President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank or the Act) on July 21, 2010. The new law is likely to have significant impact on non-US asset managers who have clients in the United States. Managers that were formerly exempt from registration will need to register as investment advisers with the US Securities and Exchange Commission (SEC).

In the coming year, the SEC will draft rules to implement Dodd-Frank, and will likely require advisers to file new reports containing information that the SEC deems necessary to protect investors or for the assessment of systemic risk. Until this rule-making is complete, significant open questions exist as to the application of the new registration requirement to non-US advisers, and what the SEC will expect of non-US registered advisers with respect to their non-US clients.

All advisers that are required to register with the SEC must do so before July 21, 2011. As a registered adviser, managers will be subject to the Investment Advisers Act of 1940 (“Advisers Act”), which requires robust compliance programs, adherence to certain conditions relating to the custody of client assets, and the making and keeping of certain books and records. Underlying these specific obligations is the duty to act as a fiduciary to advisory clients. Registered advisers—including those located outside the US—are also subject to SEC examination oversight and possible enforcement action, and should be aware of increasing international enforcement efforts. This A Closer Look provides an initial perspective on how Dodd-Frank will likely impact non-US asset managers.
Many non-US advisers will have to register with the SEC

A significant aspect of Dodd-Frank is the elimination of the existing “private investment adviser” exemption, whereby advisers to private funds are not required to register with the SEC. Many non-US advisers had relied on this exemption and had been exempt from SEC registration. While this exemption has been eliminated, the Act adds several new exemptions, which are described below.

Foreign private adviser exemption

Of most interest to non-US advisers, Dodd-Frank adds an exemption for “foreign private advisers.” To meet this definition, an investment adviser must meet ALL of the following conditions:

- It must not have a place of business in the US
- It must have fewer than 15 clients and investors in the US in private funds advised by the adviser
- It must have less than $25 million in assets under management attributable to US clients and US investors in private funds advised by the adviser
- It cannot hold itself out generally to the public in the US as an adviser

Advisers to registered investment companies and business development companies are not eligible for this exemption.

The law changes the exemption from registration: In the past, advisers with fewer than 15 clients were exempt from registration, and a fund was counted as a single advisory client and investors in the fund were not counted. Under the new law, underlying fund investors are counted. Thus, a non-US adviser with more than 14 investors in private funds advised by the adviser (with a total of more than $25 million in assets under management attributable to these US clients and investors) must register. The exemption is thus quite narrow and will be available only for advisers with few US clients and investors. While no conclusive numbers are available, many non-US advisers will likely be required to register with the SEC as investment advisers. Due to their ambiguity, some of the terms of this exemption may be subject to future clarifying rule-making.

Among the important open questions is whether the SEC will continue its historical approach to the non-US clients of non-US registered advisers. The historical approach—known colloquially as “Regulation Lite”—has been to limit application of many of the substantive provisions of the Advisers Act. It is unclear whether the SEC will revise its guidance in this area.

Other exemptions from registration

Dodd-Frank provides for other exemptions from registration, as described below.

Advisers to venture capital funds. The SEC is directed to define “venture capital fund” within one year of enactment. While exempt from registration, such funds may be subject to record-keeping and reporting requirements.

Smaller advisers. Advisers solely to private funds with assets under management of less than $150 million, and other advisers with less than $100 million in assets under management, are not subject to registration with the SEC. It is unclear whether a non-US adviser that does not meet the “foreign private adviser” definition may yet qualify for this exemption from the registration requirement. In any event, advisers that qualify for this exemption may still be subject to record-keeping and reporting requirements.

Family offices. Family offices are exempt from registration consistent with the SEC’s current exemptions. The SEC will define the term and in a manner consistent with existing exemptive orders.

Commodity trading advisers registered with the Commodity Futures Trading Commission (CFTC). Advisers to commodity pools that are currently registered with the CFTC are exempt. However, if the business of the adviser becomes predominately securities-related, the adviser will need to register with the SEC.
It will be critical for advisers to accurately assess whether they will be required to register with the SEC or are exempt from registration. Even if exempt from SEC registration, advisers will need to accurately assess whether they will be subject to record-keeping and reporting obligations. They also remain subject to the SEC’s anti-fraud rules, and thus to its enforcement authority. For non-US investment advisers that qualify for an exemption from registration as a venture capital adviser or as a smaller adviser, the SEC has authority to require that certain records be kept and filed or provided to the SEC. It is not clear how the SEC will exercise this authority with respect to exempt non-US advisers.

What obligations accompany registration?

As noted, in the coming year, the SEC will draft rules to implement the provisions of Dodd-Frank. Until this rule-making is complete, significant open questions will persist regarding the application of the new registration requirement to non-US advisers, and what the SEC will expect of non-US registered advisers with respect to their non-US clients. A brief summary of key Adviser’s Act obligations follows.

The fiduciary standard. While the Adviser’s Act contains specific requirements, several of which are described below, underlying these specific requirements is the obligation to act as a “fiduciary” to advisory clients. The SEC staff describes an adviser’s fiduciary obligation in this way:

As an investment adviser, you are a “fiduciary” to your advisory clients. This means that you have a fundamental obligation to act in the best interests of your clients and to provide investment advice in your clients’ best interests. You owe your clients a duty of undivided loyalty and utmost good faith. You should not engage in any activity in conflict with the interest of any client, and you should take steps reasonably necessary to fulfill your obligations. You must employ reasonable care to avoid misleading clients and you must provide full and fair disclosure of all material facts to your clients and prospective clients. Generally, facts are “material” if a reasonable investor would consider them to be important. You must eliminate, or at least disclose, all conflicts of interest that might incline you—consciously or unconsciously—to render advice that is not disinterested. If you do not avoid a conflict of interest that could impact the impartiality of your advice, you must make full and frank disclosure of the conflict. You cannot use your clients’ assets for your own benefit or the benefit of other clients, at least without client consent. Departure from this fiduciary standard may constitute “fraud” upon your clients (under Section 206 of the Advisers Act).1

Some of the specific obligations of registered advisers are outlined below, though this is not a full summary of all obligations.

Filing Form ADV. Advisers must file Form ADV in an accurate and timely manner. Form ADV Part I includes information related to the adviser’s business, ownership, and any disciplinary history. Form ADV Part II is a narrative statement requiring “plain English” descriptions of conflicts of interest and other matters, to be filed and provided to clients and prospective clients, and to be publicly available on the SEC’s website.

Implementing a compliance program. Advisers must (i) adopt and implement a compliance program reasonably designed to prevent violations of the Adviser’s Act; (ii) designate a chief compliance officer (CCO); (iii) implement comprehensive written compliance policies and procedures; and (iv) perform an annual compliance review.

Code of ethics and personal trading. Advisers must adopt a written code of ethics that sets forth standards of business conduct expected from firm employees, and that addresses conflicts that arise from personnel and proprietary trading, gifts and entertainment, and other conflicts. Codes of ethics must require that certain firm employees report their personal securities transactions to the CCO or another person. Codes of ethics should also address controls to prevent insider trading.

Books and records. Advisers must maintain certain specified books and records, and keep them accurate and current, for at least five years (and longer in certain cases). These records include advisory business and

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1 http://www.sec.gov/divisions/investment/advoverview.htm
financial records, records reflecting advice given and transactions made on behalf of clients, advisory agreements, records supporting and evidencing advertising and performance, and other types of records.

**Advertising and third-party solicitors.** The SEC specifically prohibits certain forms of advertising, including testimonials and the use of past specific recommendations. The use of solicitors is regulated and requires that the solicitor provide written disclosures to solicited clients.

**Custody rule considerations.** Registered advisers that have custody of client assets must keep them with a qualified custodian that sends account statements directly to clients. This custodian may also be required to have a surprise examination and internal controls report prepared by an independent accounting firm. Many fund advisers may be exempt from these provisions if the funds are audited annually by an independent accountant registered with and subject to inspection by the Public Company Accounting Oversight Board (PCAOB), and if the fund’s financial statements are audited in accordance with US Generally Accepted Auditing Standards and US Generally Accepted Accounting Principles.

**Best execution.** Advisers must seek to obtain the best price and best execution on client trades. Any conflicts must be fully disclosed or eliminated, including advisers’ trading for their principal account with a client account.

*Registration with the SEC is a significant undertaking, and not to be taken lightly. Upon registration, advisers must be operating in accordance with fiduciary standards and must be in compliance with the full range of requirements under the Investment Advisers Act of 1940. This includes providing disclosure to advisory clients of all material conflicts of interest and other information; complying with rules governing trading, advertising, and performance reporting; implementing codes of ethics governing trading by firm principals and other issues; naming a chief compliance officer; and implementing an effective compliance program. In addition, as described below, once registered, advisers become subject to examination oversight by the SEC. It is critical for advisers to establish and maintain a strong compliance program prior to becoming subject to an SEC examination.*

Prior to registration, advisers should undertake a comprehensive review of their operations to identify needed enhancements to controls and disclosures. Important steps include:

- Identifying all conflicts of interest associated with the adviser and its employees
- Implementing a tailored compliance program with written policies and procedures and an effective surveillance and testing program
- Designating a competent chief compliance officer and ensuring adequate compliance resources
- Reviewing existing disclosure documents and identifying needed improvements
- Drafting clear and accurate registration documents (Form ADV, Parts I and II)
- Ensuring that newly required records will be created and maintained consistent with books and records requirements

**Examination oversight and enforcement**

Registered advisers are subject to examinations by the SEC. The purpose of SEC examinations is to determine whether the firm is in compliance with the law, is adhering to disclosures made to clients, and is maintaining appropriate compliance programs to assure continued compliance. Registered advisers must make all records requested by the SEC available to the SEC staff upon request, answer questions, and provide information. Examinations may conclude with a non-public deficiency letter or “no further action” letter, or, if serious deficiencies are found, with a referral to the SEC or another regulator for further investigation and possible public enforcement action. In an SEC enforcement action, sanctions range from financial penalties, disgorgement, and returning funds to harmed investors to a complete bar from the industry.

Dodd-Frank provides that the SEC “shall” conduct periodic inspections of the records of private funds maintained by a registered adviser. The law also makes these advisers subject “at any time, or from time to time, to such reasonable periodic, special, or other examinations” as the SEC deems appropriate for the protection of investors or for the assessment of systemic risk.
This would seem to require that the SEC establish a regular inspection cycle or cycles for these advisers. Currently, many advisers are not subject to routine, periodic examinations, though the SEC has conducted examination sweeps of non-US advisers that are registered with the SEC, often in conjunction with local regulators. The SEC also conducts “surprise” examinations without providing notice. Dodd-Frank also explicitly expands the mission of SEC examinations beyond investor protection to include the assessment of systemic risk. This could allow the SEC to initiate examinations based on a need to evaluate risk to markets, independent of risk to investors.

The SEC is often a significantly more aggressive regulator than many non-US firms may be accustomed to. Being subject to an SEC investigation or enforcement action carries significant deleterious reputational consequences. Non-US firms should ensure strong compliance programs to avoid any possible risk of enforcement action.

Of interest to non-US advisers, the SEC has expressed its desire to continue cooperation with non-US regulators in performing cooperative examinations, and has increased its coordination with global regulators, particularly in the UK, the EU, Asia, and other jurisdictions. This coordination is likely to continue as the SEC moves forward in implementing Dodd-Frank’s reporting and oversight provisions.

This coordination also extends to enforcement efforts. In recent years, regulators have been able to more aggressively pursue cross-border fraud because of the International Organization of Securities Commissions’ Multilateral Memorandum of Understanding (MMOU), the first global multilateral information-sharing arrangement among securities regulators. More than 50 jurisdictions around the world have joined the MMOU since its creation in 2002, demonstrating regulators’ commitment to both international cooperation and to combating securities fraud in local markets. According to the SEC, the MMOU has greatly expanded regulators’ ability to bring cases because they are now able to share information and documents from the regulators’ files, obtain bank and brokerage account records, including the beneficial owners of such accounts, take or compel a person’s statement or testimony, and permit that information to be used in prosecutions. This has enhanced the SEC’s enforcement program by increasing and expediting its ability to obtain information from a growing number of jurisdictions worldwide.

Records to be provided. Dodd-Frank provides that any registered adviser must make available to the SEC “any copies or extracts from such records as may be prepared without undue effort, expense, or delay” as the SEC may request. The law further provides that records of any private fund advised by the adviser are considered records of the adviser, and are thus subject to review in an examination of the adviser.

This effectively eliminates some objections to past document requests from the SEC that required the adviser to copy records or to extract information from existing records into new documents to be produced to the regulator. It also makes clear that the SEC has access to records and information relating to the fund in an examination of its adviser.

Relationship with Financial Stability Oversight Council. Dodd-Frank creates a new Financial Stability Oversight Council, composed of the heads of financial regulatory agencies, to monitor systemic risk. The Act provides that the SEC will make all records and information filed or provided by a registered adviser available to the Financial Stability Oversight Council. This might include, for example, information obtained from an adviser pursuant to an examination, or information that the SEC requires to be filed (by rule, as described above).

Given the expansion of the SEC’s role to include assessment of systemic risk, advisers should expect that the commission will request and obtain a broader set of information than it has requested in the past, and that this information will be shared with the Financial Stability Oversight Council. Given that assessment of systemic risk is not an existing function of the SEC’s oversight of investment advisers, the new Financial Stability Oversight Council will likely play a key role.

Confidentiality of information provided to the SEC. The new law provides that the Financial Stability Oversight Council and the SEC are exempt from the Freedom of Information Act with respect to such information, and shall treat “proprietary information” of an adviser as non-public and confidential under the
Advisers Act. Proprietary information is sensitive, non-public information regarding trading data, trading strategies, and intellectual property. Other provisions of the Act allow the SEC to more readily share information—including information and documents received during examinations and investigations—with US and non-US regulators and criminal prosecutors.

Effectively, this allows the SEC to obtain sensitive confidential information from advisers for surveillance or risk assessment purposes (separately or as a part of examinations, investigations, or other inquiries), share it with other regulators, and maintain its confidentiality. This removes a longstanding concern expressed by hedge funds and other managers that sensitive, proprietary information indicating trading strategies and tactics would be made available to the public and to competitors, who could use it to their advantage. However, it is also likely that the SEC and other US and non-US regulators and prosecutors will increase information sharing. Asset management firms should thus anticipate that information provided to the SEC will be shared with other civil and criminal authorities.

New record-keeping and reporting requirements

In addition to the current requirements under the Advisers Act and related SEC rules, Dodd-Frank empowers the SEC to require registered advisers to maintain specific information regarding an advised private fund, which will be subject to examination by the SEC. Among other things, advisers will be required to maintain records describing:

- The amount and types of assets under management
- Use of leverage
- Counterparty credit risk exposure
- Trading and investment positions
- Valuation policies and practices
- Side arrangements or letters
- Trading practices

The new law allows for different reporting requirements for different classes of fund advisers, based on type or size of private fund.

Short sales. The new law requires that the SEC adopt rules that would require institutional investors to submit reports of short sales (by name and issuer of the security, the aggregate number of shares, and any other information the SEC determines) for public disclosure at least monthly.

Following SEC rule-making in the coming year, advisers will be required to create and keep records that will be specific to their business as advisers to private funds. The SEC may craft record-keeping and filing requirements that will allow it to identify heightened investor protection risks as well as to monitor for systemic risk. As described above, this information will be shared with the Financial Stability Oversight Council. It is not yet known how or whether the SEC will apply these requirements to non-US advisers, and whether they will apply to all of an adviser’s private funds or just to those with US investors.

New accredited investor and qualified client standards

Accredited investor. The new law provides that for four years, the net worth standard is $1 million excluding the investor’s primary residence. The SEC is also authorized to review the “accredited investor” standard within one year, and periodically every four years. While authorized to modify the standard, the SEC may not reduce the net worth standard below $1 million for natural persons, excluding their primary residence. The US Government Accountability Office (GAO) is also directed to complete a study with recommendations for changes to the standard within three years.
To be deemed accredited, investors now must have at least $1 million in net worth excluding their primary residence.

Qualified client. Within one year and periodically every five years, the SEC must review dollar thresholds for when an adviser can charge performance-based fees, and adjust them for inflation. Also, the law clarifies that the Adviser’s Act requirements for advisory contracts (including performance fees) do not apply to state-registered advisers. The SEC’s prohibition on performance fees in advisory contracts does not apply to contracts with persons who are not residents of the US.

The current standard ($750,000 or more in assets under management and at least $1.5 million in net worth) will be revised for inflation within a year.

A self-regulatory organization for advisers?

GAO study. The Act requires that the GAO conduct a study within one year regarding the feasibility of forming a self-regulatory organization (SRO) to oversee private funds.

SEC study. The Act also requires that, within six months, the SEC study the need for enhanced examination and enforcement resources for investment advisers, and revise its rules and identify regulatory or legislative steps necessary, considering:

- The number and frequency of examinations over the last five years
- The extent to which having one or more SROs to augment the SEC’s efforts in overseeing advisers would improve the frequency of inspections of advisers
- Current and potential approaches to examining the advisory activities of dually registered or affiliated broker-dealers and advisers

The need for an SRO is again under review. The GAO and the SEC will likely study the need for an SRO in light of (i) the current number of adviser registrants and SEC examination resources; (ii) the fact that many more advisers will be required to register with the SEC; (iii) the new focus on evaluating systemic risk; and (iv) the new requirement that the SEC shall conduct periodic inspections of the records of private funds maintained by a registered adviser, which apparently mandates routine periodic examinations (as described above). In addition, many advisers are affiliated with broker-dealers, which already have an SRO that performs regular examinations. It is too early to predict whether an SRO will be recommended, or the impact such an SRO would have on non-US advisers that already have a primary domestic regulator.
While Dodd-Frank will have significant impact on non-US asset managers, many implementation issues are currently unclear and are subject to the SEC and other agencies’ rulemaking processes and various statutorily directed studies. PwC will continue to monitor those developments and provide you with updates, which will be available at www.pwcregulatory.com.

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