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U.S. Update

SEC Clarifies Exemptions for Advisers

As we described in our Client Alert dated November 23, 2010, the Securities and Exchange Commission (the "SEC") published proposed rules to implement certain provisions of the Dodd Frank Wall Street Reform and Consumer Protection Act (the "Dodd Frank Act") that created exemptions from the requirement to register under the Investment Advisers Act of 1940 (the "Advisers Act") for advisers to venture capital funds, private fund advisers with less than $150 million in assets under management and foreign private advisers.

Significantly, the proposed rule release sets forth the SEC's view that advisers exempt from registration because they are advisers solely to (i) venture capital funds or (ii) private funds with less than $150 million in assets under management will be subject to SEC examinations under Section 204(a) of the Advisers Act and will be required to make ongoing Form ADV Part I filings with the SEC. In contrast, advisers that rely on the exemption from registration for foreign private advisers will be exempt from SEC examination and Form ADV reporting requirements. For a discussion of these rules, please click here to see our Client Alert.

SEC Proposes Amendments to Form ADV Part I

The SEC also proposed significant amendments to Form ADV Part I. The amendments would require both registered and certain unregistered advisers (as described above) to provide, and make publicly available through the SEC's web site, extensive information about the private funds that they manage, including:

- gross and net assets of each fund;
- breakdown of assets and liabilities of each fund by class;
- breakdown of ownership of each fund by type of investor and by origin (U.S. or non-U.S.), and identifying the percentage of each fund owned by affiliates of the manager;

- the principal service providers of each fund, including the prime broker, custodian, auditor, administrator and any placement agent.

SEC Proposes New "Family Office" Definition

Background

"Family offices" are entities established by wealthy families to manage their wealth, plan for their families' financial future, and provide other services to family members. Until recently, most family offices relied on the exemption under the Investment Advisers Act of 1940 (the "Advisers Act") for investment advisers with fewer than 15 clients. However, the Dodd Frank Wall Street Reform and Consumer Protection Act ("Dodd Frank") will, among other things, repeal the 15-client exemption. One potential consequence of repealing the 15-client exemption is that many family offices that relied on this exemption would be required to register under the Advisers Act or seek an exemptive order. To prevent this consequence, on October 12, 2010, in the first of several expected rulemakings required by Dodd Frank, the SEC proposed to adopt new rule 202(a)(11)(G)-1 under the Advisers Act to define family offices that would be excluded from the definition of "investment adviser" under the Advisers Act.[1]

The Proposed Rule

Under the proposed rule, three conditions would have to be satisfied for a family office to fall within the "family office" exemption:

1) *Only "family clients" and "key employees" are clients of the family office*. "Family clients" include (i) "family members" (including the individual for whose benefit the family office was established and his or her spouse or spousal equivalent, subsequent spouses or spousal equivalents, parents, lineal descendants (including adopted children or stepchildren) and such lineal descendants' spouses or spousal equivalents) and (ii) family trusts, charitable organizations and other family entities that are established and funded exclusively by one or more "family members" and any trust or estate existing for the sole benefit of one or more family clients. The SEC has also proposed to treat as a "family client" any company, including a pooled investment vehicle, that is wholly owned and controlled, directly or indirectly, by one or more "family clients" and operated for the sole benefit of "family clients". "Key employees" include executive level employees, directors, trustees and partners. The term, as proposed, also includes other employees who have directly participated in the investment activities of the family office, or at some other company, for at least 12 months. In the event that a family office's assets under management are transferred involuntarily (for example, through a will) from a family member to a non-family member, the proposed rule allows the family office to continue to advise the client for up to four months following the involuntary transfer without forfeiting its exemptive status.

2) *The family office is wholly owned and controlled, directly or indirectly, by family members*. "Control," for purposes of the exemption, means the power to exercise a controlling influence over the management or policies of the company, unless such power is solely the result of being an officer of the company.

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[1] A copy of the proposed regulations is available at http://www.sec.gov/rules/proposed/2010/ia-3098.pdf.

3) *The family office does not hold itself out to the public as an investment adviser.*

SEC Proposes New Whistleblower Rules

On November 3, 2010, the SEC proposed rules to implement new whistleblowing provisions in the Dodd Frank Act.[2]

Section 922 of the Dodd Frank Act created section 21F of the Securities Exchange Act of 1934 (the "Exchange Act"), which directs the SEC to pay awards of up to 30% of monetary sanctions exceeding $1 million to "whistleblowers" who "voluntarily" provide the SEC with "original information" about a violation of securities laws that leads to a successful enforcement of an action brought by the SEC resulting in monetary sanctions exceeding $1,000,000.

Under the proposed rules, a "whistleblower" must be a natural person. Whistleblowers will only be eligible for awards if they provide original information to the SEC "voluntarily," meaning prior to any formal or informal request, inquiry, demand or otherwise from a federal, state or local authority, any self-regulatory authority or the Public Company Accounting Oversight Board.

The proposed rules define "original information" as "independent knowledge or analysis" that is not known to the SEC and not derived from an allegation made in a judicial or administrative hearing, in a government report, hearing, audit or investigation, or from the news media, unless the whistleblower is a source of the information. Information from an attorney or accountant learned through the course of their representation or engagement would not be considered original information. Information from employees learning of a violation through a company's internal compliance program would not be considered original information if the company discloses such information to the SEC itself and does not act in bad faith. Information learned in a manner that violates federal or state criminal law would not be considered original information.

The proposed rules would also establish a "first-in-time" procedure for employees who report the violation first to the company's internal compliance program. The rule would preserve such an employee's place in line for whistleblowing award purposes as of the date such employee reported the violation internally at the company. Finally, the proposed rules require that original information submitted to the SEC must be made under penalty of perjury.

New Rules for Derivatives under Dodd-Frank

On December 1, 2010, the Commodity Futures Trading Commission ("CFTC") held a public meeting to consider the issuance of proposed rulemaking under Title VII of the Dodd Frank Act. The SEC on December 3, 2010 voted to propose similar rules covering securities-based swaps. The CFTC and SEC proposed rules to clarify which swaps traders would be subject to the new derivatives regulations.

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[2] A copy of the proposed regulations is available at http://www.sec.gov/rules/proposed/2010/34-63237.pdf

Title VII of the Dodd Frank Act, among other things, (i) divides regulatory authority over swaps between the SEC and the CFTC (with the SEC having regulatory authority over security-based swaps, the CFTC having regulatory authority over all other swaps, and joint regulatory authority over mixed swaps), (ii) creates new categories of "Swap Dealers" and "Major Swap Participants" who are subject to new registration, capital and margin requirements, record keeping, reporting and other regulatory requirements and (iii) requires that certain swaps be accepted by a clearing organization for clearing.

The Dodd Frank Act defines a "Swap Dealer" as any person who: (i) holds itself out as a dealer in swaps; (ii) makes a market in swaps; (iii) regularly enters into swaps with counterparties as an ordinary course of business for its own account; or (iv) engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps. The looseness of language in clause (iii) has particularly concerned swap market participants.

The CFTC proposed a four-part test to determine if a firm could be considered a Swap Dealer or exempt from such classification. Under the proposed test, a firm could be considered a Swap Dealer if it:

- Meets demand for transactions,
- Enters swaps to facilitate other parties' interests,
- Tends not to ask that other parties propose terms, and
- Tends to arrange customized swap terms.

Indicia that a person is holding itself out as a swap dealer or is commonly known in the trade as a swap dealer would include:

- Contacting potential counterparties to solicit interest in swaps,
- Developing new types of swaps and informing potential counterparties of their availability,
- Membership in a swap association in a category reserved for dealers,
- Providing marketing materials (such as a web site) that describe the types of swaps one is willing to enter into with other parties, and
- Generally expressing a willingness to offer or provide a range of financial products that would include swaps.

Under the Dodd Frank Act, there is a minimum level of activity which would not require registration as a swap dealer. The CFTC proposal would exempt firms whose notional aggregate amount of swaps on their books in the past year has not exceeded $100 million (of which no more than $25 million can be with "special entities," defined in the Commodity Exchange Act to include certain governmental entities) and that have traded only up to 20 swaps with no more than 15 counterparties as a dealer within a 12-month period.

The Dodd Frank Act defines a "Major Swap Participant" as any person who is not a Swap Dealer and: (i) maintains a substantial position in swaps (except for positions that are held for hedging or mitigating commercial risk); (ii) whose swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United State banking system or financial markets; or (iii) is highly leveraged relative to the amount of capital it holds.

To further clarify the definition of Major Swap Participant, the CFTC proposed that a firm would be considered to have a "substantial position" in swaps if:

- It has a daily average of current uncollateralized exposure of at least $1 billion on a net basis for credit, equity or commodity swaps, and $3 billion for rate swaps, or
- It has a daily average of current uncollateralized exposure and future exposure of at least $2 billion for credit, equity or commodity swaps, or $6 billion for rate swaps.

The SEC's proposed rules are largely similar to the proposals approved by the CFTC with respect to non-security based swaps. Like the CFTC rules, the SEC proposal would provide similar minimum exemptions from the classification of a firm as a Swap Dealer. The SEC proposals also provide certain threshold guidelines to help determine whether a firm has a "substantial position" in swaps or has "substantial counterparty exposure", which may lead to the classification of such firm as a Major Swap Participant. The SEC proposed that a firm would be considered to have a "substantial position" in swaps if:

- It has a daily average of current uncollateralized exposure of at least $1 billion in either of two major security-based swap categories: security based credit derivatives or other security based swaps, or
- It has a daily average of current uncollateralized exposure and future exposure of at least $2 billion for security based credit derivatives or other security based swaps.

A firm would be considered to have "substantial counterparty exposure" if it has uncollateralized exposure of more than $2 billion or current and future exposure exceeding $4 billion, across the entirety of a firm's security-based swap positions.

The CFTC and the SEC are scheduled to vote on a final rule in July 2011.

The CFTC and SEC have also issued proposed rules on a range of other matters affecting swaps as contemplated under the Dodd Frank Act, including the establishment of clearing houses for trading of swaps, reporting of swap positions, and anti-fraud rules.

For a link to our full C*lient Alert*, please click here.

SEC Bans Naked Access to Markets

On November 3, 2010, the SEC adopted Rule 15c3-5 of the Exchange Act[3] The Rule is designed to prohibit the increasingly popular practice of broker-dealers providing customers (particularly institutions and high-frequency traders) with the broker-dealer's market-participant identifier, a "special pass" given to broker-dealers that permits them to electronically access an exchange or alternative trading system ("ATS"), without being pre-screened by the broker-dealer (known as "naked" access arrangements).

Under the Rule, a broker-dealer has to establish, document and maintain a system of risk management controls and supervisory procedures reasonably designed to manage the financial, regulatory and other risks related to its market access. In association with this requirement, broker-dealers have to:

[3] A copy of the rule is available at http://www.sec.gov/rules/final/2010/34-63241.pdf)

- Create financial risk management controls reasonably designed to prevent the entry of orders that exceed appropriate pre-set credit or capital thresholds, or that appear to be erroneous;
- Create regulatory risk management controls reasonably designed to ensure compliance with all regulatory requirements applicable in connection with market access;
- Have certain financial and regulatory risk management controls applied automatically on a pre-trade basis before orders route to an exchange or alternative trading system;
- Maintain risk management controls and supervisory procedures under the direct and exclusive control of the broker-dealer with market access (there would be limited exceptions, as specified in the Rule, to permit a broker-dealer to reasonably allocate certain controls and procedures to another registered broker-dealer that, based on its position in the transaction and its relationship with the ultimate customer, can more effectively implement them); and
- Establish, document and maintain a system for regularly reviewing the effectiveness of its risk management controls and for promptly addressing any issues.

The SEC believes that by standardizing the procedures broker-dealers must have in place and requiring these controls to be put in place on a pre-trade basis, the Rule will effectively ban "naked" access, a practice viewed by the SEC as highly dangerous due to the technological sophistication of traders who could (and had) prior to the Rule's implementation place a high-volume of trades without what were viewed as sufficient risk management procedures in place to ensure the safety of the trades.

The Rule will become effective January 14, 2011, at which point broker-dealers will have six months to comply with the Rule.

SEC Delays Effective Date of Short Sale Rule

On February 26, 2010, the SEC adopted a new short sale pricing rule. Although the new rule became effective on May 10, 2010, the SEC provided a six-month implementation period to enable trading centers and others to prepare for complying with the new rule, making the new rule's compliance date November 10, 2010. However, on November 4, the SEC announced that it was extending the compliance date to February 28, 2011. The SEC extended the compliance date in order to give national securities exchanges additional time to modify their procedures.

Annual Compliance Actions for SEC Registered Advisors Investment Advisers

As the end of the year approaches, SEC registered investment advisers should remember to take any actions that must be taken annually (not necessarily based on a calendar year), including:

- update Form ADV Part 1 (which may be changing later next year) and prepare and file the new (and very different) Part 2 of Form ADV within 90 days after the end of the adviser's fiscal year (i.e., by March 31, 2011 in the case of an adviser with a calendar fiscal year);

> offer to provide Form ADV Part 2 of Form ADV to all clients at least annually;
> provide an annual privacy notice to all natural person clients and individual retirement accounts;
> perform and document an annual review of the adviser's compliance program, including policies and procedures;
> have employees sign an appropriate annual compliance certificate;
> file any required Schedule 13G amendment, Form 13F or Form 5 within 45 days after the end of the calendar year; and
> update compliance materials to reflect the SEC's new pay-to-play rule prior to March 14, 2011.

EU Update

EU Adopts Alternative Investment Fund Managers (AIFMs) Directive

Agreement on a draft text of the Alternative Investment Fund Managers Directive (the "AIFM Directive") was reached by members of the EU ("Member States") at the Economic and Financial Affairs Council ("ECOFIN") meeting on October 19, 2010 and the European Parliament adopted the AIFM Directive on November 11. Official publication of the text is expected in the first or second fiscal quarter of 2011. Member States will be required to incorporate the AIFM Directive into their national laws within two years of publication (2013).

Among the highlights of the AIFM Directive are:

> Alternative investment fund managers ("AIFMs") with assets under management, including any acquired through use of leverage, not exceeding EUR100 million are exempt from the AIFM Directive.
> AIFMs whose assets under management do not exceed EUR500 million are also exempt if the manager only manages alternative funds ("AIFs") that are not leveraged and have no redemption rights exercisable during a period of five years following the date of initial investment in each AIF.
> The AIFM Directive introduces a marketing passport under which an AIFM which is authorized in one EU Member State will be able to market an AIF to professional investors in other Member States without additional authorization or registration requirements.
> The passport will automatically be available to EU AIFMs managing EU AIFs, but its extension to cover the marketing of non-EU AIFs is deferred for two years following the AIFM Directive's implementation into Member States' national law (i.e., not before 2015), subject to a positive recommendation by the European Securities and Markets Authority, and the passage of secondary legislation by the European Commission.
> EU AIFMs managing non-EU AIFs as well as non-EU AIFMs will be able to continue to make use of national private placement regimes ("NPPRs") until at least 2018.

- During the period 2013 to 2015 - i.e., pending the passport becoming available - NPPRs will be the sole regime available to non-EU funds and AIFMs wishing to market in the EU. Between 2015 and 2018, NPPRs and the EU passport would co-exist.

From 2013 the Directive also requires cooperative agreements between the non-EU AIFM regulator and the EU country where the fund is being offered.

The AIFM Directive requires that EU member countries adopt rules that will require AIFMs to comply with a number of new regulations and procedures, including:

- An AIFM must set a maximum level of leverage for each AIF it manages. The AIFM must be able to demonstrate to its competent authorities that the levels set are reasonable. When it is deemed necessary, the competent authority may impose limits on the level of leverage that an AIFM may employ, or other restrictions on the management of an AIF.
- An AIFM must establish procedures for each AIF it manages to ensure that a 'proper and independent' valuation of the AIF's assets can be performed in accordance with the national law of the jurisdiction in which the AIF has its registered office and/or the national law governing the AIF's rules or instruments of incorporation.
- For each AIF managed or marketed, the AIFM must produce an annual report, for each financial year, in accordance with the accounting standards of the home Member State of the AIF or the third country where the AIF has its registered office. The AIFM must also ensure that certain information is also readily available to investors before they invest in the AIF.
- AIFMs should take all reasonable steps to identify, prevent, manage and monitor conflicts of interests that may adversely affect the AIF or its investors.
- AIFMs must establish remuneration policies for senior staff designed to promote effective risk management.
- Subject to certain exceptions, a depository must be appointed to hold the assets of AIFs.
- From 2013 use of the NPPRs by non-EU AIFMs will be subject to certain transparency and portfolio company disclosures.

FSA to Strengthen Remuneration Code

On December 17, 2010, the UK Financial Services Authority (the "FSA") published its final revised Remuneration Code rules which comes into force on January 1, 2011 (and covers bonus payments with respect to the 2010 fiscal year). Limited transitional provisions have been provided. For example, firms must comply with the applicable principles relating to remuneration structures by July 1, 2011 at the latest, while the FSA will expect firms to have made their first public disclosure of remuneration by no later than December 31, 2011.

The Remuneration Code will cover all banks, building societies and "Capital Adequacy Directive" investment firms. The latter category includes most hedge fund managers, many UCITS firms, plus some firms which engage in venture capital, corporate finance, the provision of financial advice and brokers. More specifically, the Remuneration Code does not apply to non-MIFD firms or to certain exempt CAD firms so many private equity firms will not be covered.

In order to apply the Code proportionately, the FSA has introduced the concept of tiers (1 to 4) to which firms will be allocated according to their size and activities. Firms in tier 1 will be required to apply the Code most strictly, while those in tier 4 may ignore some parts of the Code and choose either to comply with other principles or explain their non-compliance. We would anticipate that the vast majority of our clients in the alternative assets industry who are covered by the Code will fall within Tier 4.

Our Private Investment Funds Group comprises more than 100 lawyers and advises clients worldwide on all of the legal and business issues important to private equity and hedge funds and their managers, including structuring investment vehicles of all types, portfolio company investments, institutional investor representation and secondary purchases and sales.

This newsletter for clients of our Private Investment Funds Practice discusses recent developments affecting hedge funds and private equity funds.

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