision of “accredited investor” definition An investor is no longer permitted to include the value of his or her primary residence in determining whether such person meets the \$1 million net worth test.</p> <p>“Bad actors” disqualification The Act adds a disqualification of any offering or sale of securities by a person who engages in securities; insurance; banking or savings or credit union activities; and has been in violation of the law.</p>	The changes and new Regulation D requirements under the Act are applicable to all investors who are not legal entities and to all investment advisers, even advisers that are exempt from SEC/state registration.	Effective immediately	<p>Advisers to private funds should amend their subscription agreements to comply with the new definition of “accredited investor.”</p> <p>This change only applies to new investors or additional subscriptions from existing investors, with no need to remove any existing investors who fall below the new requirement.</p>

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OTC/derivative regulation (Title VII)	The Act grants new regulatory authority to the SEC and CFTC; requires that certain derivatives transactions trade through clearinghouses and exchanges; and indicates that large private fund managers will be required to register if they are considered to be a “swap dealer” or a “major swap participant.”	Hedge funds and investment advisers	Certain provisions of Title VII of the Act become effective on the later of 360 days following Act enactment or, to the extent a provision of Title VII of the Act requires a rulemaking, not less than 60 days after publication of the final rule or regulation by the relevant regulators. The provisions effective 360 days following Act enactment relate to clearing through trading houses and registration and regulation of swap dealers and major swap participants. Effective July 2011 through July 2013, the SEC/CFTC will be required to establish additional rules.	Grant Thornton can help you analyze the Act and SEC/CFTC laws to see if the level of your derivatives trading activities requires you to be registered or to trade through a clearing house or exchange. Our professionals can assist with compliance with reporting, recordkeeping, capital requirements, margin requirements, business conduct standards and other duties and obligations required under the Act as well as emerging SEC/CFTC regulations. We can perform transactions testing and tax advisory services on restructuring to help the adviser adhere to the new regulations, as well as capital, disclosure and reporting requirements.
Designation as “systemically important” (Title I)	There is the possibility of certain private funds being designated as “systemically important financial institutions,” which would be accompanied by strict regulatory oversight, higher capital levels and very tight monitoring of risk activities. Private funds may also be subject to an additional tax depending on their state.	To be determined by systemic risk regulators (Federal Reserve and the newly formed Financial Stability Oversight Council — FSOC) based on fund size and risk profile.	The FSOC is required to report findings on the study on the economic impact of systemic risk regulation within 180 days of Act enactment.	Advisers must comply with capital, reporting, recordkeeping and other regulatory requirements that aid in the evaluation of systemic risk. Grant Thornton LLP can provide comprehensive enterprise risk management (ERM) solutions and implement Governance, Risk Management, Compliance systems, and perform stress testing. Our professionals can evaluate the design and operating effectiveness of compliance risk and control processes related to existing and new regulations.

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Short sale reporting (Title IX)	<p>The Act amends Section 9 of the Securities Exchange Act of 1934 (Exchange Act) to prohibit manipulative short selling and give the SEC authority to adopt rules necessary to ensure enforcement.</p> <p>Exchange Act Section 13(f) is amended to require the SEC to issue rules requiring at least monthly public disclosure of short sale activities.</p>	Private funds that transact in short positions.	Effective immediately. However, no deadline is specified for when the SEC must issue disclosure rules for short sales.	<p>Advisers must comply with the new short sale rules and be prepared for increased SEC scrutiny and future regulations.</p> <p>Grant Thornton can assist in enumerating the various requirements and evaluate systems, policies and procedures related to compliance with the short sale rules.</p>
Volcker Rule (Title VI)	<p>The Volcker rule bans 1) banking entities from proprietary trading activities and 2) limits banks' investments in hedge funds or private equity funds to three percent of Tier 1 capital. In addition, banking entities must reduce their ownership in the hedge fund or private equity fund within one year of the fund's establishment to not more than three percent of the total ownership interests of the hedge fund or private equity fund.</p> <p>Investments in small business investment companies (SBIC's) are permitted under the Volcker Rule.</p>	Banks, hedge funds and private equity funds	The Volcker Rule must be implemented within two years from the enactment of the Act.	<p>Banking entities must comply with the Volcker Rule.</p> <p>Grant Thornton can assist with the accounting, tax restructuring and compliance, information systems and valuation matters that arise with these transactions. We can also assist banks and funds with Act compliance efforts.</p>
Future regulatory studies by the GAO (Title IV, Title IX)	<p>The Act mandates several governmental studies and reporting that could lead to changes in the regulatory framework applicable to private funds and investment advisers, including these items from the Government Accountability Office (GAO):</p> <ul style="list-style-type: none"> • study and report on accredited investors, • study regarding the feasibility of forming a self-regulatory organization to oversee private funds, and • study on the state of short selling on national securities exchanges and over-the-counter markets. 	Private funds and their investment advisers	The GAO must report to Congress within one year of Act enactment regarding the feasibility of forming a self-regulatory organization to oversee private funds. The GAO must report to Congress the findings of a study on the appropriate criteria for determining the financial thresholds or other criteria needs to qualify for accredited investor status and eligibility to invest in private funds.	<p>Private funds and their investment advisers should continue to monitor the changes in the regulatory environment.</p> <p>Grant Thornton can assist in providing advisory services to meet your needs based on changes in regulation.</p>

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