

Financial Services and Markets

Implications of Dodd-Frank for UK and EU fund managers and advisers

Many UK and EU investment managers and advisers (including those in the private equity, hedge fund and real estate sectors) may be required to register with the US Securities and Exchange Commission (the "SEC") with effect from 21 July 2011, even if they are already authorised by the UK Financial Services Authority or another EU regulator. Firms that register must comply with a number of US federal legal and regulatory requirements, many of which overlap with UK FSA rules. Some firms exempt from registration will still need to comply with certain record-keeping and reporting requirements. Whilst many of the detailed provisions of implementing legislation are yet to be finalised by the SEC, and there is considerable uncertainty about the scope of certain exemptions, firms should begin to consider the impact of the changes and plan for compliance. We recommend that applications for registration, if required, should be submitted by the end of March 2011.

This memorandum, which has been prepared jointly by Travers Smith LLP and Goodwin Procter LLP, provides general guidance for non-US fund managers and advisers on the potential impact of the new registration requirements.

Overview

On 21 July 2010, President Obama signed into law the US Private Fund Investment Advisers Registration Act of 2010 (the "Registration Act"). This was one part of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The Registration Act includes amendments to the US Investment Advisers Act of 1940 (the "Advisers Act"), which is the principal US law concerning the regulation of investment managers and advisers. We reported on this development in our [briefing note](#) of July.

At present, few UK and EU-based investment managers or advisers are registered with the SEC. They generally rely on an exemption from registration which applies to firms with fewer than 15 US clients (each fund or managed account being considered to be a separate client for this purpose) who do not hold themselves out generally to the public as investment advisers. As a result of the Registration Act, effective 21 July 2011, this exemption will no longer be available.

The elimination of this exemption means that many investment managers and advisers (whether or not based in the UK) will be required to register with the SEC for the first time, and comply with all of the provisions of the Advisers Act and the regulations promulgated pursuant to such Act. The Registration Act also increases record-keeping and reporting obligations for both registered and certain unregistered investment managers and advisers, among other changes.

This note comments only on those aspects of the current wide-ranging US regulatory reforms which are directly connected with SEC registration for non-US firms.

Which firms are affected in principle?

A firm that meets the definition of "investment adviser" under the Advisers Act and is subject to the SEC's jurisdictional reach is required to register with the SEC under the Advisers Act, unless an exemption applies. Beginning on 21 July 2011, the private adviser exemption described above will no longer apply, but several potential new exemptions will come into effect.

The term "investment adviser" is defined to include "any person who, for compensation, engages in the business of advising others...as to the value of securities or as to the advisability of investing in, purchasing, or selling securities...". The term includes firms who provide discretionary or non-discretionary advice with respect to securities belonging to another person. It therefore

incorporates the UK regulated activities of investment management and investment advice. It is uncertain the extent to which the term may apply to managers of assets that do not constitute "securities" under US law, such as direct interests in real estate and certain other tangible assets. Accordingly, real estate managers and other managers of tangible assets may need to assess the types of assets they hold in client portfolios, and perhaps await additional guidance from the SEC and its staff, to determine whether they will be subject to the registration requirements under the Advisers Act.

In principle, it does not matter where in the world an investment advisory or management firm is established or conducts its business. The statute, as drafted, does not provide any relief for non-US advisers or managers, irrespective of whether they are subject to regulation outside of the United States. Instead, the SEC's jurisdictional reach extends to any person who uses the US mails or "any means or instrumentality of [US] interstate commerce in connection with his or its business as an investment adviser." As a practical matter, communication with clients or investors in the United States or investing in the United States may be sufficient to afford the SEC jurisdiction over an investment adviser or manager.

As a general matter, unless an exemption applies, a firm is required to be registered under the Advisers Act if it manages securities for funds or other accounts in the United States or for funds that have investors in the United States. Most fund managers and segregated portfolio managers would be investment advisers under the Advisers Act. Also, most firms providing investment advice (as that term is used in the UK) to funds or other accounts would be investment advisers under the Advisers Act.

In light of the broad definition of investment adviser under the Advisers Act, it is important to analyse closely the activities in which the firm is engaged in assessing whether a firm is an investment adviser. For example, managers of UCITS that are offered in the United States would need to establish that an exemption applies in order to avoid registration, and at the same time they would need to consider separately any segregated portfolios that they manage.

In many fund structures there may be several legal persons who provide investment advice or exercise discretion over a portfolio of securities, for example, a general partner, an offshore investment manager, an onshore investment manager and/or an onshore adviser-arranger. In principle, each of them may be an "investment adviser" for these purposes depending on the specific activities it undertakes, its compensation, and its relationship to the fund. In the past, the SEC staff has taken the position that a special purpose vehicle ("SPV") set up by a registered investment adviser to serve as the general partner of a private fund need not register separately if the SPV is subject to the supervision and control of the registered adviser (and any employees of the SPV are treated as "supervised persons" of the registered adviser), although in this case the SPV nevertheless would be subject to inspection by the SEC.

Firms may be affected by these changes whether or not they are exempt from the registration requirement (see below).

New exemptions from registration

New exemptions from registration that will become effective on 21 July 2011 and may be available to certain non-US investment managers and advisers are described below. The SEC is required to adopt regulations with respect to these exemptions to provide additional detail regarding scope and defined terms. The SEC has indicated it expects to issue preliminary regulations for public comment in Q4 2010 (starting perhaps as early as Friday, 19 November 2010) and early 2011, and to adopt final regulations between April and July 2011.

The new exemptions are summarised below.

Foreign private advisers

New exemption

The Registration Act includes an exemption for "foreign private advisers". A foreign private adviser is as an investment manager or adviser that meets each of the following requirements:

- it has no place of business in the United States;
- it has, in total, fewer than 15: (i) investors in the United States in "private funds" managed or advised by it; and (ii) clients in the United States, including fund vehicles managed or advised by it;
- it has aggregate assets under management attributable to clients in the United States and investors in the United States in such funds of less than \$25 million (or such higher amount as the SEC may deem appropriate); and
- it does not hold itself out to the public in the United States as an investment manager or adviser and does not manage or advise "registered investment companies" or "business development companies".

For these purposes a "private fund" is any pooled vehicle, however constituted, which invests in securities and issues shares or units to its investors but which is exempt from the registration requirements of the US Investment Company Act of 1940 under Section 3(c)(1) of that Act (which applies to funds offered on a private placement basis to not more than 100 beneficial owners, with a look-through for certain 10% investors) or under Section 3(c)(7) of that Act (which applies to funds offered on a private placement

basis to "qualified purchasers" including individuals with investment portfolios of at least \$5 million or institutions with investment portfolios of at least \$25 million). By virtue of "no-action" positions taken by the SEC staff historically, non-US funds may be offered simultaneously to an unlimited number and type of non-US investors and to US investors in the same manner and to the same extent as is contemplated by Section 3(c)(1) or 3(c)(7).

Unlike the exemptions relating to venture capital funds and private funds (see below), this exemption can be used by managers and advisers who provide services to non-fund clients.

Affiliates (Unibanco)

Under principles set forth in a series of SEC staff no-action letters (often referred to as "Unibanco" after the original 1992 letter), the SEC staff has permitted non-US financial institutions to provide investment advice to US clients through a US registered investment adviser affiliate without registering the non-US entity under the Advisers Act, provided that certain conditions are met (including generally that (1) the entities are separately organised; (2) the US registered adviser is staffed with capable personnel; (3) the non-US personnel involved in the US activities are treated as "associated persons" of the registered adviser; and (4) the SEC has certain access to trading and other records (and personnel) of the non-US entity). Although the Registration Act does not expressly adopt the Unibanco principles, the forthcoming SEC rules may preserve that aspect of current regulation, which was the approach taken by the SEC staff in 2005 when the SEC initially promulgated regulations seeking to cause managers of hedge funds to be subject to the registration requirements of the Advisers Act.

Offshore managers and advisers to offshore funds

The SEC staff has in the past generally not subjected non-US registered investment managers and advisers to the substantive provisions of the Advisers Act with respect to offshore clients. Of course, non-US advisers registered with the SEC have been required to comply with the entirety of the Advisers Act and the regulations thereunder with respect to US clients (and prospective US clients).

Outstanding issues

A significant number of issues remain unclear in relation to this exemption, including the following. The forthcoming SEC rules are expected to provide definitions and clarify these questions.

- The meaning of clients and investors "in the United States". There are many possible approaches to defining this term. One approach turns on residence/domicile – this is the approach used in the SEC's existing Regulation S (which provides an exemption from SEC registration for certain sales of securities outside of the United States), which the SEC staff has applied (in slightly modified form) for purposes of the offering of non-US funds on a private placement basis consistent with the Investment Company Act, as set out in the no-action letters referred to above.
- The extent to which clients and investors with which the firm has no direct relationship are included. For example, where a fund of funds invests in a fund managed by a firm, should the firm take account of US investors in the fund of funds; and does the firm count both the fund of funds and its US investors? It should be assumed that indirect relationships structured with a view to avoiding the requirements will be counted.
- Over what period the number of clients and investors should be calculated. Under the current private adviser exemption, the number of a firm's clients is determined over a rolling 12 month period.
- How many clients a sub-adviser providing advice solely to a fund manager will be treated as having.
- How "assets under management" are to be calculated (for example, using a fund's capital commitments or invested capital versus the fund's total assets), particularly for a non-discretionary adviser or a sub-adviser.
- Whether non-US funds that do not conform fully to Section 3(c)(1) or 3(c)(7) of the Investment Company Act, but rely on no-action relief that is based upon such sections, will constitute "private funds" under the Registration Act.
- Whether the SEC will use its authority to raise the \$25 million threshold, which has been suggested by many commentators in response to the SEC's initial request for public comment.
- Whether, in order to limit the extraterritorial effects of the Advisers Act, the SEC will adopt the Unibanco principles for "participating affiliates" and limit the application of the Advisers Act for non-US firms to the US clients (and prospective clients) they advise, although this may be more complex in light of the specific provisions of the Registration Act contemplating a "look through" of funds to count the number of US investors.

Venture capital funds

New exemption

The Registration Act also includes an exemption from registration for firms which only manage or advise one or more "venture capital funds". The SEC is required to define the term "venture capital fund" by 21 July 2011. However, the rule is expected well before that date in order to allow firms adequate time to prepare for registration, if applicable.

While the SEC has not yet issued regulations, it would be reasonable to assume that this exemption will assist only true venture capital firms, who provide seed, start-up or early stage capital, and not mid-market or large buy-out houses providing growth or development capital, or engaged in leveraged buy-outs.

The condition that the firm must manage or advise "only" one or more venture capital funds should be construed narrowly. If the firm carries on other management or advisory business, including acting as adviser or manager to funds which do not qualify as venture capital funds, the exemption would not be available.

A manager or adviser that qualifies for this exemption will still be subject to new record-keeping and reporting requirements to be established by the SEC.

Outstanding issues

As indicated above, SEC rules are awaited in relation to:

- the definition of venture capital fund; and
- record-keeping and reporting requirements.

Private fund advisers

New exemption

The Registration Act requires the SEC to adopt an exemption for any investment manager or adviser that only advises "private funds" (as defined above – see *Foreign private advisers*) and has total assets under management in the United States of less than \$150 million.

As with the venture capital exemption, the private fund exemption applies if the adviser "only" manages or advises private funds. It would therefore be reasonable to assume that if it carries on other management or advisory business, the exemption will not be available. In this context, firms should take account of the structure of co-investment arrangements.

A manager or adviser that qualifies for this exemption will still be subject to new record-keeping and reporting requirements to be established by the SEC.

Outstanding issues

SEC rules implementing the exemption are awaited and are expected to clarify a number of issues raised by the statute, including the following:

- how "assets under management in the United States" are to be calculated;
- what types of co-investment structures will be acceptable under the exemption; and
- record-keeping and reporting requirements for managers and advisers.

Mid-sized advisers

An adviser with between \$25 million and \$100 million in assets under management (or such higher number as the SEC may designate) will not be permitted to register with the SEC unless that adviser either: (1) is an adviser to a US registered investment company or business development company; or (2) would be subject to registration in 15 or more states. Such advisers may be required to register with individual states in which they maintain their principal office or place of business if the rules of the relevant state so require.

Advisers to mid-sized private funds

The Registration Act directs the SEC, when prescribing regulations relating to the registration and examination/supervision of advisers to "mid-sized private funds," to consider the size, governance and investment strategy of such funds so that such regulations will reflect the level of systemic risk posed by such funds. The Registration Act does not define "mid-sized private fund,"

and it is not clear whether the SEC will consider establishing a separate (perhaps partial) exemption relating to such "mid-sized private funds."

Family offices

The Registration Act amended the definition of investment adviser to exclude "family offices" as such term may be defined by SEC rule. The SEC recently proposed implementing regulations that largely codify prior SEC exemptive relief in this area.

The rule would define "family office" as an organisation (including its directors, partners, trustees and employees acting within the scope of their position or employment) that (a) has no clients other than specified "family clients" (with some allowance for situations resulting from the death of a family member); (b) is wholly owned and controlled by family members; and (c) does not hold itself out to the public as an investment adviser. For additional detail on the proposed rule, please see Goodwin Procter's separate [client alert](#).

Other exemptions

Other exemptions added by the Registration Act cover: (1) investment advisers to small business investment companies under the Small Business Investment Act of 1958; and (2) investment advisers that are registered with the US Commodity Futures Trading Commission as a commodity trading adviser, advise a private fund, and whose business is not predominately the provision of securities-related advice.

Implications of registration

Firms registered with the SEC as investment advisers will need to comply with a range of requirements. In some cases the requirements extend to the funds they manage or advise. Key requirements include the following.

- *Chief compliance officer.* A firm must nominate a chief compliance officer responsible for the firm's compliance with SEC requirements. In many firms a single individual will perform the same role in relation to both SEC and FSA compliance.
- *Compliance policies and procedures.* A firm will need to have compliance policies and procedures which reflect the SEC requirements. There will be many similarities to the requirements under the FSA rules, although there are likely to be some differences.
- *Custody requirements.* Firms which (or whose affiliated persons) hold, directly or indirectly, client funds or securities, or have authority to obtain possession of them, are required to ensure that the securities managed by them are held in custody by a qualified custodian, such as a bank, subject to regular account statements and an independent surprise audit. In the case of funds, in lieu of account statements and the surprise audit (but not in lieu of the requirement to have a custodian), a fund manager may cause audited financial statements conforming to US GAAP (or IFRS or other non-US accounting reconciled to US GAAP) to be furnished to investors in the fund within 120 days after the year end of the fund (180 days for funds of funds). Complying with this "audit provision" allows a private fund that holds certain private securities that are both uncertificated and subject to transfer restrictions to hold such uncertificated securities without a designated custodian; however, (1) this provision applies only to such uncertificated securities: all other assets would need to be held with a custodian and therefore this is unlikely to operate as an exemption from the need to appoint a designated custodian; (2) many assets would not meet the test for being both uncertificated and subject to relevant transfer restrictions (for US purposes, securities will not be treated as uncertificated if they are held in dematerialised form in CREST); and (3) if a non-fund account holds such securities or if a private fund holding such securities does not comply with the "audit provision" of the custody rule then it is necessary to cause such uncertificated securities to be held by a qualified custodian, generally by keeping the originally signed subscription agreement (instead of the security itself) with a qualified custodian or having the custodian act as nominee for the private fund. Importantly, the SEC staff has noted in its response to "[Frequently Asked Questions](#)" regarding custody that offshore advisers registered with the SEC are not subject to the custody rule with respect to offshore funds; however, non-US firms that have direct US clients, including funds organised under US law (such as Delaware limited partnerships), would need to comply with the custody rule for such accounts.
- *Record-keeping, reporting and inspections.* The Registration Act enhances the SEC's record-keeping, reporting and inspection authority over both registered firms and the private funds that they advise. In particular, registered firms must maintain (and make subject to inspection by the SEC) records and reports for each private fund they advise that include: (i) the amount of assets under management and use of leverage, including off-balance-sheet leverage; (ii) counterparty credit risk exposure; (iii) trading and investment positions, (iv) valuation policies and practices of the fund; (v) types of assets held; (vi) side arrangements or side letters with investors; and (vii) trading practices. The SEC is expected to issue for public comment in late 2010 or early 2011 preliminary regulations implementing these requirements.
- *SEC may impose further requirements.* The SEC is also permitted to require registered firms to maintain records of, and file with the SEC, such reports regarding private funds advised by such advisers as is necessary and appropriate in the public interest and for the protection of investors, or for the assessment of systemic risk. Additional records and reports may therefore be specified by SEC rule.

- *SEC enquiries.* The SEC may at any time conduct supervisory or investigative enquiries, including by access to the firm's premises.
- *Information sharing.* Information provided to the SEC may be shared with other authorities, including the US Financial Stability Oversight Council.

For a general description of the types of responsibilities and ongoing compliance obligations of a registered investment adviser, information provided by the SEC is available [here](#).

Getting registered

It is likely to take at least several weeks to prepare the forms necessary to register with the SEC, as well as the supporting documents. Firms should be prepared to commit substantial management time to this process and may wish to obtain specialist support.

In order to register with the SEC, firms must submit one form, in three parts:

- Form ADV Part 1A (Part 1B will not be relevant to non-US firms);
- Form ADV Part 2; and
- execution pages.

Once the form is filed, the SEC has up to 45 days (under current regulation and practice) to review a new application (generally, for completeness) and to determine whether to grant or deny registration. The timetable can be extended if the form is incomplete or the SEC makes comments. Historically, registrations have been granted before the 45-day period has expired, so (as with applications to the UK FSA for authorisation) it is important to be ready to comply with applicable rules the day the application is filed and not to expect to use the 45-day period to get ready. The SEC is entitled to visit the firm (to conduct an "examination" or inspection) as soon as the firm is registered in order to establish whether it complies.

The form can only be submitted through an online registration system. Firms must first register for an account with the [Investment Adviser Registration Depository](#) and fund a related financial account for the purposes of covering the costs of registration. A template form, together with detailed instructions for completing it, is available in PDF format [here](#).

Many of the requirements of Form ADV will be familiar to those who have coordinated applications for FSA authorisation and a copy of a firm's original application for FSA authorisation may be a useful reference point when completing the form.

Marketing restrictions

Current US marketing restrictions applicable to private funds address both: (i) the permissible form and content of advertising to potential US clients or investors; and (ii) the persons to whom it is permissible to market certain products. These will remain in place. They apply irrespective of whether the relevant investment manager or adviser is subject to SEC registration.

Additional substantive limitations on the content of materials constituting "advertising" by a registered adviser apply under the Advisers Act. "Advertisements" is broadly defined and may include "flip books," "sales decks" and other materials often used to solicit investors, as well as quarterly letters or slides for annual meetings to the extent they are shared with consultants or prospective investors or are intended to generate interest in additional funds or services. In this respect the scope is similar to that of the UK financial promotion regime. The substantive US limitations on the content of these materials include prohibitions on the use of "testimonials" (including limitations on the use of client or investor lists), limitations on the promotion of specific investments and requirements as to presentation of performance information or investment returns on a basis that is "net" of fees (including carried interest payments) to the adviser (and certain affiliates).

Next steps

All UK and EU managers or advisers should now take the following steps:

- Engage with senior management.
- Allocate responsibility for this issue to a senior member of staff and allocate them sufficient resource to address it.
- Identify clients and investors "in the United States". Whilst that term is not yet defined, firms may wish to consider conducting an analysis based on addresses or tax information (particularly in the case of a non-US listed fund where the shareholder base may be diverse and changing).

- Review the basic scope of the registration requirement and available exemptions and determine (so far as possible) the likelihood that registration will be required. Many non-US managers and advisers (those who have any substantial amount of capital from US investors) are unlikely to be able to determine definitively whether they will need to register until further SEC rules define and clarify the exemptions from the registration requirement. Some will be able to make a good guess.
- Decide whether or not US investors are (or are likely to become) a sufficiently important part of the firm's investor base to warrant the effort of registering and complying and, if not, whether existing US commitments or client relationships could be unwound or terminated before the rules come into force.
- Consider whether to engage with trade associations, such as AIMA, BVCA and EVCA, who are lobbying the SEC on behalf of their member firms.

If it appears unlikely that registration will be required

If it appears unlikely that registration will be required, we recommend that firms should wait until there is further SEC rule-making before taking further significant steps. However, they should note that in the case of the "venture capital fund" exemption and the "\$150 million in assets under management" exemption, an exempt firm will still be obliged to comply with record-keeping and reporting requirements to be developed by the SEC. Firms should keep a watching brief on developments.

If registration is certain to be required or this is more likely than not

If registration is certain to be required or this is more likely than not, firms should not focus first on the registration forms and filing process. Instead, we recommend that they should take the following steps.

- Designate a Chief Compliance Officer (likely to be the firm's existing compliance officer for UK FSA purposes), who should have sufficient seniority and authority within the organisation to lead this effort and to compel others to adhere to compliance policies and procedures.
- Evaluate how the firm's business may need to change to comply with the Advisers Act once the firm is registered. Conduct a gap analysis against existing compliance policies and procedures.
- Develop policies and procedures that will go with the grain of the particular business whilst satisfying the requirements of the Advisers Act. Decide whether to integrate such policies and procedures into existing compliance arrangements, or to address them in a "wrapper" to established policies and procedures.
- If the firm plans to be fundraising after 21 July 2011, draft or amend marketing documents, for example to refer to the fact of SEC registration.
- Consider whether to begin to implement policies and procedures prior to 21 July 2011 in order to make sure the firm's internal controls are in good order and that the compliance effort is a well-oiled, fully-functioning operation prior to registration becoming effective. Only after those steps have been taken should firms turn to completing the registration forms.

Further developments

We will continue to monitor the progress of the Registration Act and any other related proposals.

Key dates

Late 2010 into 2011	SEC expected to publish detailed implementing rules, including clarifying the scope of exemptions and, perhaps, addressing the status of non-US managers and advisers which are already regulated in their own jurisdiction.
31 March 2011	If registration is required, we recommend that firms should submit Form ADV to the SEC for registration by end of Q1 2011 (although this is not a strict deadline).
6 June 2011	The last possible date for submission of registration forms.
21 July 2011	Deadline for affected firms to be registered with the SEC.

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