

Morgan Lewis

Third Annual
ADVANCED TOPICS IN HEDGE FUND
PRACTICES CONFERENCE
Manager and Investor Perspectives

Expectations Regarding the New Regulatory Climate and Regulation

Ethan Johnson Jen Klass Steve Stone

www.morganlewis.com

Overview

- U.S. Regulatory Reform
- OCIE's Examination Focus
- Impact of Amended and Proposed SEC Rules
- International Perspective

U.S. Regulatory Reform

- **Private Fund Investment Advisers Registration Act of 2009**
 - All advisers to “private funds” must register, subject to certain exceptions
 - “Private fund” is any issuer that relies on Section 3(c)(1) or 3(c)(7)
 - Eliminates Section 203(b)(3) exemption for fewer than 15 clients
- **Advisers to “mid-sized” private funds – must register**
 - SEC directed to tailor registration, examination and reporting requirements to characteristics of funds and whether they pose systematic risk
- **Advisers to “small private funds” – are not required to register**
 - Advise exclusively private funds
 - Aggregate AUM of less than \$150 million
 - Must keep records and provide annual or other reports to the SEC

U.S. Regulatory Reform

- Advisers to “venture capital funds” – are not required to register
 - Must keep records and provide annual or other reports to the SEC
- Advisers to “small business investment companies” – are not required to register
- “Foreign private advisers” – are not required to register
 - No place of business in U.S.
 - Fewer than 15 U.S. clients within last 12 months
 - Less than \$25 million in AUM from U.S. clients within last 12 months
 - Does not hold itself out in U.S.
 - Does not act as investment adviser to a registered investment company or business development company

U.S. Regulatory Reform

- Collection of systematic risk data about private funds – registered advisers
 - Amount of AUM
 - Use of leverage, including off-balance sheet leverage
 - Counterparty credit risk exposures
 - Trading and investment positions
 - Trading practices
 - Other information as SEC determines necessary or appropriate for the protection of investors or for the assessment of systematic risk
- Additional information – registered and unregistered advisers
 - SEC authority to require additional information based on public interest and systemic risk
- Disclosure – registered advisers
 - SEC authority to require registered advisers to provide such reports, records and other documents to investors, prospective investors, counterparties and creditors of private funds

U.S. Regulatory Reform

- **Books and records**
 - Records and reports of private funds are considered books and records of the adviser
- **Client anonymity**
 - Elimination of express provision that prohibited SEC from requiring disclosure of the identity, investments and affairs of clients
- **Information sharing and confidentiality**
 - SEC authority to share information with Fed and the Financial Services Oversight Council
 - No waiver of privileges
 - Protection of proprietary information
 - SEC may not be compelled to disclose any report or other information filed with the SEC, except for Congress, Federal departments and agencies, SROs and courts

OCIE's Exam Focus

- Insider trading
- Custody and safekeeping of investor assets
- Valuation
- Performance claims
- Preferential treatment, including access to information and waiver of redemption restrictions
- Side pockets
- Advisory and performance fee calculations

SEC Rules – Custody Rule

- Amendments to Advisers Act Rule 206(4)-2 adopted on December 30, 2009
- Pooled investment vehicles are not subject to the annual surprise examination, notice and account statement delivery requirements if:
 - Fund is subject to an annual audit
 - Audit is performed by a PCAOB-registered independent public accountant
 - Audited financial statements prepared in accordance with GAAP are distributed to all investors within 120 days (180 days for funds-of-funds) of fiscal year end
 - In event of liquidation, fund performs a liquidation audit and distributes audited financial statements promptly after completion of audit
- Internal control report requirement applies if adviser or related person of adviser holds fund assets as qualified custodian
 - Unless related person is operationally independent

SEC Rules – Custody Rule

- Delivery to related persons
 - Account statements (if required) and audited financial statements may not be sent to special purpose vehicles (SPV) that are related persons of the adviser
 - Alternatives
 - Consider each SPV to be separate client and send audited financial statements of the SPV to its investors
 - Consider SPV assets to be part of the fund over which the adviser has custody and include the SPV assets in the audit of the fund

SEC Rules – Pay-to-Play

- Advisers Act Rule 206(4)-5 proposed on August 3, 2009
- Two-year “time out”
 - Prohibits an adviser from receiving compensation for the two-year period after the adviser or any of its covered associates makes a contribution to an official of a government entity who is in a position to influence the award of the government entity’s business
- Ban on using third parties to solicit government business
 - December 18, 2009 letter from SEC to FINRA
 - Signals SEC’s willingness to create exception for registered broker-dealers serving as legitimate placement agents if they were subject to FINRA rules prohibiting members from engaging in pay-to-play
- Ban on soliciting and coordinating contributions and payments

SEC Rules – Pay-to-Play

- Look-through for “covered investment pools”
 - “Covered investment pools” includes mutual funds, as well as private funds and collective investment trusts that are not registered in reliance on Sections 3(c)(1), 3(c)(7) or 3(c)(11) of the Investment Company Act
 - Prohibitions of rule apply to advisers that provide or seek to provide services directly to a government entity, but also where government entities are investors or are solicited to invest in covered investment pools managed by the adviser
 - Two-year time out does not apply to a mutual fund unless its is an investment option for a 529 plan or governmental retirement plan

International Perspective

- AIFM/AIF Proposed Directive - General

- In April 2009 the European Commission issued proposed directive to regulate managers (AIFM) of hedge funds, private equity funds and other locally regulated funds (AIF). The European Parliament issued commentary on the proposed directive in November 2009.
- The directive would apply to all AIFMs that operate or market funds in EU and are not covered by UCITS directive, with further exclusion for:
 - managers that operate funds with assets under €100 million; or
 - managers that operate funds with assets under €500 million if the funds are not leveraged and prohibit redemption for a period of at least five years following formation.

International Perspective

- AIFM/AIF Proposed Directive - General

- The European Parliament report recommends removal of the de minimis exclusions although it does advocate proportionality in the regulation of managers based on size.
- The European Parliament report advocated narrowing the scope of the directive to exclude certain types of funds but it would nevertheless still apply to real estate funds, venture capital funds and some securitization vehicles that are not otherwise excluded on the basis of assets or redemption restrictions.

International Perspective

- **AIFM/AIF Proposed Directive – Passport**
 - AIFMs will require regulatory authorization by a member state.
 - The authorization can be passported throughout EU with respect to marketing and selling shares of AIFs to professional investors.
 - The Parliament Report would restrict the “passport” to apply only to the marketing of EU domiciled AIFs. The marketing of Non-EU funds would be left for regulation on a national level.
 - Pursuant to the EU Commission proposal, the passport would not entitle AIFMs to market funds to retail investors.
 - Exception for funds of funds that invest more than 30% of their assets in Non-EU funds managed by AIFMs or other foreign funds.

International Perspective

- **AIFM/AIF Proposed Directive - Capital**

- The Commission proposal establishes minimum capital requirements for AIFMs of €125,000. If the value of the assets managed by the AIFM exceeds €250 million, additional equity of 0.02% of the amount by which the value of the portfolio of the AIF exceeds €250 million has to be provided.
- The Parliament Report recommends a maximum capital requirement of €10 million.

International Perspective

- **AIFM/AIF Proposed Directive - Disclosure**
 - The proposed directive mandates a significant amount of disclosure to investors including risk factors, liquidity characteristics, preferential treatment of other investors and explanation of fees.
 - Additionally, an AIFM will have to distribute an annual report for each fund managed. The Parliament report would expand disclosure requirements with respect to funds of funds and feeder funds.
 - The proposed directive requires disclosure and notification for AIFMs that manage AIFs that either individually or in aggregate acquire 30% or more of the voting rights of a publicly traded company or a non-listed company domiciled in the EU.

International Perspective

- AIFM/AIF Proposed Directive - Leverage

- The proposed directive restricts funds that use leverage on a systematic basis. An AIF will be deemed to employ a high level of leverage on a systematic basis when the combined leverage from all sources exceeds the value of the equity capital of the AIF in two out of the past four quarters. The Commission would be empowered to set leverage limits where required to ensure the stability of the financial system. Additionally, emergency powers would be granted to the national authorities to restrict the use of leverage in respect of individual AIFMs or funds.

International Perspective

- AIFM/AIF Proposed Directive - Miscellaneous

- The proposed directive requires the use of EU-based depositories for fund assets under certain circumstances.
- The proposed directive restricts the ability of AIFMs to delegate responsibilities to other firms, particularly those outside of the EU.
- The Parliament report would require that AIFMs establish remuneration policies that are compatible with the rules applicable to EU credit institutions and investment firms. The regulatory authorities would be able to take corrective measures to offset risks resulting from a manager's failure to comply with this requirement.

International Perspective

- AIFM/AIF Proposed Directive – Non-EU Implications
 - The proposed directive generally permits marketing of non-EU funds in the EU subject to strict limits; e.g., the country where the fund is domiciled has to comply with Article 26 of the OECD Model Tax Convention.
 - Commentators have recommended that an EU AIFM may manage a non-EU AIF only if the third country has relevant legislation in line with standards set by international organizations such as IOSCO or the manager can otherwise show that the fund complies with such standards. The Parliament report would permit marketing of foreign funds in the EU provided the AIFM is domiciled in the EU and there are cooperation agreements among regulators.

International Perspective

- AIFM/AIF Proposed Directive – Non-EU Implications

- The proposed directive strictly limits the authorization of non-EU AIFMs. If the country where the AIFM is domiciled has adopted and enforces regulatory legislation similar to the AIFM-Directive, member states may authorize such foreign AIFM to market funds within those states. The criteria will be based on requirements applicable to EU fund managers including minimum capitalization and restrictions regarding the use of leverage.
- The Parliament report recommends removing some of the proposed rules that make it practically impossible for AIFMs from the US to conduct business in the EU and leaves the regulation of non-EU AIFMs largely to the member states.