

What the "New Foundation" Could Mean for Private Funds and Their Sponsors

June 25, 2009

On June 17th, the Department of the Treasury (the "Treasury") released a white paper entitled "Financial Regulatory Reform: A New Foundation: Rebuilding Financial Supervision and Regulation," generally outlining its proposals for reforming financial regulation in the United States (the "New Foundation"). The New Foundation proposes, among other things, that (i) a Financial Oversight Council (the "Council"), chaired by the Secretary of the Treasury be created, (ii) certain private fund advisers be required to register with the Securities and Exchange Commission (the "SEC") and (iii) each private fund advised by an SEC-registered adviser be required to make certain disclosures and potentially face increased regulation.¹ This memorandum discusses the impact that the New Foundation, as proposed, would have on hedge funds and other private fund advisers, including private equity funds and venture capital funds.

The Council

In an effort to promote robust supervision and regulation of financial firms, the New Foundation proposes the creation of the Council to, among other things, facilitate information sharing, identify "emerging risks," advise the Federal Reserve on firms whose failure could pose a threat to financial stability (as discussed below) and provide a forum for the discussion of cross-cutting issues among regulators. The members of the Council would be (i) the Secretary of the Treasury, who will serve as the Chairman, (ii) the Chairman of the Board of Governors of the Federal Reserve System (the "Federal Reserve"), (iii) the Director of the National Bank Supervisor, (iv) the Director of the Consumer Financial Protection Agency, (v) the Chairman of the SEC, (vi) the Chairman of the Commodity Futures Trading Commission, (vii) the Chairman of the Federal Deposit Insurance Corporation and (viii) the Director of the Federal Housing Finance Agency. The New Foundation proposes to give the Council the authority to "gather information from any financial firm" as well as the responsibility to refer "emerging risks" to the appropriate regulators.

Registration

Advisers to private funds whose assets under management "exceed a modest threshold" will be required to register with the SEC under the Investment Advisers Act of 1940. Although the New Foundation does not specify what that "modest threshold" will be, other proposals for private fund regulation have proposed to

¹ For a broader description of the New Foundation, please see the Dewey & LeBoeuf Client Alert "The Proposed New Foundation for Financial Regulation," June 18, 2009.

This memorandum is intended only as a general discussion of these issues. It is not considered to be legal advice. We would be pleased to provide additional details or advice about specific situations. For additional information on this important topic, please feel free to call upon your Dewey & LeBoeuf relationship partner.

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regulate funds with as little as \$30 million or \$50 million under management.² The most significant regulatory obligations applicable to SEC-registered investment advisers are: (i) detailed disclosure requirements to clients and the SEC (including new information requirements designed to enable the SEC to oversee the funds they manage); (ii) the establishment and maintenance of a detailed and well-documented compliance program; and (iii) the provision of access to records and personnel for regular and surprise SEC examination. For more information as to requirements currently applicable to investment advisers, please see Exhibit A hereto.

Disclosure and Regulation

The New Foundation also proposes that funds managed by SEC-registered advisers, in addition to the advisers themselves, will be subject to certain requirements with respect to (i) recordkeeping, (ii) disclosure to investors, creditors and counterparties and (iii) regulatory reporting. The New Foundation also proposes that these funds be subject to regular, periodic SEC examinations for compliance with these requirements. These requirements may vary based upon the type of private pool in question. The regulatory reporting requirements, as proposed, will require the confidential disclosure of certain information to the SEC to determine whether a fund poses a threat to financial stability. The SEC will share this information with the Federal Reserve. Any fund whose combination of size, leverage, reliance on short-term funding and interconnectedness would pose a threat to financial stability upon failure could be considered a "Tier 1 Financial Holding Company" and, as a result, may be subject to stricter and more conservative prudential regulation by the Federal Reserve, including capital, liquidity and risk management standards.

The New Foundation is a broad outline of the proposed regulatory reform. As the New Foundation works its way through Congress, it is likely that modifications will be made. We will monitor the process and keep you updated as new information becomes available.

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² Please see the Dewey & LeBoeuf Client Alert "Proposed Hedge Fund Transparency Act," February 11, 2009 (proposing registration of private funds with more than \$50 million under management). In a version recently introduced in the Senate, SEC regulation would apply to private funds with more than \$30 million in assets under management.

EXHIBIT A

Summary of Advisers Act Requirements

This exhibit sets forth a number of the principal actions that a registered investment adviser must take to ensure compliance with the Investment Advisers Act of 1940, as amended (the "Advisers Act"). Certain of these actions are required of all investment advisers (each, an "Adviser"), whether registered or exempt from registration, while others are required only of registered investment advisers. Please note that this exhibit is not intended to be and cannot be an exhaustive review of all of the requirements of the Advisers Act, the rules promulgated thereunder and the numerous interpretations thereof issued by the Securities and Exchange Commission (the "SEC"), but should help answer common questions and identify additional issues arising under the Advisers Act. For investment advisers to pension plans, it should also be noted that certain types of transactions that are permissible under the Advisers Act, upon compliance with the applicable requirements, may nevertheless be impermissible under the Employee Retirement Income Security Act of 1974.

I. Registration Process. Advisers required to register under the Advisers Act must complete SEC Form ADV, the Adviser registration form.³ Advisers have an affirmative responsibility to keep Form ADV current – not doing so can lead to disciplinary, administrative, injunctive or criminal sanction. Form ADV must be updated annually within 90 days of the end of the Adviser's fiscal year, and certain changes to information on Form ADV must be recorded promptly.

II. Form ADV. Form ADV has two parts, Part I and Part II.

Part I. Part I is filed with the SEC and provides the background information that the SEC needs from an Adviser for administrative and regulatory purposes, including trade names, principal place of business, website addresses, basis for registration, identification of any person who controls the Adviser, how the Adviser's operations are financed, whether the Adviser maintains custody of clients' assets, a description of the Adviser's ownership, the number and size of the Adviser's discretionary and non-discretionary clients and the disciplinary background of the Adviser. The form is made publicly available by the SEC.

Part II. Part II (or a brochure containing all of the information therein) is distributed to customers and includes information that must be provided to clients. Part II, and changes to Part II, must be kept on file at the Adviser's principal office, distributed to clients, and made available for SEC examination, but does not need to be filed with the SEC. (See *Disclosure* discussion below.)

III. Compliance Requirements. A registered Adviser must create and implement a set of compliance policies and procedures and must designate a chief compliance officer (the "Compliance Officer") to administer the compliance program. Rule 206(4)-7 requires that those policies and procedures be reasonably designed to prevent violations of federal securities laws and should be tailored to the risk exposure and client base of the particular Adviser. In addition, the compliance program should be able to detect violations that have occurred and correct such violations promptly. The Compliance Officer must (i) be "competent and knowledgeable regarding the Advisers Act," and (ii) "have a position of sufficient seniority and authority within the organization" to compel others to follow the firm's compliance policies and procedures. The SEC requires that the Adviser review its compliance program annually. Copies of the policies and procedures for the last five years and evidence of the annual review must be maintained.

Code of Ethics. Rule 204A-1 and related provisions require that Advisers establish, maintain, and enforce a written code of ethics (the "Code of Ethics"). The Code of Ethics must enumerate the mechanisms for safeguarding material non-public information as required under Section 204A to minimize the risk of insider trading. It must also, at a minimum, contain:

³ An entity that registers as an Adviser covers its employees and other people under the Adviser's control, and the employees do not have to register individually. Note, however, that employees that are "investment adviser representatives" may still be subject to state registration requirements.

- (a) standards of business conduct which must reflect the Adviser's fiduciary obligations and those of Supervised Persons;⁴
- (b) provisions requiring Supervised Persons to comply with applicable federal securities laws;
- (c) provisions requiring Supervised Persons to report any violations of the Code of Ethics promptly to the Compliance Officer or to other persons designated in the Code of Ethics;
- (d) provisions requiring distribution to all Supervised Persons of a copy of the Code of Ethics and any amendments, and requiring Supervised Persons to provide a written acknowledgment of their receipt of the code and any amendments to it;
- (e) provisions requiring that Access Persons⁵ obtain pre-clearance from the Adviser before directly or indirectly acquiring beneficial ownership in any security in (i) an initial public offering of securities or (ii) a private placement of securities; and
- (f) provisions that require all Access Persons to report, and the Adviser to periodically review, each Access Person's holdings and their personal securities transactions.

The Code of Ethics must be summarized in Form ADV Part II and provided to clients and perspective clients upon request.

Recordkeeping. Pursuant to Rule 204-2, Advisers are required to maintain certain true, accurate and current books and records (Please see Schedule I for a list of books and records that are required to be maintained). Records must be maintained in the Adviser's office for two years after the last entry therein and for another three years at an easily accessible location. Documents relating to the organization of the Adviser must be maintained in the Adviser's office until termination of the entity and in an easily accessible location for three years thereafter.⁶

IV. Disclosure. Rule 204-3 requires that the Adviser provide to each potential client either Part II of Form ADV or a brochure containing at least all of the information required to be disclosed in Part II. Under this "brochure rule," the information must be delivered (i) at least 48 hours before entering into an advisory contract or (ii) at the time of the signing of the advisory contract, provided that the client has a five-day termination period without penalty. In addition, the Adviser must deliver, or offer to deliver without charge, annually, a copy of its Part II of Form ADV or its brochure upon written request from a client. Finally, an Adviser has a general duty to disclose all information that might reasonably be considered material to its clients, including any financial condition that would impair its ability to meet its contractual commitments or any legal or disciplinary event that is material to evaluating an Adviser's integrity or ability to meet its contractual commitments.

V. Custody of Client Assets. Rule 206(4)-2 (the "Custody Rule") requires that Advisers who have custody⁷ of client securities or funds implement controls to protect client assets from loss, misappropriation or misuse. It is a "fraudulent, deceptive, or manipulative act, practice or course of business" for an Adviser to have custody of client funds or securities unless such Adviser meets the safekeeping and reporting requirements set forth in the Custody Rule. Client assets that are under the

⁴ Supervised Persons are partners, officers, directors (or other persons occupying a similar status or performing similar functions) and employees, as well as any other persons who provide advice on behalf of the Adviser and are subject to the Adviser's supervision and control.

⁵ Access Persons are an Adviser's Supervised Persons who have access to non-public information regarding clients' purchases or sales of securities, or non-public information about the portfolio holdings of a registered investment company managed or underwritten by the Adviser or certain of its affiliates.

⁶ Under Rule 204-2(j), Offshore Advisers must either maintain complete copies of the required books and records at a place in the United States designated to the SEC or must file an undertaking with the SEC to provide the required books and records upon demand.

⁷ The Custody Rule defines custody of client assets as holding, directly or indirectly, client funds or securities or having any authority to obtain possession of them. This definition encompasses: (i) an Adviser's physical possession of client funds or securities, not including assets received inadvertently and returned to the sender within three business days or checks drawn by clients that are payable to third parties; (ii) any arrangement where the Adviser is authorized or permitted to withdraw client funds or securities maintained with a custodian, upon instruction to the custodian, for example, to pay itself a regular management or advisory fee; and (iii) an Adviser or Supervised Person of the Adviser with the capacity to assert legal ownership of, or access to, client funds or securities. An Adviser may be deemed to have custody if an affiliate of the Adviser has custody.

Adviser's custody must be maintained by a qualified custodian ("Qualified Custodian")⁸ in either a separate account for each client under its name or in accounts containing only the clients' assets held under the Adviser's name as agent or trustee.

Custody Disclosure Requirements. If an account is created with a Qualified Custodian on behalf of a client, the Adviser must promptly notify the client in writing of the qualified custodian's name, address and the manner in which the assets are maintained. In addition, when an Adviser has client assets under custody with a Qualified Custodian, the Adviser is responsible for providing quarterly account statements to each client. This can be done by the Qualified Custodian or by the Adviser subject to certain requirements.⁹

VI. General Antifraud Provisions. Section 206 sets forth the general antifraud standard for many of the more specific prohibitions discussed below. The antifraud requirements apply to all Advisers, whether or not currently required to be registered under the Advisers Act and these requirements apply to all activities with respect to advisory clients – not solely to activities involving securities. Section 206 makes it unlawful for an Adviser directly or indirectly:

- (a) to employ any device, scheme or artifice to defraud any client or prospective client;
- (b) to engage in any transaction, practice or course of business that operates as a fraud or deceit upon any client or prospective client;
- (c) acting as a principal for its own account, to knowingly sell any security to or purchase any security from a client or acting as broker for a person other than such client, to knowingly effect any sale or purchase of any security for the account of any such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting, and obtaining the consent of the client to such transaction; or
- (d) to engage in any act, practice or course of business that is fraudulent, deceptive or manipulative.

This standard, which is more expansive than those in other federal securities laws, has been interpreted broadly by the SEC. A list of many of the practices that violate or have been alleged to violate Section 206 is attached hereto as Schedule II.

Material Misstatements. Section 207 makes it unlawful to willfully make any untrue statement or purposeful omission of a material fact in any registration application or report filed with the SEC under the Advisers Act.

VII. Advertising. Section 206(4) provides the SEC with rule-making authority to define what constitutes a fraudulent, deceptive or manipulative act, practice or course of business and prescribe means to prevent such activities. Rule 206(4)-1 prohibits the use in advertisements of testimonials, specific past profitable recommendations (unless all recommendations made within the past year are disclosed or the recommendations are selected on the basis of specific non-performance-based criteria), any chart, graph, formula or other device that purports to guide the investor on how to invest by himself or any other statement that is false or misleading. An advertisement is generally defined as any written communication addressed to more than one person or any notice or announcement in any publication or by radio or television or other electronic medium that offers any analysis, report, or publication regarding securities, any graph, chart, formula or other device for making securities decisions or any other investment advisory services regarding securities.

VIII. Cross Trading and Agency Cross Transactions. Under Rule 206(3)-2, if an Adviser is managing more than one account or acting as a broker-dealer, there may be situations in which it wishes to sell securities from one managed account to another ("Cross Trading"), from a managed account to a brokerage client or from a brokerage client to a managed account (each known as an "Agency Cross Transaction"). Subject to the exceptions set forth in the next two sentences, the Adviser must receive the

⁸ Qualified Custodians include banks, savings associations, registered broker-dealers, registered futures commission merchants (for assets related to futures transactions) and foreign financial institutions that customarily hold financial assets for its customers, provided the assets are kept in individual client accounts.

⁹ The SEC has proposed amendments to the custody rule which would eliminate the ability for an Adviser to send a quarterly account statement and require the Adviser to undergo an annual surprise audit from an independent accountant.

written consent of the relevant client(s) prior to the settlement of any Cross Trading or Agency Cross Transactions. First, Cross Trading does not require any consent if the Adviser will not receive any compensation other than its advisory fee (*i.e.*, will not be receiving brokerage commissions), provided that the Adviser has disclosed in its Form ADV and to its clients that it will engage in Cross Trading and does not disfavor any client in making such trades. Second, the Adviser may receive blanket prior consent to Agency Cross Transactions, provided Rule 206(3)-2 is obeyed.¹⁰

IX. Principal Transactions. Section 206(3) requires Advisers to obtain the consent of a client prior to the completion of any transaction in which the Adviser, acting as principal for its own account or the account of an affiliate, buys any security from, or sells any security to, such client.¹¹

X. Allocation of Securities. Section 206 has been interpreted to require Advisers to allocate securities and advisory recommendations among their clients in a fair and equitable manner. The SEC has stated that some sort of formula or program (*e.g.*, pro rata allocation among all accounts, a strict rotational system, etc.) must be in place, must be consistently applied to all accounts and must not unfairly discriminate against any client. These allocation procedures should be disclosed to clients either in the Form ADV or the advisory contract, and written records evidencing the implementation of the procedures should be retained.

XI. SEC Examinations. Section 204 requires registered Advisers to make their books and records of Advisers available to the SEC for examination. The SEC conducts three types of inspections of Advisers – routine, cause, and sweep inspections. The purposes of SEC inspections are (i) to detect violations, (ii) to detect weaknesses in internal controls and compliance systems that could lead to violations and (iii) to seek to detect new areas of compliance risk. When the examination staff finds problems, they most often instruct the firm to take corrective action; however, they may also recommend more serious problems to the SEC enforcement staff for investigation. The SEC seeks to conduct an inspection of an Adviser within 18 months of the Adviser's initial registration. The frequency of subsequent investigation depends on the staff's evaluation of the Adviser's risk profile. Advisers deemed high risk by the staff can expect to be examined once every two to three years.

XII. SEC Enforcement. The Advisers Act gives the SEC the authority to impose disciplinary and/or seek civil, administrative or injunctive relief. The SEC may reject an application; censure an Adviser; suspend or revoke a registration; and/or bar a person from associating with an Adviser for a given period of time. In 1990, the SEC was granted the additional power to impose fines ranging from

¹⁰ To rely on Rule 206(3)-2, the following five conditions must be satisfied:

- (1) the client must prospectively authorize Agency Cross Transactions in writing;
- (2) the Adviser must disclose to the client in writing the capacities in which it will be acting and the possible conflicts in interest that may arise in Agency Cross Transactions;
- (3) each Agency Cross Transaction must be confirmed in writing;
- (4) the Adviser must provide an annual summary of all Agency Cross Transactions; and
- (5) all client statements must disclose that the client at any time may terminate the authority to conduct Agency Cross transactions.

¹¹ The SEC has not provided any opportunity for blanket advance consent of the type permitted for Agency Cross Transactions. Rather, the Adviser must ensure that prior to the settlement of any transaction between a client, on the one hand, and itself or an affiliate, on the other hand, it provides the client with information including the price to be charged to the account, the best price at which the transactions could be effected elsewhere and any commission charges and then receives the consent of the client to the transaction. While this consent need not necessarily be in writing, written consent is preferred for evidentiary reasons.

\$5,000 to \$100,000 for natural persons and \$50,000 to \$500,000 for entities. In addition, the Justice Department has the authority to pursue criminal actions for violations of the Advisers Act.

SCHEDULE I

The required books and records include the following:

- A journal or journals (including cash receipts and disbursements) and other records of original entry forming the basis of entries in any ledger;
- General and auxiliary ledgers reflecting asset, liability, reserve, capital, income and expense accounts;
- A memorandum of each order given and instructions received by the Adviser from clients for the purchase, sale, delivery or receipt of securities (showing, among other things, the terms and conditions of the order, who recommended the transaction on behalf of the Adviser, who placed the order, the account for which entered, the date of entry and where appropriate the bank, broker or dealer that executed the order);
- All checkbooks, bank statements, canceled checks and cash reconciliations of the Adviser;
- Bills or statements relating to the Adviser's business;
- Trial balances, financial statements and internal audit working papers relating to the Adviser's business;
- Originals or copies of certain communications sent or received by the Adviser (including responses to requests for proposals) that detail proposed investment advice, the placing or execution of purchase or sale orders, or the receipt, delivery or disbursement of funds or securities;
- A list of and documents relating to the Adviser's discretionary client accounts (including powers of attorney or grants of authority);
- Copies of all of the Adviser's written agreements with clients or relating to the Adviser's business;
- Copies of publications and recommendations the Adviser distributes to ten or more persons and a record of the factual basis and reasons for the recommendation (if not set forth in the publication);
- A record of each Holdings Report and Transaction Report submitted by any Access Person;
- Copies of performance advertisements and documents necessary to form the basis for such performance information;
- All written acknowledgments of receipt obtained from clients and copies of disclosure statements delivered to clients from solicitors; and
- Copies of Adviser's compliance policies and procedures, including its Code of Ethics; records of violations of such policies and procedures; records of any actions taken as a result of such violations; and copies of all written acknowledgments by Supervised Persons of receipt of the Code of Ethics.

SCHEDULE II

- “Front-running” or “scalping”
- Misrepresenting pricing methodology or failing to follow disclosed valuation methods
- Deliberate mispricing of portfolio holdings or manipulating market prices to inflate valuations
- Failing to disclose in communications to clients that a large portion of a fund’s superior performance was due to investments in initial public offerings
- Misrepresenting internal controls
- Miscoding, forging or failing to submit order tickets
- Overstating performance results
- Purchasing securities in contravention of prospectus disclosure
- Favoring certain clients or proprietary accounts in allocating initial public offerings or other trades without adequately disclosing such practice
- Taking advantage of investment opportunities belonging to a client or fund
- Undisclosed commission-splitting arrangements
- Failing to disclose the receipt of commissions or service fees from client investments
- Failing to disclose soft dollar or other brokerage practices
- Failing to disclose personal financial interest in securities transactions for clients or related conflicts of interest
- Failing to disclose that the Adviser would profit by trading as a principal with clients
- Willfully submitting inaccurate reports to a board of directors of a mutual fund
- Not disclosing remuneration to be received in connection with the assignment of an advisory contract
- Misusing and diverting funds under management
- Failure to disclose “double fees” received from clients’ assets invested in a fund advised by the Adviser
- “Inter-positioning” a broker between a fund and dealers making a primary market in securities, thereby causing the fund to incur unnecessary expenses
- Failing to disclose to clients that they paid materially different commissions due to directed brokerage arrangements
- Failing to disclose to clients that the prices obtained for them were not the most favorable under the circumstances
- Failing to seek best execution on client transactions
- Failure to disclose that client commissions were used to compensate brokers for client referrals
- Failing to disclose arrangements with “market timers” or “late traders”
- Undisclosed short-term trading by portfolio managers in funds they manage

- Improperly providing confidential portfolio holdings information
- Undisclosed bribery or “kickback” schemes
- Misrepresenting that performance results were prepared in accordance with AIMR performance standards