

Roadmap for implementing US financial reform

Regulatory implications for private fund advisors

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) was signed into law by President Obama on 21 July. It is clear that, with the signing of this landmark legislation, the regulatory regime governing hedge fund and private equity fund managers and other investment advisors will change dramatically. For the first time, registration for most advisors will be mandatory, as will new record-keeping requirements and compulsory disclosure of certain financial and operational information. Advisors to hedge funds and private equity funds with more than \$100 million in assets under management will be required to register with the SEC and be subject to SEC regulatory oversight unless they qualify for one of the express exemptions. Exemptions exist for venture capital funds and family offices, with a definition of venture capital funds to be provided by the SEC within a year of enactment, and for advisors solely to private funds with less than \$150 million in assets under management. Even if exempt from registration, advisors to private funds with less than \$150 million assets under management and venture capital funds will be subject to record-keeping and reporting requirements to be established by the SEC and inspection of their records by the SEC.

Additionally, regulatory changes not specifically directed at hedge funds, private equity funds, other asset managers and investment advisors – including provisions regarding swaps and other derivatives and asset-backed securities – will nevertheless have a substantial impact on these organizations.

Not only will these changes have a material impact on operational and compliance requirements and processes – for example, firms will need to develop rigorous processes for the creation and maintenance of documentation – they also portend an increase in document requests, “sweep reviews” and examinations and inspections by the SEC. In light of the broad reach of the legislation, we have highlighted areas that firms should take into consideration.

Registration obligations

Those required to register will have to do so by 21 July 2011, unless the SEC extends the deadline. One result of registration is the requirement to comply with the following rules:

- ▶ Designate a chief compliance officer
- ▶ Establish and maintain a compliance program, including the adoption and implementation of written policies and procedures reasonably designed to prevent violations of law and regulatory requirements
- ▶ Annually assess the adequacy of the compliance program

Reporting and record-keeping requirements

The SEC will adopt rules that require each registered private fund advisor, as well as unregistered advisors to venture capital funds and private funds with less than \$150 million assets under management, to maintain records and file reports about certain information relating to each private fund it advises, to assist in the assessment of systemic risk, including:

- ▶ Assets under management
- ▶ Information on the 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 appropriate and necessary by the SEC (in consultation with the Financial Stability Oversight Council or FSOC)

The SEC is mandated to share copies of these reports and information with the FSOC and other federal agencies. However, this information could include “proprietary information,” defined as sensitive non-public information pertaining to:

- ▶ Investment or trading strategies
- ▶ Analytical or research methodologies
- ▶ Trading data
- ▶ Computer hardware or software containing intellectual property
- ▶ Such other information determined by the SEC to be proprietary

The SEC may not be compelled to produce it generally, and it is exempted from disclosure under a FOIA request.

SEC’s powers to be enhanced

Under Dodd-Frank, the SEC’s powers will be enhanced. First, the SEC’s budget will be doubled over the next five years. In addition, the SEC will be able to tap a new \$100 million “reserve fund” to supplement its budget and facilitate long-range planning and commitments. Second, the SEC will have a streamlined process to recruit market specialists with “specialized knowledge of financial and capital market formation or regulation, financial markets structures or surveillance, or information technology.” Third, enhanced “whistleblower” protection rewards individuals who provide the SEC with original information that leads to successful prosecution of securities cases between 10% and 30% of any settlement in excess of \$1 million.

Specialized SEC enforcement unit

Before the Dodd-Frank Act, the SEC took several post-Madoff actions to strengthen its enforcement capabilities. Among other things, it set up five specialized enforcement units, including one on asset management to focus expressly on investigations on hedge funds, private equity and managed accounts. Our understanding is that the goals of the asset management unit will be to build industry expertise within the SEC. Asset management priorities and initiatives are expected to include valuation practices, redemption policies, conflicts of interest, risk management and reporting, insider trading, the role of administrators, misrepresentation of information in offering documents and funds of funds due diligence.

Timeline

The new requirements under Dodd-Frank will not be effective immediately, giving firms the opportunity to review and upgrade their current practices, particularly with respect to operations, technology and compliance functions, to implement new systems and processes and to prepare for registration and subsequent regulatory review. We recommend a proactive approach: build compliance infrastructure now to avoid complications down the road upon SEC investigation. Immediate action steps should include designating a chief compliance officer, updating compliance manuals and processes to be current and sensitive to SEC focus areas, and performing tests or mock examinations of the compliance program to identify possible improper activities. In addition, training of staff should begin on the new policies and procedures.

Activities investment advisors should be focused on

Below is a list of some of the activities investment advisors should be focused on in light of the new legislation:

- ▶ Compliance governance structure
 - ▶ Identifying and naming a chief compliance officer
 - ▶ Creating an appropriate compliance program
 - ▶ Developing and implementing adequate and effective written compliance policies and procedures
 - ▶ Establishing monitoring, surveillance and testing programs
 - ▶ Implementing issue reporting, remediation and escalation processes
 - ▶ Developing formal compliance training and learning programs
 - ▶ Developing and implementing an annual compliance risk assessment process
- ▶ Assessment and planning
 - ▶ Preparing for SEC registration and reporting requirements (e.g., Form ADV, holdings reporting, other SEC reporting requirements)
 - ▶ Identifying financial, operational and system enhancements
 - ▶ Assisting with the creation of compliance topic listing
 - ▶ Identifying key compliance risks and evaluating mitigating controls
 - ▶ Comparing current record-keeping practices to what is required by the regulators

- ▶ Remediating gaps pertaining to
 - ▶ Controls, governance structure and risk management framework
 - ▶ Records management, including retention and retrieval processes and controls
 - ▶ Data management and technology infrastructure
 - ▶ Collateral management, safekeeping and segregation of assets
 - ▶ Management and regulatory reporting
- ▶ Testing controls effectiveness
 - ▶ Annual compliance program assessment
 - ▶ Mock examinations
 - ▶ Safety and soundness for systemically important firms
 - ▶ Consumer compliance

Advisors to real estate funds should consult with their counsel to determine if registration is required.

How Ernst & Young can help

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If you would like to discuss our regulatory compliance advisory services please contact:

Jeffrey Bunder
jeffrey.bunder@ey.com
+1 212 773 2889

Alan Fish
alan.fish@ey.com
+1 212 773 6560

Donald MacNeal
donald.macneal@ey.com
+1 212 773 9153

Daniel New
daniel.new@ey.com
+1 617 585 0912

Michael Patterson
michael.patterson1@ey.com
+1 212 773 2824

Nancy Reich
nancy.reich@ey.com
+1 212 773 0300

Arthur Tully
arthur.tully@ey.com
+1 212 773 2252

Christopher Votta
chris.votta@ey.com
+1 212 773 7700

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