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Clients&FriendsMemo

# Hedge Fund Regulation Under the Dodd-Frank Wall Street Reform and Consumer Protection Act*

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The inevitable heightened regulation of the hedge fund industry has come to fruition with the passing of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "**Act**") by the Senate on July 15, 2010. It now awaits the signature of President Obama. While the Act could be worse – it does not appear to be the operational and expense burden to hedge funds that Sarbanes-Oxley is for corporate America – its ultimate effects remain to be seen, as much of the detailed formulation and implementation of the Act's largely ambiguous provisions are left to future rulemaking by a wide range of increasingly powerful governmental regulators having tremendous discretionary authority, such as the Securities and Exchange Commission ("**SEC**"), the Commodity Futures Trading Commission ("**CFTC**"), the Board of Governors of the Federal Reserve System (the "**Federal Reserve**"), and the to-be-established Financial Stability Oversight Council[1] (the "**FSOC**").

What is clear, however, is that the composition of the set of registered investment advisers will change dramatically with the SEC's regulatory efforts being concentrated on managers with a larger amount of assets under management ("**AUM**"). The Act accomplishes this through changes in the statutory provisions governing the investment advisers that are required to, and indeed are able to, register as investment advisers with the SEC. Larger fund managers that were not previously registered will be required to register, and smaller fund managers that are registered may

* Cadwalader has prepared a short summary of the Act and a series of memoranda focused on the Act's application to specific industries, entities and transactions. To see these other memoranda please see a *Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act* (Appendix A links to the various topic-focused memoranda) or visit our website at http://www.cadwalader.com/list_client_friend.php.

1 The Act establishes the FSOC, which will consist of the Treasury Secretary, the respective heads of the SEC, CFTC, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, Federal Reserve, National Credit Union Administration Board, Federal Housing Finance Agency and (new) Bureau of Consumer Financial Protection, and an independent insurance expert named by the President and confirmed by the Senate.

need to de-register (subjecting them in most instances to a patchwork of state investment adviser regulation).[2]

Coupled with this altered pool of registered advisers is a significantly enhanced disclosure and reporting regime. Important proprietary information on both strategies and portfolios is required to be reported to the government, under the guise of preventing another financial calamity (how so many small snippets of information can be meaningfully analyzed to prevent a future financial crisis will be interesting to see). This, of course, is to say nothing of the remarkable volume of transaction information with respect to swaps that is required to be disclosed under Title VII of the Act.

What is more troubling are the open-ended powers that the Act confers upon the Federal Reserve and the FSOC to regulate systemically significant financial firms, which could include certain large hedge funds. The ultimate effect of these broad powers – which could include the ability to impose capital requirements and even to intercede in the actual business affairs of these financially significant funds – is unknown.

Further, hedge funds that enter into a significant volume of swaps may be required to register with either or both of the SEC and the CFTC as "major swap participants." Such forced registration could entail regulation of capital as well as other significant requirements that could endanger individual funds' operating models, to say nothing of the expense of such regulation. Added to this is the substantially increased CFTC regulation to which certain fund managers will be subject, as the Act's new treatment of many swaps as futures will cause many funds to be considered commodity pools, and thus their managers may be required to register with the CFTC as "commodity pool operators" or "commodity trading advisors" unless an exemption applies.

The following discussion highlights the most noteworthy effects the Act will have on the regulatory regime under which hedge funds and asset managers operate:

## I. Investment Adviser Registration

### A. Elimination of "Fewer than 15 Clients" Exemption

Until now, many advisers to hedge funds and other investment vehicles have relied upon the exemption contained in Section 203(b)(3) of the Investment Advisers Act

2 From the standpoint of national economic policy, this is in fact one aspect of the Act that does seem sensible: to focus on the oversight of advisers having control over greater sums of money and leaving the regulation of smaller advisers to the states, which, in theory, should have the personnel to oversee this larger number of advisers. That said, advisers who are forced to de-register with the SEC and re-register with numerous states are likely to face increased expenses and compliance issues from dealing with numerous local regulators.

of 1940, as amended (the "**Advisers Act**"), as their basis for not registering with the SEC under the Advisers Act. Section 203(b)(3) exempts advisers that have fewer than 15 clients, do not "hold themselves out to the public as investment advisers" and do not provide advice to investment companies registered, or companies electing business development company treatment, under the Investment Company Act of 1940, as amended (the "**Investment Company Act**"). Title IV of the Act eliminates this exemption. Many advisers that relied upon Section 203(b)(3) therefore will be required to register with the SEC as investment advisers, regardless of the number of clients they advise, provided they meet the $100 million of AUM threshold discussed below (or $150 million in the case of certain advisers to "private funds"), unless they qualify for a different exemption.

As is the case with most of the provisions of Title IV, the elimination of Section 203(b)(3) becomes effective one year after the date of the Act's enactment.

### B. Increase in AUM Threshold for SEC Registration

Previously, an investment adviser generally could not register with the SEC unless it had at least $25 million of AUM, leaving the registration of advisers with less AUM to the individual states. The Act raises this threshold to $100 million (or such higher amount as the SEC, by rule, may determine) in an effort to permit the SEC to focus its resources on larger managers. As a result, advisers with less than $100 million of AUM generally will not be permitted to register with the SEC (or, if already registered, will be required to withdraw their registrations) if they are otherwise required to register with and be subject to examination by the state in which their principal office and place of business is located.[3] However, advisers with at least $25 million of AUM will be permitted to register with the SEC if (1) without such registration, they would be required to register with 15 or more states; or (2) they are not subject to registration or examination in the state where they have their principal office and place of business. Regardless of AUM, registration is still required for advisers to registered investment companies and business development companies.

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[3] Given the manner in which the Act is drafted in relation to state Blue Sky laws, this provision does not apply to advisers with their principal office in either New York State (because New York law does not authorize routine examinations of registered advisers) or Wyoming (because Wyoming has no statutory requirement for adviser registration). Rather, advisers in either of those states will be required to register with the SEC if they have AUM of at least $30 million and will be permitted to register if they have AUM of at least $25 million in the case of New York advisers, and AUM of any amount in the case of Wyoming advisers.

**C. Addition or Modification of Other Registration Exemptions**

The Act adds certain new exemptions from Advisers Act registration and pares back on one existing exemption. The newly-added or modified exemptions relate to:

- advisers to "private funds" with aggregate AUM in the U.S. under $150 million;
- advisers to "venture capital funds";
- advisers to "small business investment companies";
- "foreign private advisers";
- "family office" advisers;
- intrastate advisers with no private fund clients; and
- certain commodity trading advisors.

**D. Definition of "Private Fund"**

The Act defines a "private fund" as any fund that would be an investment company (including foreign entities offering securities in the U.S.) but for the exceptions contained in Section 3(c)(1) or 3(c)(7) of the Investment Company Act. This "private fund" concept is used throughout the Act whenever new regulation is meant to apply to hedge funds, private equity funds and similar investment vehicles. However, the Act is unclear in many instances in distinguishing between investment advisers, on the one hand, and the funds they manage, on the other hand. Clarification of this distinction in related regulations will be important in determining how the Act's provisions affect the hedge fund industry and to which entities the Act's provisions apply.

**E. Small Private Fund Advisers**

The Act directs the SEC to provide an exemption for advisers for which the sole clients are "private funds" and which have aggregate AUM in the U.S. of less than $150 million ("**Small Private Fund Advisers**"), although such advisers will be subject to certain recordkeeping and reporting requirements, to be established by SEC rules.

Note that the Act directs the SEC to consider the systemic risk of "mid-sized private funds" and authorizes the SEC to require registration and examination of advisers to such funds commensurate with their level of systemic risk. However, the Act does not define "mid-sized private funds."

### F. Advisers to Small Business Investment Companies and Venture Capital Funds

The Act also creates new exemptions for advisers for which the sole clients are: (1) "small business investment companies" ("**SBICs**") licensed, or applying for a license, under the Small Business Investment Act, provided the client[4] is not a "business development company" under Section 54 of the Investment Company Act; or (2) "venture capital funds." The Act requires the SEC, by rule issued within one year after enactment, to define the term "venture capital fund." The SEC is also directed to require venture capital fund advisers to maintain such records and file such reports with the SEC as the SEC determines necessary or appropriate.

Although the exemptions for Small Private Fund Advisers and advisers to SBICs and venture capital funds each use the term "solely," it is unclear whether the foregoing exemptions will be construed to work in tandem to cover a Small Private Fund Adviser with other clients that are solely SBICs and/or venture capital funds.

### G. Offshore Advisers

The Act creates a new exemption for "foreign private advisers." The Act defines "foreign private advisers" as investment advisers (1) with no place of business in the U.S.; (2) that do not hold themselves out to the public in the U.S. as investment advisers; (3) that do not advise investment companies registered, or business development companies filing elections, under the Investment Company Act; (4) that have fewer than 15 total U.S. clients, including for this purpose U.S. investors in private funds managed by the adviser; and (5) that have less than $25 million of AUM attributable to such U.S. clients and investors (or such greater amount as the SEC may provide by rule). Because this exemption is quite narrow,

[4] Although the Act describes business development status as applying to the adviser itself, we assume this reference was intended to apply to the status of the adviser's clients.

a large number of offshore advisers will likely be required to either register under the Advisers Act or limit their provision of advisory services to U.S. investors.[5]

Note that the SEC has historically taken the position that a number of the Advisers Act's provisions are generally not applicable to an offshore adviser's relationship with its non-U.S. clients. For example, when the SEC adopted a subsequently-invalidated rule in 2004 requiring both U.S. and offshore advisers to "look through" their fund clients for purposes of determining whether they qualified for the Section 203(b)(3) exemption (the under 15 client exemption), the SEC indicated that, although an offshore adviser might be registered with the SEC on the basis of the number of U.S. investors in one or more of its offshore funds, "because the offshore fund would be a non-U.S. client, the substantive provisions of the [Advisers] Act generally would not apply to the offshore adviser's dealings with the offshore fund."[6] The SEC noted that any U.S. investors in such a fund should not expect the full protection of the U.S. securities laws.

With that premise in mind, the SEC concluded that registered offshore advisers would be required to maintain certain books and records (including records of certain personal securities transactions) and submit to examinations by the SEC staff. However, the SEC also concluded that, at least with respect to its offshore activities, such an adviser would not be subject to the Advisers Act compliance procedures rule (Rule 206(4)-7), custody rule (Rule 206(4)-2), proxy voting rule (Rule 206(4)-6), rule regarding customer solicitations (Rule 206(4)-3), advertising rule (Rule 206(4)-1), or brochure rule (Rule 204-3), and would not be subject to the prohibition on performance fees contained in Section 205 of the Advisers Act, the provisions of Section 205 relating to advisory agreements, or the Section 206(3) restrictions on "principal transactions."

Whether the SEC will take a similar approach with respect to the implementation of the Act in the context of offshore advisers is currently unclear.

### H. Family Offices

The Act adds an exemption for "family offices," to be defined by SEC rule, regulation or order to (1) be construed in a manner that is consistent with the

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[5] It is unclear whether offshore advisers can rely upon the exemption for Small Private Fund Advisers, and if so, whether the exemption's assets under management "in the U.S." test would apply solely to the assets of such adviser's U.S. domiciled funds or would extend to U.S. investors in such adviser's offshore funds. The SEC will need to clarify these issues.

[6] SEC Rel. No. IA-2333 (Dec. 2, 2004) at 69 Fed. Reg. 72054, 72072 at n. 213 (Dec. 10, 2004).

previous exemptive policy of the SEC; (2) recognize a range of organizational, management and employment structures used by family offices; and (3) not exclude certain grandfathered advisers. Based on the foregoing, the term “family office” is likely to include single-family offices that provide a wide range of services in addition to investment advice and to other family offices that operate under the specific requirements of SEC exemptive orders issued before January 1, 2010. It does not appear that multi-family offices will be covered by this exemption.

### I. Intrastate Advisers

The Act eliminates the existing exemption in Section 203(b)(1) of the Advisers Act for an otherwise intrastate adviser if the adviser advises one or more private funds, even if the private funds and all of their investors are located in the same state as the adviser’s principal office.

### J. Commodity Trading Advisors

The Act adds a new exemption to Section 203(b)(6) of the Advisers Act for commodity trading advisors registered with the CFTC that advise private funds, but requires such advisors to register with the SEC if, after the Act’s enactment date, their business becomes “predominately” the provision of securities-related advice. The Act does not define “predominately.”

### K. State Blue Sky Regulation

Investment advisers that are not registered with the SEC, and in certain cases one or more of their employees or other representatives, will be subject to regulation in each state (as well as the District of Columbia and certain U.S. territories and possessions) in which a client may be located or from which the adviser provides investment advice, unless one or more federal or state-specific exemptions apply.

For example, Section 222(d) of the Advisers Act provides a “national de minimis standard,” which preempts states from requiring registration of an adviser with no place of business and fewer than six clients in the state in any 12-month period. While an SEC rule presently prohibits a “look-through” to investors in a private fund or other entity when counting clients in this context, it remains to be seen whether that rule will continue in effect following enactment of the Act.

Notwithstanding Section 222(d), most Blue Sky laws include either exceptions from the definition of “investment adviser,” or exemptions from registration, similar or identical to Section 222(d), and typically (and more generously than Section 222(d)) exclude from the numerical client limit certain types of institutional investors. However, these exceptions and exemptions are not uniform and must be considered on a state-by-state basis.

If an adviser is required to register with one or more states, Sections 222(b) and (c) of the Advisers Act preempt certain other state requirements, so that a state-registered adviser need only comply with the books and records, capital and bonding requirements of the state in which it has its principal place of business, and not those imposed by other states where it may be registered. However, except as limited by Sections 222(b) and (c), states are free to, and often do, impose disparate requirements on state-registered advisers, so that, for example, an adviser may be subject to different restrictions on its ability to charge performance fees to clients, may be required to file different reports, and may be subject to different custody requirements, in each state in which it is registered, as compared to those permitted or required under the Advisers Act.

In the case of SEC-registered investment advisers, states generally require that advisers offering advice in or from the state make "notice filings," which may consist of nothing more than a copy of the adviser's Form ADV and payment of a filing fee. While Section 222(d) of the Advisers Act does not apply to such notice filings, most states have enacted exceptions or exemptions from these filings that track the exceptions and exemptions applicable to state registration (discussed above).

Apart from notice filings, states may not require any other filings from, or impose substantive requirements on, SEC-registered advisers.

Most states also require registration of certain personnel of a state-registered adviser (as well as certain personnel of SEC-registered advisers) as "investment adviser representatives." In particular, these individuals may be required to pass a qualification exam as a condition of registration.

## II. Records and Reports

### A. Private Fund Records

The Act contains a number of provisions relating to the maintenance, filing and inspection of records regarding private funds, in each case pursuant to rules to be promulgated by the SEC within 12 months following passage of the Act. In particular, the Act requires an adviser to maintain, and be subject to SEC inspection with respect to, the following records for each private fund it advises:

- 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; and
- other information deemed necessary by the SEC, in consultation with the FSOC.

The Act also requires each adviser to a private fund to file reports containing such information as the SEC deems necessary or appropriate in the public interest or for the assessment of systemic risk.

Furthermore, the Act directs the SEC to conduct periodic inspections of the records of private funds maintained by registered advisers and to conduct such additional examinations as the SEC may deem necessary or appropriate in the public interest or for the assessment of systemic risk. Such advisers must also make available to the SEC, upon request, any copies or extracts of such records "as may be prepared without undue effort, expense or delay."

Although many hedge fund managers and other asset managers maintain much of this information on a routine basis and disclose some of this information to their investors and counterparties, this information has never before been subject to compulsory disclosure to regulators outside of investigatory or enforcement proceedings.

### B. Information Sharing and Confidentiality

The Act requires the SEC to provide the FSOC with any private fund information collected by the SEC and deemed by the FSOC to be necessary to assess the systemic risk posed by such private fund. The SEC and FSOC must generally maintain the confidentiality of any private fund information they collect, and the Act exempts such information from disclosure under the Freedom of Information Act ("**FOIA**").

Notwithstanding the foregoing, the Act provides that such information may be disclosed (1) to Congress, subject to an agreement of confidentiality; (2) to any government agency or self-regulatory organization requesting the information for purposes within the scope of its jurisdiction; or (3) pursuant to a court order in an action brought by the U.S. or the SEC. Information provided to any government agency or self-regulatory organization is also exempt from FOIA disclosure and is subject to the same confidentiality standards applicable to the SEC and FSOC.

Furthermore, "proprietary information" is subject to the same heightened confidentiality standards that apply to facts ascertained by the SEC during examinations. The Act describes "proprietary information" as including sensitive, non-public information regarding (1) the investment or trading strategies of an investment adviser; (2) analytical or research methodologies; (3) trading data; (4) computer hardware or software containing intellectual property; and (5) any additional information that the SEC determines to be proprietary. Investor identity and other investor information is not specifically protected under the Act, the significance of which will depend on whether the SEC can compel disclosure of such information under the information maintenance, filing and disclosure provisions discussed above.

The Act also amends Section 210(c) of the Advisers Act, which generally prohibits the SEC from requiring investment advisers to disclose the identity, investments or affairs of a client, except in an enforcement proceeding or investigation, so as to permit the SEC to require investment advisers to disclose such information for the purpose of assessing potential systemic risk. Although in the registration and exemption context the term "client" generally refers to funds and not to the investors in such funds, the information maintenance, filing and disclosure provisions of the Act are sufficiently vague that it is unclear whether the SEC or another regulator (such as the FSOC) could rely on this provision to require disclosure of private fund investor names and other details that to date have been considered highly confidential by advisers and investors alike.

### C. Additional Disclosures

The Act requires each adviser subject to Section 13(f) of the Securities Exchange Act of 1934, as amended (the "**Exchange Act**"), (*i.e.*, advisers with investment discretion of $100 million or more of U.S. public company equity and certain other securities) to disclose at least annually its votes cast with respect to U.S. public company say-on-pay proposals and submit a report of the "aggregate amount of the number of short sales" of securities it makes each month. It is not clear whether the report would be of all short sales during the month, which seems to be suggested by the language, or all open positions on the last day of the reporting period, which would be consistent with the current requirements of Section 13(f) as to long positions. Further, it is not clear whether such reports would be required as to all securities or only securities as to which long positions must be reported under Section 13(f).

The Act also makes a number of changes to the reporting requirements for holders of securities subject to Section 13(d) of the Exchange Act, most significantly authorizing the SEC to shorten the time period between a transaction and the required report.

## III. Custody of Client Assets

The Act adds a new Section 223 to the Advisers Act, which requires registered investment advisers to safeguard client assets over which the adviser has custody, including verification of client assets by independent public accountants, as may be prescribed by SEC rule. It is not clear from the Act's text whether any such rule is expected to be in lieu of, or in addition to, the existing "custody rule" (Rule 206(4)-2) under the Advisers Act.

## IV. "Significant Firm" Prudential Safeguards

The Act establishes a new class of systemically significant nonbank financial firms ("**SSNFs**") that will be subject to new regulations. An SSNF is a firm that directly or indirectly engages in financial activities if the FSOC determines that either (1) material financial distress at the firm could pose a threat to financial stability or the economy; or (2) the nature, scope, size, scale, concentration and interconnectedness or mix of the firm's activities pose such a threat.

Although the SSNF designation is seemingly intended to cover large, traditional financial institutions and certain insurance companies, it is certainly possible that the FSOC will extend SSNF treatment to large hedge funds. It is also unclear how the FSOC will look at hedge funds – is the relevant firm the adviser or the fund? If the latter, will the FSOC use an analysis of similar investment strategies or common control to aggregate a group of smaller private funds?

SSNFs will be subject to Federal Reserve oversight similar to that of banks and bank holding companies, including Federal Reserve examinations, cease and desist orders for unsound practices or business activities deemed by the Federal Reserve to pose a "grave threat" to U.S. financial stability, conditions on the conduct of one or more activities, limits on mergers and acquisitions, forced divestitures of off-balance sheet assets, and forced liquidation by the Federal Deposit Insurance Corporation ("**FDIC**").

SSNFs will also be subject to new regulation to be promulgated by the Federal Reserve, in consultation with the FSOC. Such new regulation will be more strict than comparable regulation applicable to ordinary banks and bank holding companies and will cover the following:

- Risk-based capital requirements;
- Contingent capital (convertible debt) requirements;
- Risk management requirements;
- Liquidity requirements;
- Credit exposure and other reporting requirements;
- Limits on short-term debt, including margin and repurchase financing;
- Semi-annual stress tests;
- "Living will" plans to facilitate the firm's rapid, orderly liquidation;
- Restrictions on investment in banks, thrifts and other financial companies;
- Separation of banking activities from other operations; and
- Other prudential standards deemed appropriate by the Federal Reserve.

Of these regulations, the capital requirements, liquidity requirements, debt financing limits and restrictions on investments in financial companies are likely to be the most significant for hedge funds designated as SSNFs, although the particular details of each of these regulations remains unclear.

In addition to these regulations, the Act subjects the officers and directors of SSNFs forcibly liquidated by the FDIC to potential civil liability for gross negligence or similar misconduct leading to such liquidation, and to a potential compensation clawback for the two years leading up to such liquidation.

## V. Large Firm Stress Testing

The Act requires any financial company, including any private fund, with more than $10 billion in total assets, regardless of SSNF status, to conduct annual stress tests under baseline, adverse, and severely adverse conditions, and to file a report with the Federal Reserve and the company's primary financial regulatory agency. Although not specifically provided in the Act, on the basis of accounting rules for balance sheet consolidation, the SEC or other regulators may seek to apply this requirement to a group of funds which are managed by a single manager and have aggregate assets of more than $10 billion.

## VI. Volcker Rule

The Act establishes the so-called "Volcker Rule," which, among other things and subject to certain exceptions, prohibits banks, bank holding companies, entities treated as bank holding companies (such as foreign banks with a U.S. presence) and any of their affiliates ("**Covered Banks**") from investing in or sponsoring any private fund or any similar fund that the federal banking agencies, the SEC and the CFTC may, by rule, include within the scope of the prohibition ("**Covered Funds**").

The provisions of the Volcker Rule will become effective twelve months after the adoption of the coordinated final regulations by the federal banking agencies, the SEC and the CFTC, but in no case later than two years after passage of the Act. Covered Banks that currently engage in the prohibited activities will have an additional two years to wind down or divest such activities, subject to three additional one-year extensions granted by the Federal Reserve and an additional five-year extension, also granted by the Federal Reserve, for activities involving illiquid funds or certain currently existing contractual obligations. Thus, it is possible that certain Covered Banks will have as many as seven years to address the Volcker Rule's requirements with respect to certain Covered Funds.

### A. Investing in Private Funds

Despite the Volcker Rule's general prohibition, Covered Banks will be permitted to invest in Covered Funds if the Covered Bank organizes the fund, subject to certain restrictions on the amount of the investment. Under this exemption, a Covered Bank is permitted to establish a Covered Fund and provide the fund with sufficient initial equity capital for investment to permit the fund to attract unaffiliated investors. The Covered Bank is required actively to seek unaffiliated investors, and within one year after the fund is established, the Covered Bank is required to have reduced its investment (whether by redemption, sale, or dilution) as follows:

- the Covered Bank's investment in an individual Covered Fund does not exceed 3% of the total net asset value of the fund (it is unclear how the coordinated final regulations will treat master-feeder structures when making this calculation);
- the Covered Bank's investment in such fund is "immaterial" to the Covered Bank as defined in the coordinated final regulations, and provided further that the aggregate of all such investments by the Covered Bank does not exceed, on a consolidated basis, 3% of its Tier 1 capital; and
- the Covered Bank's total amount of investment in Covered Funds (including the amount of the Covered Funds' leveraged assets) must be deducted from the Covered Bank's assets and tangible equity for purposes of determining compliance with the new capital requirements for Covered Banks (discussed below).

### B. Sponsoring Private Funds

The Volcker Rule prohibits Covered Banks from "sponsoring" a Covered Fund, which includes (1) serving as the general partner, managing member or trustee of the fund; (2) selecting or controlling a majority of the directors or trustees or management of the fund; or (3) sharing the same or similar name with the fund for marketing, promotion, or other purposes.

Despite the Volcker Rule's general prohibition, a Covered Bank will be permitted to sponsor a Covered Fund provided the following conditions are satisfied:

- the Covered Bank provides "bona fide trust, fiduciary, or investment advisory services";
- such fund is organized and offered only in connection with such bona fide services and only to persons that are customers of such services;
- the Covered Bank does not acquire or maintain any ownership interest in the fund except as seed money (discussed above);
- the Covered Bank complies with the newly imposed Section 23A and 23B restrictions on transactions between the Covered Bank and the fund (*i.e.*, certain asset purchases and loans, derivatives and other extensions of credit), other than prime brokerage transactions deemed sound by the Federal Reserve;

- the Covered Bank does not assume, guarantee, or otherwise insure the obligations of the fund (or any private equity or hedge fund in which the fund in turn has invested);
- the Covered Bank discloses in writing to its prospective and actual investors that any losses in the fund are borne solely by the fund's investors and not by the Covered Bank;
- the Covered Bank and the fund do not share, whether for corporate, marketing, promotional, or other purposes, the same name or a variation thereof; and
- no director or employee of the Covered Bank takes or retains any ownership interest in the fund, except for those directors or employees that are directly engaged in providing investment advisory or other services to the fund.

### C. Prudential Limits on Exempted Activities

All of the above exemptions are subject to prudential limitations, including that no otherwise exempt transaction or activity may:

- involve or result in a material conflict of interest;
- result in a material exposure by the Covered Bank to high-risk assets or high-risk trading strategies;
- pose a threat to the safety and soundness of the Covered Bank; or
- pose a threat to the financial stability of the U.S.

The federal banking agencies, the SEC and the CFTC are required to adopt coordinated final regulations implementing these limitations (including defining the terms used, such as "material conflict of interest," "high-risk assets," and "high-risk trading strategies").

The Act also requires the federal banking agencies, the SEC and the CFTC, as part of the coordinated final regulations, to adopt rules regarding additional capital requirements, diversification, and quantitative limits (including diversification requirements) for Covered Banks sponsoring or investing in Covered Funds, if the agencies determine that such additional capital requirements and quantitative limits are appropriate for safety and soundness reasons.

### D. Foreign Entities

The Volcker Rule permits a foreign banking entity with affiliates engaged in U.S. operations to sponsor or invest abroad in hedge funds or private equity funds, provided that the transactions are solely with non-U.S. residents.

## VII. Major Swap Participants

The Act provides a comprehensive scheme for regulation of "swaps," including:

- SEC and/or CFTC registration of buy-side participants, including certain hedge funds, as "major swap participants";[7]
- capital and conduct requirements for major swap participants similar to those applicable to swap dealers;
- mandatory central clearing of certain swaps and margin requirements on many other swaps;
- trade reporting obligations; and
- position limits.

In this context, the term "swap" is defined in an extremely broad manner, including transactions traditionally regarded as swaps and potentially more.

In particular, a "major swap participant" is a legal entity (*i.e.*, not a group of related companies) that, subject to certain exemptions, either (1) maintains a substantial position in swaps in any major swaps category; (2) engages in swaps that create substantial counterparty exposure that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets; or (3) is a financial entity that is highly leveraged, is not subject to U.S. bank capital requirements and maintains a substantial position in swaps in any major swaps category. While the Act's language is subject to regulatory interpretation by the SEC and CFTC, it is likely that at least some hedge funds will satisfy one or more of these three tests.

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[7] More precisely, large users of swaps regulated by the CFTC are defined as "major swap participants" and large users of security based swaps regulated by the SEC are defined as "major security based swap participants." The Act generally treats both groups in a similar and parallel fashion.

## VIII. Accredited Investor Standard

Currently the test for "accredited investor" status with respect to natural persons under the Securities Act of 1933, as amended (the "**Securities Act**"), is either a net worth of at least $1 million or an annual income of at least $200,000 (or $300,000 joint income with spouse). The Act adjusts the net worth threshold so that, upon enactment and for 4 years thereafter, the value of the investor's primary residence is not included in such investor's net worth. The Act importantly does not make any changes to the annual income threshold.

The Act authorizes the SEC to conduct an initial general review of the definition of "accredited investor," as applied to natural persons, and to promulgate rules adjusting the provisions of the definition that do not relate to the net worth test.

Beginning on the fourth anniversary of the passage of the Act and at least once every four years thereafter, the Act requires the SEC to review the definition of "accredited investor," as applied to natural persons, and gives the SEC broad authority to modify the definition, including the net worth test, as appropriate for the protection of investors, in the public interest, and in light of the economy.[8]

Although this new standard reduces the number of potential new investors in private funds, the Act does not require existing investors to withdraw from private funds if such investors do not meet the new standard.

## IX. "Bad Boy" Disqualification from Reliance on Rule 506

The Act requires the SEC to issue rules, within one year after enactment, disqualifying from reliance on the private offering safe harbor of Rule 506 under Section 4(2) of the Securities Act offerings by issuers which have been, or which have officers, directors, affiliates or placement agents which have been, the subject of certain civil, criminal or administrative proceedings under federal and state laws. This disqualification may affect hedge funds relying on Rule 506 to satisfy the private offering requirements of the

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8 Curiously, the Act only requires the SEC to consider modifying the definition of "accredited investor" in Rule 215 under the Securities Act, which defines the term for purposes of Sections 2(15) and 4(6) of the Securities Act, exempting offerings not exceeding $5 million exclusively to "accredited investors." Since the definitions of "accredited investor" in Rule 215 and in Rule 501(a) of SEC Regulation D (applicable to private offerings complying with Rule 506 under Section 4(2) of the Securities Act) are identical, it is anticipated that any modification to Rule 215 would be accompanied by a conforming change to Rule 501(a).

investment company registration exceptions contained in Sections 3(c)(1) and 3(c)(7) of the Investment Company Act.[9]

## X. Qualified Client Standard

The Act requires that the various dollar amount tests for "qualified client" status for purposes of Section 205(e) of the Advisers Act, permitting payment of performance fees to investment advisers with regard to such clients, such as the $1.5 million net worth threshold, be indexed for inflation within one year following enactment and every five years thereafter. Any inflation adjustment that is not a multiple of $100,000 will be rounded up to the nearest multiple of $100,000.

Although investors in private funds need not be qualified clients by reason of Section 3(c)(1) or 3(c)(7) of the Investment Company Act, a private fund may not pay a performance fee with respect to investors that do not satisfy the test.[10] There does not appear to be any grandfathering provision for existing investors in private funds, likely making it necessary for some private funds to amend their investment terms to either exclude non-qualified clients or apply a different fee structure to such clients.

## XI. Other Potentially Relevant Provisions

The Act contains other financial market regulatory provisions that may directly or indirectly affect various aspects of the investment management industry. These provisions include the following:

- SEC and CFTC regulation of over-the-counter derivatives and pre-approval of contracts before they can be cleared by a clearing house;
- a requirement that a "securitizer" retain 5% of the credit risk of any asset, and increased disclosure about the underlying assets;
- increased supervision of banks and bank holding companies;
- supervision by the Federal Reserve of holding company subsidiaries;
- the possible imposition of fiduciary duties for broker-dealers;

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9 Hedge fund offerings to natural persons in the U.S. generally seek to comply with Rule 506 so as to qualify the offering as "covered securities" under Section 18(b)(4)(D) of the Securities Act, which preempts securities registration requirements under Blue Sky laws.

10 This requirement is most relevant for 3(c)(1) funds because the "qualified purchaser" requirement for 3(c)(7) funds by definition satisfies the "qualified client" test.

- potential restrictions on mandatory predispute arbitration agreements between any investment adviser and its customers or clients;
- creation of a Federal Insurance Office; and
- provisions relating to trade reporting and mortgage loans, among others.

In particular, the provisions relating to swaps and other derivatives will likely have a significant impact on hedge fund trading operations and compliance costs.

## XII. Studies for Future Regulatory Changes

The Act mandates the following government studies that could lead to changes in the regulatory framework applicable to private funds and investment advisers:

- a Government Accountability Office ("**GAO**") study regarding the compliance costs associated with SEC Rules 204-2 and 206(4)-2 under the Advisers Act with respect to custody of funds or securities of clients by investment advisers and the additional costs if subsection (b)(6) of Rule 206(4)-2 were eliminated (this subsection provides an exemption to the "independent verification" rule when an adviser has "custody" because client assets are held by an "operationally independent" person related to an adviser);
- a GAO study regarding the feasibility of forming a self-regulatory organization to oversee private funds;
- an SEC study regarding the standards of conduct applicable to all broker-dealers and investment advisers when providing personalized investment advice regarding securities to retail customers and whether there are any regulatory gaps or shortcomings;
- an SEC study regarding the need for enhanced examination and enforcement resources with respect to investment advisers;
- an SEC study regarding improved investor access to information on investment advisers and broker-dealers; and
- an SEC study regarding the state of short selling on national securities exchanges and in over-the-counter markets, with particular attention to the impact of recent rule changes and the incidence of the failure to deliver shares sold short and the delivery of shares on the fourth day following a short sale transaction.

While it is clear that the Act will have significant consequences for the regulation of investment managers and their clients – hedge funds in particular – the scope and depth of these consequences remain uncertain as many provisions await clarification and implementation by various regulatory agencies.

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Please feel free to contact any of the following Cadwalader attorneys if you have any questions about this memorandum.


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