



# Alert

Securities Litigation and Enforcement  
Client Service Group

Alternative Investment Team

To: Our Clients and Friends

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## Enforcement Landmines For Private Funds in Dodd-Frank

By now, most “private” or “hedge” fund managers know that the Dodd-Frank Wall Street Reform and Consumer Protection Act requires SEC registration of most advisers to private funds, effective July 2011. But SEC registration is not the only aspect of the new law that fund managers need to be aware of. Other provisions of the law will have significant effects on funds.

Key issues include:

- Funds must meet expanded books and records requirements.
- Advisers to venture capital funds, exempt from registration under the law, will have to take pains to avoid being treated as private equity or hedge fund advisers, who do have to register.
- The standard for aiding and abetting liability has been lowered, such that “recklessness” rather than “actual knowledge” is sufficient.
- Smaller advisers, not subject to SEC registration, will become subject to the vagaries of state regulation.

“Private” or “hedge” funds are swept into the law through Title IV, the “Private Fund Investment Advisers Registration Act of 2010.” While Title IV does contain the registration requirements, it also contains other provisions that expand the scope well beyond the regulatory hook of registration. Further, other provisions of Dodd-Frank - notably, Title IX, entitled “Investor Protections and Improvements to the Regulation of Securities” - also have significant implications for private funds.

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In this alert, we note in particular the following “landmines” for private funds in the new law’s enforcement and examination provisions:

1. Expanded Books and Records Requirements.

The Investment Advisers Act imposes extensive record-keeping requirements on registered advisers. To the extent that an adviser to a private fund already is registered, it will be familiar with these requirements and presumably have established the necessary document control protocols. To the extent that an adviser will now have to register, it will need to establish such protocols.

But, beyond this requirement, Dodd-Frank empowers the SEC to impose a separate requirement on advisers to “maintain such records and file with the SEC such reports regarding private funds advised by the...adviser, as necessary and appropriate in the public interest and for the protection of investors, or for the assessment of systemic risk by the Financial Stability Oversight Council.” (The “FSOC” is the committee of regulators and others charged with assessing and responding to indications of systemic risk.) The legislation specifies that these records should include records relating to:

- the amount of assets under management and 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 “necessary and appropriate in the public interest and for the protection of investors or for the assessment of systemic risk.”

Many of these documents, of course, are captured by existing rules for advisers, and the SEC rule-making process to define the scope of any new requirements pursuant to the Act has only just begun. The rule-making, moreover, is likely to be extensive, involving consultation between the SEC and the FSOC. The SEC likely will develop a far-reaching set of requirements and launch a cycle of examinations to ensure that advisers to private funds understand and are complying with their new responsibilities under the Act. Although this first set of examinations may result in deficiency letters, it is unlikely that it will result in enforcement actions unless the deficiencies detected are egregious or reflective of contumacy by the adviser as to regulatory requirements. Nevertheless, for advisers that are not experienced with the nuances of the SEC examination process, it will be important to prepare for these likely reviews, for example, by undertaking mock compliance examinations.

Title IV also requires advisers to provide the SEC with “any copies or extracts...as may be prepared without undue effort, expense, or delay.” In other words, advisers are required to prepare reports as requested, whereas they previously had been required only to provide the SEC with

materials already in existence or specifically required by regulation. Although most advisers currently try to accommodate requests from the SEC Staff, the statute may give the Staff impetus to issue broader or more specific requests, and limit the ability of advisers to “push back” if they disagree with the appropriateness of a particular request.

## 2. The Dividing Line Between Private Funds and Venture Capital Funds.

Dodd-Frank exempts advisers that advise solely venture capital funds from the new registration provisions. Despite the exemption from registration, such advisers will be required to “maintain records and provide to the SEC reports as the SEC may require.” (In earlier-circulated versions of the bill, private equity firms were exempted as well.) The Act directs the SEC to develop, within one year, rules to define “venture capital funds.”

The distinction between private funds and venture capital funds is not precise. To the extent possible, funds will want to be characterized as venture capital funds to avoid the more onerous aspects of registration. Depending on the clarity of the rules that the SEC adopts, funds may believe that they are acting as venture capital funds when the SEC may decide that they are, in fact, acting as private funds. After the SEC adopts a definition, funds that seek to take advantage of the exemption may try to adjust their business models to comply, and they may be subject to investigations as to whether they have, in fact, complied. The key point is that funds that consider themselves venture capital funds will need to carefully follow this rule-making definitional process.

## 3. The Slippery Slope of Aiding and Abetting Liability.

Title IX, Sections 929 M, N and O lower the standard for aiding and abetting liability in SEC actions. (A proposal to overturn the long-standing *Central Bank* decision and enable private causes of action for aiding and abetting liability did not become law, although the Act mandated a study of the issue, which suggests that the proposal could resurface.) Previously, the standard had been articulated as requiring the provision of “knowing and substantial assistance” to the primary violator. The Act changes that formulation, so that the standard now will require proof of “recklessness” rather than “knowledge.”

The “actual knowledge” standard has not been quite as high in application as the words themselves would suggest. As a practical matter, proof of “knowledge” usually involves proof that a person acted “recklessly,” i.e., that the person “must have known” that his or her actions were contributing to the violation. Moreover, the “recklessness” standard - usually articulated as involving conduct well-beyond even gross or inexcusable negligence - has itself been degraded. It is possible that rephrasing the standard for aiding and abetting liability as involving recklessness rather than knowledge is a step down an already slippery slope which may lead to the SEC (at least in practice) regarding the standard as requiring proof of something akin to highly negligent conduct. Similarly, the Act conforms the Advisers Act and the Securities Act to the Exchange Act, providing that one who aids and abets a violation by another is liable “to the same extent as the person that committed such violation.” The implication is that the full range of remedies, including penalties, is now available in such actions.

#### 4. Smaller Advisers Become Subject to the Vagaries of State Regulation.

Dodd-Frank raises the assets under management threshold for SEC registration of advisory firms to \$100 million (\$150 million for advisers that solely advise private funds), from the prior level of \$25 million (it also eliminates the current registration exemption for investment advisers with fewer than 15 clients). The intent is to enable the SEC to focus on advisers managing greater amounts of assets that may present greater systemic risk. One consequence, however, is that many advisers no longer eligible for SEC registration will have to register at the state level, perhaps in multiple states. Regulations frequently vary from state to state, as does the level of aggressiveness pursued by state regulators. The level of understanding of sophisticated investment strategies and other aspects of the private fund industry also may vary, creating additional complexity.

Other potential landmines exist in Dodd-Frank. For example, the Act requires the General Accounting Office to conduct a study on whether a self-regulatory organization for private funds should be established. The Act also requires the SEC's Division of Risk, Strategy and Financial Innovation (known as "RiskFin") to study short selling, with the potential for regulatory revisions. Similarly, increased encouragement of and protection for whistleblowers may result in more investigations of activities by private funds. Finally, the Act mandates more rigorous deadlines for the completion of enforcement actions, which may cause the SEC Staff to be less flexible than currently in accommodating reasonable scheduling requests. The more rigorous deadlines may also cause the Staff to be less open to consideration of a potential defendant's/respondent's arguments.

As is true of other aspects of Dodd-Frank, the broad parameters of the enforcement and examination provisions will be sharpened by subsequent agency rulemaking. In addition, from an enforcement perspective, the discretion with which the SEC Staff deploys the tools now available will largely determine the legislation's true impact.

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