Impact of US Dodd-Frank and other reforms on alternative investment vehicles: a brief guide

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As a result of the financial crisis of 2008, the US Congress passed the US Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act). In addition to amending numerous laws, the Dodd-Frank Act authorised US financial regulators, including the US Securities and Exchange Commission (SEC) and the US Commodity Futures Trading Commission (CFTC), to significantly alter the US regulatory environment. While much of the Dodd-Frank Act and other laws and regulations focus on banks and depository institutions, investment funds and fund managers also face an increasingly complex legal landscape:

- First, due to the regulatory changes, many fund managers must now register as one or both of the following:
  - an investment adviser with the SEC; and
  - a commodity pool operator (CPO) with the CFTC (*see box, Glossary*).
- Second, fund managers now face a vastly changed and more complex system of regulation due to the:
  - regulation of swaps (*see box, Glossary*), which, among other things, creates a comprehensive new regime for the reporting and clearance of swaps;
  - "Volcker rule", which, among other things, substantially restricts banking entities from acquiring or retaining, as principals, ownership interests in or acting as sponsors of, covered funds (*see box, Glossary*) (subject to certain exemptions); and
  - US Jumpstart Our Business Startups Act (JOBS Act), which, among other things, amends the rules relating to solicitation and advertising in connection with the non-public offer and sale of securities.

As a result, registered and unregistered fund managers located inside and (to a lesser extent) outside the US and dealing in US markets or with US investors, must now navigate a significantly different business environment. Despite these already substantial changes, regulations continue to be modified by the SEC, CFTC, congressionally mandated oversight boards, self-regulatory organisations and other agencies. All the while, the SEC and the CFTC continue to claim broad jurisdiction to regulate non-US managers (even in relation to non-US managers of non-US funds). As a result, managers worldwide must adapt to the reach of US regulations and the regulations of other competing jurisdictions.

This article provides a brief guide to the:

- Fairly recent registration requirements affecting fund managers, such as the requirement to register as an investment adviser, commodity pool operator or commodity trading advisor, and the manager's subsequent regulatory obligations, in Part I (*see below, Part I: Registration and subsequent regulatory obligations*).
- New and evolving systems of regulation of the investment funds market brought about by the regulation of swaps, the Volcker rule, and the JOBS Act, in Part II (*see below, Part II: Regulation*).

PART I: REGISTRATION AND SUBSEQUENT REGULATORY OBLIGATIONSINVESTMENT ADVISERS

Removal of private adviser exemption. Prior to 2011, under the "private adviser exemption", many investment fund managers were not required to register as investment advisers with the SEC. However, in 2011 the SEC repealed that exemption and, although the SEC also adopted new rules that established more limited exemptions from registration and from certain reporting requirements for certain advisers pursuant to its authority under the US Investment Advisers Act of 1940, as amended (Advisers Act), the SEC's changes ultimately required many investment advisers to register with the SEC.

The rules requiring registration and the main exemptions are summarised in the following tables, *Investment advisers organised in the United States* and *Investment advisers organised outside the United States.*

Investment advisers organised outside of the United States

Registration with the SEC using Form ADV. Registering with the SEC as an investment adviser requires filing the two parts of Form ADV with the Investment Adviser Registration Depository (IARD). The two parts of Form ADV serve slightly different purposes, and are placed in a public database (available at *www.iard.com*).

Ongoing considerations for investment advisers. Among other things, investment advisers should be aware of the following:

- **Ethics and fiduciary duty.** An investment adviser is a fiduciary that owes each client and private fund investor an affirmative duty of good faith and full and fair disclosure of all material facts.
- **Compliance policies and procedures**. Each registered investment adviser must adopt written policies and procedures (including a code of ethics) tailored to its business, the adequacy and effectiveness of which must be reviewed annually by the adviser's principals. The policies and procedures (both as adopted and as applied) should be reasonably designed to prevent and detect, insofar as practicable, violations of securities and investment adviser laws and regulations by the adviser and its personnel.

INVESTMENT ADVISERS ORGANISED IN THE UNITED STATES				
Principal office and place of business of adviser	**Type of accounts managed**	**Domicile of investors/ clients**	**Aggregate regulatory asset under management (RAUM) of all accounts**	**Exempt from registration?**
US	Private funds (see box, Glossary) only (regardless of domicile of the funds).	US and/or non-US.	Less than US$150 million.	Exempt from reporting under §203(m) of the Advisers Act as a "private fund adviser". Potential state registration required (unless exemption adopted by state).
US	Private funds only (regardless of domicile of the funds).	US and/or non-US.	Equal to or greater than US$150 million.	SEC registration required under §203(a) of the Advisers Act.
US	Venture capital funds only.	US and/or non-US.	Not applicable.	Exempted from reporting under §203(l) of the Advisers Act as a "venture capital fund adviser". Potential state registration required (unless exemption adopted by state).
US (other than states of Wyoming, New York and Minnesota)*	Managed accounts only or private funds and managed accounts.	US and/or non-US.	Equal to or greater than US$25 million and less than US$100 million.	State registration required if adviser meets minimum threshold for number of clients and there is no institutional exemption available; otherwise SEC registration required.
US (other than states of Wyoming, New York and Minnesota)*	Managed accounts only or private funds and managed accounts.	US and/or non-US.	Equal to or greater than US$100 million.	SEC registration permitted (mandatory if RAUM (*see box, Glossary*) greater than or equal to US$110 million). SEC registration must be withdrawn if RAUM falls below US$90 million.
US domiciled in state of Wyoming*	Managed accounts only or private funds and managed accounts.	US and/or non-US.	Greater than zero (US$0).	SEC registration required. No qualifying state registration regime.
US domiciled in state of New York or Minnesota*	Managed accounts only or private funds and managed accounts.	US and/or non-US.	Equal to or greater than US$25 million.	SEC registration required. No qualifying state registration regime. SEC registration must be withdrawn if RAUM falls below US$25 million.

*Each US state (other than Wyoming) maintains its own regulatory regime. All Wyoming state investment advisers are subject to SEC registration. Minnesota and New York state regulate investment advisers but does not have a regular examination programme. Therefore, mid-sized advisers (that is, advisers with RAUM greater than or equal to US$25 million and less than US$100 million) in Minnesota and New York state must register with the SEC.

Although the SEC has not outlined exactly what procedures advisers must have, the following must be addressed (at a minimum):

- a code of ethics setting out standards of conduct expected of advisory personnel and addressing conflicts that arise from personal trading by advisory personnel and otherwise;
- portfolio management processes, including allocation of investment opportunities among clients and consistency of portfolios with guidelines established by clients, disclosures and regulatory requirements;
- trading practices, including procedures by which the adviser satisfies its best execution obligation, uses client brokerage to obtain research and other services ("soft dollar arrangements") and allocates aggregate trades among clients;
- proprietary trading of the adviser and personal trading activities of supervised persons, including policies designed to prevent and detect insider trading;
- the accuracy of communications and disclosures made to investors, including information in advertisements and social media;

INVESTMENT ADVISERS ORGANISED OUTSIDE OF THE UNITED STATES					
Principal office and place of business of adviser	**Type of accounts managed***	**US place of business**	**Domicile of investors/clients**	**Aggregate RAUM of all accounts**	**Exempt from registration?**
Non-US	US private funds only and non-US client accounts (whether or not private funds).	No	US and non-US.	Not applicable.	Exempt reporting adviser under §203(m) of the Advisers Act as a "private fund adviser".
Non-US	Non-US private funds and other non-US client accounts only.	No	US and non-US investors only, no US clients.	Not applicable.	Dependent on facts and circumstances: No US jurisdiction if adviser does not use US jurisdictional means in connection with its advisory business. May be exempt from registration and reporting as a "foreign private adviser" if certain conditions are met. If adviser sufficiently uses US jurisdictional means (and thus falls under US jurisdiction), adviser is an exempt reporting adviser under §203(m) of the Advisers Act as a "private fund adviser".
Non-US	US private funds only and/or non-US private funds and non-US client accounts.	Yes	US and non-US.	Less than US$150 million.**	Exempt from reporting under §203(m) of the Advisers Act as a "private fund adviser".
Non-US	US and non-US private funds and/or US managed accounts.	Yes	US and non-US.	Greater than zero (US$0).	SEC registration required under §203(a) of the Advisers Act.
Non-US	US and non-US private funds and/or US managed accounts.	No	US and non-US.	Greater than zero (US$0).	SEC registration required unless qualified to claim the "foreign private adviser" exemption.
Non-US	US and non-US private funds and/or US managed accounts.	No	Fewer than 15 US clients and investors in private funds, with less than US$25 million in assets attributable to such US clients and investors.	Less than US$25 million.	Exempt under §203(b)(3) of the Advisers Act as a "foreign private adviser" if not holding itself out to the public in the US as an investment adviser.

The information on this chart is also applicable to advisers organised in the US whose principal office and place of business are outside the US.

*For the purpose of determining the type of accounts managed, advisers should exclude the accounts of non-US clients that are not private funds.

**For the purpose of determining if a non-US adviser is eligible for the "private fund adviser" exemption, the adviser should aggregate the RAUM of all US and non-US private fund clients managed from the United States. The adviser should exclude accounts of non-US clients that are not private funds. To be eligible for the "private fund adviser" exemption, the adviser must not have US clients other than private funds.

- the safeguarding of client assets (*see below, Custody of client assets*) from conversion or inappropriate use by advisory personnel;
- the accurate creation of required records and their maintenance in a manner that secures them from unauthorised alteration or use and protects them from untimely destruction;
- processes to value client holdings and assess fees based on those valuations;
- safeguards for the protection of client records and information (including a written privacy policy);
- controls on gifts and contributions (including campaign contributions) to public officials in a position to award business to the adviser both domestically, under SEC "pay-to-play" rules and abroad, under the US Foreign Corrupt Practices Act; and
- business continuity and disaster recovery plans.

FORM PF			
Type of private fund adviser	**RAUM***	**Filing frequency**	**Form sections**
Private fund adviser to hedge funds (*see box, Glossary*).	Equal to or greater than US$150 million and less than US$1.5 billion.	Annually, within 120 days of fiscal year end.	Sections 1a, 1b and 1c.
	Equal to or greater than US$1.5 billion.	Quarterly, within 60 days of fiscal quarter end.	Sections 1a, 1b, 1c and 2a, and, for any hedge fund with a net asset value of greater than or equal to US$500 million, 2b.
Private fund adviser to private equity funds (*see box, Glossary*).	Equal to or greater than US$150 million and less than US$2 billion.	Annually, within 120 days of fiscal year end.	Sections 1a and 1b.
	Equal to or greater than US$2 billion.	Annually, within 120 days of fiscal year end.	Sections 1a, 1b and 4.
Private fund adviser to liquidity funds (*see box, Glossary*).	Equal to or greater than US$150 million and less than US$1 billion.	Annually, within 120 days of fiscal year end.	Sections 1a and 1b.
	Equal to or greater than US$1 billion.	Quarterly, within 15 days of fiscal quarter end.	Sections 1a, 1b and 3.
Other private fund adviser.	Equal to or greater than US$150 million.	Annually, within 120 days of fiscal year end.	Sections 1a and 1b.
*For the purposes of this table, the RAUM thresholds are based on the adviser's RAUM attributable to private funds, hedge funds, private equity funds or liquidity funds, as the context of the row requires.			

- **Chief Compliance Officer.** Each registered investment adviser must appoint a Chief Compliance Officer who is "competent and knowledgeable" about relevant laws and regulations and "empowered" to enforce the adviser's policies and procedures.
- **Custody of client assets.** A registered investment adviser may be deemed to have custody of assets by:
  - physically possessing client assets;
  - having authority to obtain the assets (such as through deducting advisory fees from a client account, writing cheques or withdrawing funds on behalf of a client); or
  - acting in a capacity, such as general partner of a limited partnership or manager of a limited liability company that gives the adviser the authority to withdraw funds or securities from the client's account.

  Advisers with custody of client assets must:
  - maintain those client assets with a qualified custodian;
  - notify the client in writing of the qualified custodian's name and address;
  - have a reasonable basis, after due inquiry, for believing that the qualified custodian is providing quarterly statements setting out all positions in the account at the end of the period and all transactions during the period; and
  - undergo surprise examinations by independent public accountants. However, advisers that have custody only by virtue of deducting fees from client accounts are not required to undergo the surprise examinations.

As an alternative to complying with items two to four above, managers of private funds can provide each investor with audited financial statements of the fund within 120 days after the end of the fund's fiscal year (or 180 days in the case of an adviser to funds-of-funds).

SEC examinations. Registered investment advisers are routinely examined by the SEC. Recently, the SEC has focused its examination efforts on testing the effectiveness of advisers' controls and related compliance procedures and has placed the onus on advisers' management personnel to rectify any weaknesses that the SEC identifies.

Investment advisers managing private funds: requirement to file Form PF. Investment advisers may, depending on the type of activities in which they engage, be required to file various regulatory reports. Of particular note is Form PF, which advisers must file if the adviser fulfils all of the following criteria:

- The adviser is registered or required to be registered with the SEC as an investment adviser.
- The adviser is responsible for advising one or more private funds.
- The adviser manages at least US$150 million in assets attributable to private funds as of the end of such adviser's most recently completed fiscal year.

Advisers that fulfil all of the above criteria are "Private Fund Advisers".

Increased reporting requirements on Form PF are triggered if a Private Fund Adviser qualifies as a "Large Private Fund Adviser" (as defined on Form PF).

Form PF is lengthy and complex and any adviser required to complete it should consult with a legal adviser. For a summary of Form PF, see table, *Form PF*.

Commodity pool operators and commodity trading advisors

Removal of CFTC Rule 4.13(a)(4). In early 2012, the CFTC rescinded CFTC Rule 4.13(a)(4), which had exempted from CPO registration certain CPOs of commodity pools that were offered solely to certain "qualified eligible persons" (QEPs) (*see box, Glossary*) and institutional investors.

Since the adoption of CFTC Rule 4.13(a)(4) in 2003, many advisers had used that exemption to avoid both registration with the CFTC as CPOs and compliance with the CFTC's disclosure, reporting and recordkeeping requirements. Following its elimination, CPOs that were relying on CFTC Rule 4.13(a)(4) must now comply by either:

- Relying on a different registration exemption, for example, a CPO could limit its trading of commodity interests in accordance with CFTC Rule 4.13(a)(3) and rely instead on that registration exemption (*see below, The exemption from CPO registration under CFTC Rule 4.13(a)(3)*).
- Registering with the CFTC as a CPO.

Registering with the CFTC as a CPO:

- Subjects such CPO to CFTC and National Futures Association (NFA) jurisdiction and oversight.
- Obligates the CPO to comply with certain disclosure, recordkeeping and reporting rules.

The exemption from CPO registration under CFTC Rule 4.13(a)(3). Due to the regulatory burden associated with registration as a CPO, many CPOs choose to limit their activities to exempt themselves from registration. One of the more popular exemptions is CFTC Rule 4.13(a)(3). However, changes to the definition of "commodity interest" (specifically, the inclusion of "swaps") have substantially impacted who is eligible to claim this exemption.

CFTC Rule 4.13(a)(3) allows a CPO to operate commodity pools without registering as a CPO with the CFTC (and thereby avoid many disclosure, recordkeeping and reporting requirements), provided that each commodity pool operating under CFTC Rule 4.13(a)(3):

- Generally only accepts investors that are either "accredited investors", "knowledgeable employees", or QEPs.
- Is not marketed to the public and is not marketed as or in a vehicle for trading in the commodity futures or commodity options markets.
- Meets one of the following tests in relation to its commodity interest positions (including its positions in security futures products and certain swaps), whether entered into for bona fide hedging purposes or otherwise:
  - the aggregate initial margin, premiums, and required minimum security deposit for retail forex transactions (*see box, Glossary*) required to establish such positions, determined when the most recent position was established, does not exceed 5% of the liquidation value of such pool's portfolio (excluding from such calculation any option that is in-the-money at the time of purchase), after taking into account unrealised profits and unrealised losses on any such positions into which such pool has entered; or
  - the aggregate net notional value of such positions, determined at the time the most recent position was established, does not exceed 100% of the liquidation value of such pool's portfolio, after taking into account unrealised profits and unrealised losses on any such positions into which such pool it has entered.

CPOs must claim this exemption annually for each pool by filing a notice electronically with the NFA.

Registering as a CPO. If a CPO is unable to claim an exemption, the CPO must register with the CFTC and become a member of the NFA. CPOs register electronically through the NFA's online registration system:

- First, the CPO must register itself by filing Form 7-R and paying an application fee of US$200 and an NFA membership fee of US$750.
- Second, the CPO must file Form 8-R for each principal (*see box, Glossary*) and for each associated person (*see box, Glossary*) of the CPO, submit fingerprint cards for each of these persons (with limited exceptions) and pay an application fee of US$85. At least one principal must also be an associated person. All associated persons (but not principals, if not also associated persons) must also satisfy a proficiency requirement. This is generally achieved, by passing the Series 3 exam, or obtaining a waiver from the exam.

Generally, registered CPOs operate two types of pools:

- Non-exempt pools (that is, pools that have full disclosure, recordkeeping and reporting obligations).
- CFTC Rule 4.7 pools (that is, pools that have limited disclosure, recordkeeping and reporting obligations).

In addition to the above, some registered CPOs also operate some of their pools under CFTC Rule 4.13(a)(3) (that is, the registered CPOs operate some of their pools as if they were not registered and therefore avoid CFTC disclosure, recordkeeping and reporting obligations in respect of those pools only).

Registered CPOs operating non-exempt pools. Registered CPOs operating non-exempt pools must fully comply with all rules and regulations of the CFTC and the NFA, including disclosure, recordkeeping and reporting requirements. The requirements imposed by these rules and regulations are beyond the scope of this article.

Registered CPOs operating CFTC Rule 4.7 pools. Many registered CPOs operate their pools under CFTC Rule 4.7. This enables them to limit (and in some cases completely eliminate) most of the burdensome disclosure, periodic reporting, annual reporting, and recordkeeping requirements otherwise required of registered CPOs. CPOs often manage pools under CFTC Rule 4.7 because these pools (unlike pools operated under CFTC Rule 4.13(a)(3)) can engage in limitless commodity interest trading if, among other things, they are limited to investors that are QEPs.

However, although pools operated under CFTC Rule 4.7 are exempt from distributing a disclosure document to investors and from certain other disclosure, recordkeeping and reporting rules, these pools are still subject to general commodities and securities law principles and must disclose to investors all material facts regarding the offering of interests in the pool. For this reason, CPOs of pools operating under CFTC Rule 4.7 should still prepare an offering memorandum with detailed risk disclosures. Among other things, the offering memorandum must disclose that the pool is operated under CFTC Rule 4.7 on the cover page of the offering memorandum. These pools also must provide investors with certain periodic and annual reports and must keep certain books and records.

Unlike other registered CPOs, a registered CPO that only operates pools exempt under CFTC Rule 4.7 (or under other exemptions) is not required to maintain specific detailed records otherwise required under

CFTC Rule 4.23. However, the CPO must still maintain the following at its main business offices (or, subject to compliance with recent CFTC rule changes, with certain approved third parties) in accordance with CFTC recordkeeping rules:

- All quarterly and annual reports.
- All other books and records prepared in connection with its activities as a pool operator (including any records relating to the qualifications of investors as QEPs and substantiating performance representations).

All registered CPOs (including those operating under CFTC Rule 4.7) are generally prohibited (under NFA Bylaw 1101) from engaging in commodities-related business with any of the following that is required to be a member of the NFA but is not a member:

- A futures commission merchant.
- An introducing broker.
- A commodity trading advisor (CTA) (*see box, Glossary*).
- A CPO.

CPOs of pools operated under CFTC Rule 4.7 also must file certain reports with the NFA, including:

- NFA Form PQR.
- CFTC Form CPO-PQR.

CFTC Form CPO-PQR and NFA Form PQR. As a result of recent NFA rule changes, all registered CPOs are subject to quarterly regulatory filing requirements, either on CFTC Form CPO-PQR or NFA Form PQR. Both filings have been integrated into a single process in the NFA's online filing system.

Generally speaking, CFTC Form CPO-PQR is the CFTC's equivalent of SEC Form PF (*see above, Investment advisers organised outside of the United States: Investment advisers managing private funds: requirement to file Form PF*). Like Form PF, Form CPO-PQR is lengthy and complex and any CPO required to complete it should consult with a legal adviser. For a summary of Form CPO-PQR filing requirements, see table, *Form CPO-PQR.*

FROM CPO-PQR

CPO's Aggregated (Gross) Pool AUM	Filing Frequency	Schedules
Less than US$150 million (Small CPOs).	Annually, within 90 days after calendar year end.	Schedule A.
Equal to or greater than US$150 million and less than US$1.5 billion (Mid-sized CPOs).	Annually, within 90 days after calendar year end.	Schedules A and B.
Equal to or greater than US$1.5 billion (Large CPOs).	Quarterly, within 60 days after calendar quarter end.	Schedules A, B and C part 1, and, for any pool with a net asset value of greater than or equal to US$500 million, C part 2.

Generally, a registered investment adviser that is also a CPO (dual registrant) must report on both Form PF and on Form CPO-PQR. However, the CFTC's rules allow a dual registrant that is required to file Schedule B and/or Schedule C of Form CPO-PQR (as applicable) to elect to use its Form PF filing as "substitute compliance" for its Schedule B and/or Schedule C reporting obligations. Further, a dual registrant can choose to also report on Form PF any pool that does not meet the definition of "private fund" and the CFTC will deem this reporting to have satisfied that dual registrant's reporting requirements on Schedules B and/or C (as applicable). If the dual registrant does not elect to report such pools on Form PF, the dual registrant must report the pools on Schedules B and/or C (as applicable). Filing Form PF does not remove the requirement for the dual registrant to file Schedule A, as all CPOs must file Schedule A.

The NFA recently amended its rules to require any CPO (regardless of that CPO's AUM) that is a member of the NFA (generally, any registered CPO, including those operating under CFTC Rule 4.7) to make a quarterly filing. This filing must be made:

- 60 days after the end of each calendar quarter (except for the last calendar quarter of each year, when Small and Mid-Sized CPOs have 90 days to make the filing).
- On NFA Form PQR, which is substantially similar to Schedule A and Schedule B, Item 6 (a schedule of investments) of CFTC Form CPO-PQR.

Large CPOs fulfil the NFA filing requirement by filing CFTC Form CPO-PQR.

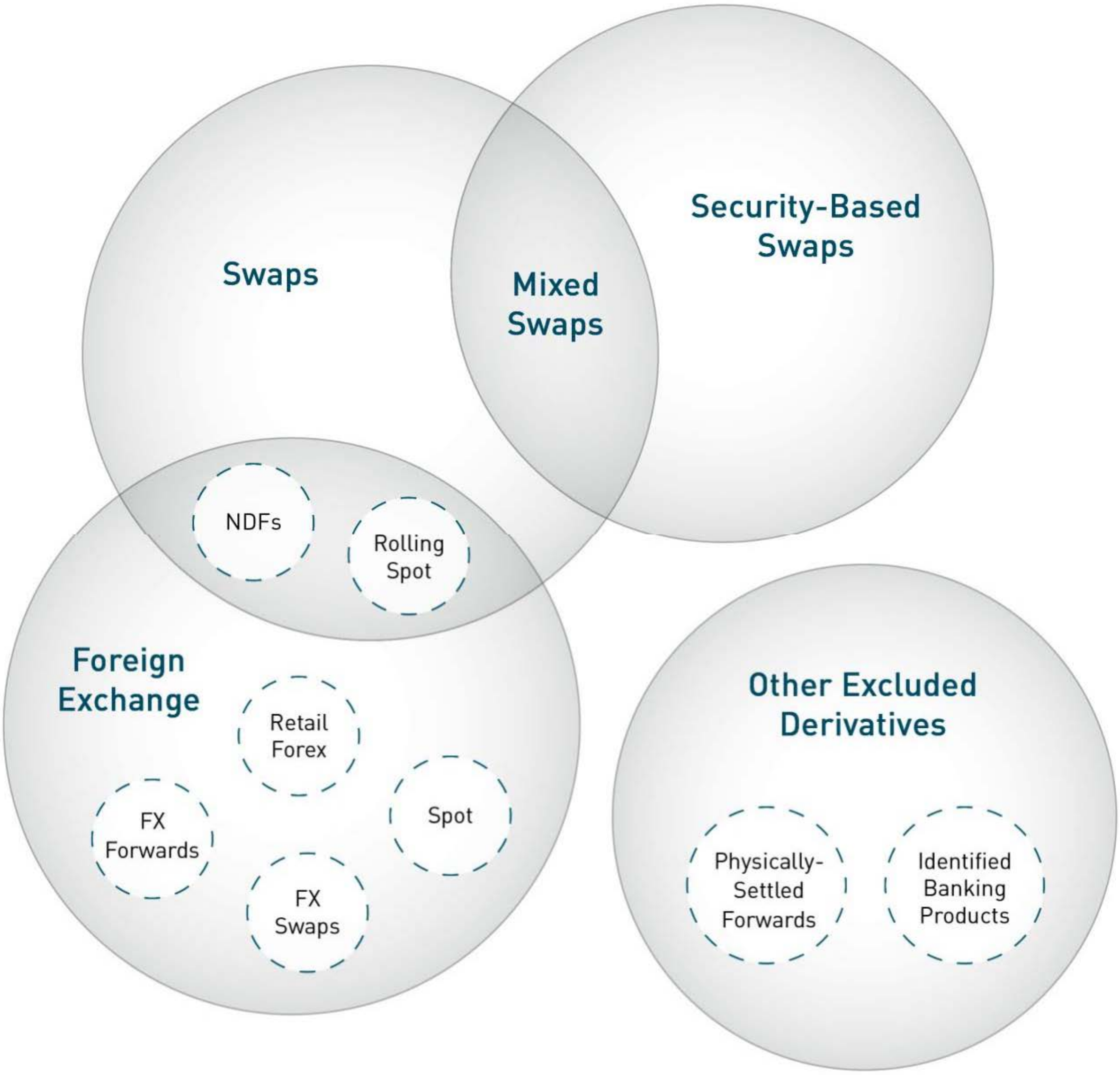
Dual registrants that file Form PF with the SEC in lieu of CFTC Form CPO-PQR are still required to file NFA Form PQR on a quarterly basis within 60 days of the quarter end (except for the filing for the end of the last calendar quarter, which will generally be satisfied by complying with the Form PF and Form CPO-PQR filings (except that Small CPOs must complete both the schedule of investments and Schedule A).

CFTC Form CTA-PR and NFA Form PR. The CFTC requires all registered CTAs to file Form CTA-PR within 45 days of the end of the CTA's fiscal year (that is, on or before 14 February of each year, based on a 31 December fiscal year end). Form CTA-PR solicits only general demographic data.

As part of its rule amendments discussed above, the NFA has imposed a quarterly filing requirement on its members that are CTAs. The NFA's quarterly Form PR consists of the CFTC annual Form PR along with some additional questions relating to certain trading programmes being offered by the CTA, and the related monthly rates of return and the assets under management for those trading programmes. The NFA's quarterly Form PR is due within 45 days of the end of each quarter. As with the CPO filings described above, the quarterly filings for CTA members of the NFA have been integrated into a single filing process in the NFA's online filing system.

The interplay between Form PF, NFA Forms PQR and PR, and CFTC Forms CPO-PQR and CTA-PR is complex and still evolving. Filing Form PF and/or Form CPO-PQR does not relieve the adviser from filing Form CTA-PR (and filing Form CTA-PR does not relieve any obligation under Form PF and/or Form CPO-PQR). Form CTA-PR is required of all registered CTAs.

CATEGORISATIONS OF DERIVATIVES PRODUCTS UNDER THE DODD-FRANK ACT



For definitions of these products, see box, *Glossary.*

PART II: REGULATION

Derivatives

Over-the-counter derivatives are customised, privately negotiated contracts linked to underlying market measures that, unlike on-exchange commodities and securities trades, have not been subject to direct regulation since their invention in the 1980s.

Regulation under the Dodd-Frank Act. Title VII of the Dodd-Frank Act creates a comprehensive regulatory regime for derivative products and market participants that has not yet been fully implemented but that has already caused significant changes in the way derivatives are traded and documented. These changes include:

- New categorisations of derivative products.
- New categorisations of derivative market participants.
- New derivatives infrastructure.
- Mandatory registration for swap dealers (SDs) and major swap participants (MSPs) (*see box, Glossary*).
- Mandatory clearing for some standardised derivatives.
- Mandatory exchange execution for some cleared derivatives.
- New recordkeeping requirements.
- Public reporting of swap transaction data.
- Mandatory margin and capital requirements for the largest and most active participants.
- Conduct standards for transactions between SDs and MSPs and their customers.
- Internal risk management standards for SDs and MSPs.
- Position limits for non-cleared derivatives.
- Mandatory policies and procedures and compliance regime for SDs and MSPs.

Title VII introduces new categorisations of derivative products that reflect the fact that responsibility for regulating derivatives has been split between the SEC and the CFTC. Under these new categorisations:

- Swaps are derivatives relating to commodities that are subject to regulation by the CFTC. The term "swap" is very broadly defined, but has some exclusions, including ones for:
  - foreign exchange swaps and forwards (provided the exclusion is affirmatively approved by the Treasury Secretary);
  - physically settled forwards and spot/cash transactions;
  - traditional securities (including structured notes) and futures contracts; and
  - transactions with the Federal Reserve and certain government entities.
- Security-based swaps are derivatives relating to securities that are subject to regulation by the SEC.
- Derivatives with both types of features are called mixed swaps and are jointly regulated.

The CFTC regulatory regime for swaps has already been implemented to a significant degree. The SEC regulatory regime for security-based swaps is not expected to come into effect until late 2014 at the earliest.

See chart, *Categorisations of derivatives products under the Dodd-Frank Act*.

Clearing of swaps. Clearing is the process by which a swap between two parties is submitted to a derivatives clearing organisation (DCO) and novated so that the original swap is replaced by two new swaps, in each of which the DCO faces one of the original parties.

The Dodd-Frank Act requires a swap to be cleared through a DCO if clearing of that swap has been mandated by a relevant regulator and no exception to clearing applies. Swaps subject to mandatory clearing must also be executed on a designated contract market (DCM) or swap execution facility (SEF) (*see box, Glossary*) if any SEF or DCM has formally made the relevant swap "available for trading", subject to certain exemptions. Any party that wishes to clear swaps but that is not a clearing member of the relevant DCO must first enter into a customer relationship with a clearing member.

Mandatory clearing is now in effect for four specific classes of US Dollar interest rate swaps and two specific classes of broad-based index credit default swaps. Other types, classes and kinds of swaps can (and most likely will) become subject to mandatory clearing in the future, based on submissions from DCOs or action by the CFTC on its own initiative. Mandatory DCM and SEF execution is also now in effect for many of the interest rate swaps covered by the current clearing mandate.

Margin rules. Under the new regime, both cleared and uncleared swaps will have mandatory margin requirements. DCOs set initial and variation margin requirements for swaps that they clear. Margin rules for uncleared swaps will be set by different regulators (the banking regulators, the CFTC and the SEC) for different types of entities. The US regulators initially proposed their own margin rules, but it now appears that the US will go along with the global margin framework for non-centrally cleared derivatives that has been developed under the auspices of the Bank for International Settlements and IOSCO. That framework, which is scheduled to be implemented starting in December 2015, will require financial entities and systemically important non-financial entities to calculate (based on a table or an approved model), exchange and segregate gross initial margin on a two-way basis for every swap (subject to a threshold applied on corporate group to corporate group basis). Such entities must also exchange full net variation margin on a daily basis (subject to a EUR500,000 *de minimis* amount). Margin requirements between other types of parties will be set by mutual agreement as they are now.

ECP status. Every party to a bi-lateral swap or a security-based swap must be an eligible contract participant (ECP) (*see box, Glossary*) unless the swap is executed on a DCM. The CFTC has interpreted this requirement to also apply to guarantors of swaps. Any fund that enters into swaps is considered to be a commodity pool by the CFTC and special rules govern how commodity pools qualify as ECPs.

Conduct rules and reporting. Swap dealers are subject to numerous conduct requirements with respect to their swaps with non-dealers. The International Swaps and Derivatives Association (ISDA) has drafted "protocols" that provide an efficient means for entities that engage in swap trading to exchange information, notices, representation and undertakings necessary to comply with these rules. Details of every swap must now be reported to a swap data repository (SDR), and SDRs are required to make most of that information publicly available (though without identifying the parties to any swap).

Other issues. There is still considerable uncertainty about the extraterritorial effect of the new swap regime. The CFTC has published detailed cross-border guidance concerning the application of its rules, but this guidance is currently the subject of legal proceedings.

Due to the heightened regulation, mandatory margin and continued regulatory uncertainty associated with the new swap regime, many market participants have begun to use futures, rather than swaps to satisfy their business objectives. Whether this trend will continue remains to be seen.

See table, *Derivatives products subject to clearing and regulation under the Dodd-Frank Act*.

Volcker rule

Section 619 of the Dodd-Frank Act added a new section to the US Bank Holding Company Act, section 13, which is commonly referred to as the "Volcker rule". Final regulations implementing the Volcker rule were adopted in December 2013 by the five agencies responsible for oversight of the Volcker rule (the Federal Reserve, the Office of the Comptroller of the Currency, the CFTC, the SEC and the Federal Deposit Insurance Corporation). The date for compliance with the Volcker rule is 21 July 2015.

The Volcker rule prohibits a "banking entity" (*see box, Glossary*) from:

- Engaging in proprietary trading.
- Acquiring or retaining, as principal, an ownership interest in or acting as sponsor of, a covered fund.

In each case banking entities are subject to numerous and complicated exclusions and exemptions. The prohibition against ownership of covered funds does not apply to, among other entities, wholly-owned subsidiaries, foreign public funds, loan securitisation vehicles and qualifying asset-backed commercial paper conduits.

A foreign banking organisation that has operations in the US is generally a "banking entity" for purposes of the Volcker rule, but there are exclusions for the activities of such an organisation that take place solely outside the US. As a result, a foreign banking organisation can

<table>
<tr><th colspan="5">DERIVATIVES PRODUCTS SUBJECT TO CLEARING AND REGULATION UNDER THE DODD-FRANK ACT</th></tr>
<tr><th colspan="2">Cleared derivatives</th><th colspan="3">Non-cleared derivatives***</th></tr>
<tr><th>Traditional cleared products*</th><th>Cleared swaps**</th><th>Non-cleared swaps</th><th>Not swaps but regulated in part under the Dodd-Frank Act****</th><th>Not swaps and not regulated under the Dodd-Frank Act</th></tr>
<tr><td>• Futures.
• Listed Options.</td><td>Swaps, security-based swaps, and mixed swaps subject to either:
• Mandatory clearing (except if end user opt-out applies).
• Voluntary clearing (by agreement or if voluntary opt-in applies).</td><td>Swaps, security-based swaps, and mixed swaps not subject to mandatory or voluntary clearing.</td><td>• Foreign exchange swaps.
• Foreign exchange forwards</td><td>• Non-financial and securities forwards intended to be physically settled.
• Options on securities.
• Non-contingent (and certain contingent) securities purchases and sales.
• Debt securities with embedded derivatives.
• Securities-based transactions by an issuer to raise capital.
• Any agreement, contract or transaction that would be a "swap" but is transacted with:
- the federal government;
- a Federal Reserve Bank; or
- a federal agency backed by full faith and credit of the US.
• Other derivatives (if any) falling outside the swap definitions.</td></tr>
<tr><td colspan="5">*Must be exchange-traded.
**Must be traded on a DCM or SEF if the swap has been made available to trade, otherwise by any method.
***Can be traded by any method, including on a SEF or other electronic platform.
****Products exempted from the definition of swap by a determination made by the US Secretary of the Treasury</td></tr>
</table>

sponsor, own, or engage in "covered transactions" with foreign funds (*see box, Glossary*) (*see below, Covered transactions*) that are not offered for sale in the US or sold to US residents.

Fund sponsorship. Notwithstanding the second primary prohibition in the Volcker rule (*see above*), a banking entity can still sponsor a covered fund, provided that the banking entity:

- Offers the covered fund only to current or future customers of the banking entity's trust, fiduciary, or investment advisory services.
- Does not invest in the covered fund (except for limited "seed" or *de minimis* investments (*see below, Fund ownership*)).
- Does not engage in covered transactions.
- Does not guarantee, assume, or otherwise insure obligations or performance of the covered fund.
- Does not share the same or similar name as the covered fund.
- Prohibits directors or employees of such banking entity from having an ownership interest in the covered fund (except for directors or employees who directly provide investment advisory or other services to the covered fund).
- Discloses to investors in writing that any losses in the covered fund are borne solely by such investors.

Fund ownership. Banking entities can "seed" (that is, provide capital to) newly created covered funds, but must dilute their investment to no more than 3% of the total amount or value of such covered fund's outstanding interests within one year of the establishment of the covered fund.

Banking entities are also permitted to make and keep *de minimis* investments in such covered funds, so long as the banking entity:

- Owns less than 3% of the total number or value of each covered fund's outstanding interests.
- Limits its total aggregate ownership in all covered funds to less than 3% of that banking entity's tier 1 capital.

GLOSSARY

Please note: the definitions of many terms provided in this glossary are simplified summaries of complex official determinations concerning US statutes and related rules.

Associated person. This is any person who either engages in soliciting investors for the pools or who supervises persons so engaged. All registered CPOs must have at least one individual principal who also is registered as an associated person.

Banking entity. This includes:

- Insured depository institutions.
- Companies that control insured depository institutions.
- Companies that are treated as bank holding companies for purposes of section 8 of the US International Banking Act of 1978.
- Any affiliate or subsidiary of an entity described above, but not including certain qualifying funds and such fund's subsidiaries.

Commodity pool operator (CPO). This is an individual or organisation that operates a commodity pool and solicits funds for that commodity pool. A commodity pool is an enterprise in which funds contributed by a number of persons are combined for the purpose of trading futures contracts, options on futures, retail off-exchange forex contracts or swaps, or to invest in another commodity pool.

Commodity trading advisor (CTA). This is an individual or organisation that, for compensation or profit, advises others as to the value of or the advisability of buying or selling futures contracts, options on futures, retail off-exchange forex contracts or swaps.

Covered fund. These can include:

- A commodity pool.
- An issuer that would be an investment company as defined under the 1940 Act but for section 3(c)(1) or 3(c)(7) of that Act.
- Any similar fund that may be determined, by rule, to be a covered fund by the appropriate federal banking agencies, the SEC and the CFTC.
- Any foreign equivalent of the above.

Covered transactions. These transactions typically include, among other things:

- Transacting loans with a covered fund.
- Purchasing or investing in securities issued by a covered fund.
- Purchasing certain assets from a covered fund.

Eligible contract participant (ECP). This is a person or entity (such as a floor trader merchant or commodity pool) that is, by virtue of its regulated status or amount of assets, designated by the CFTC as an eligible contract participant and thereby permitted to engage in over-the-counter swaps transactions, which are not generally available to non-eligible contract participants (that is, retail customers).

FX forward. This is a transaction involving the exchange of two different currencies on a specified future date at a fixed rate that is agreed when the contract governing the exchange is created.

FX swap. This is a transaction involving an exchange of two different currencies on a specific date at a fixed rate that is agreed when the contract governing the exchange is created (contract date), and a reverse exchange of the two currencies at a later date and at a fixed rate also agreed on the contract date.

Hedge fund. This is a private fund (including a commodity pool) that has a payable performance fee or allocation calculated on unrealised gains, can borrow or guaranty in excess of half its net asset value or may have, or guarantee gross notional exposure in excess of twice its net asset value (in each case, including committed capital), or can sell short (other than to hedge currency exposure or manage duration). For purposes of this definition, long and short positions should not be netted.

Liquidity fund. This is a private fund that seeks to generate income by investing in a portfolio of short-term obligations in order to maintain a stable net asset value per unit or minimise principal volatility for investors. Advisers to liquidity funds must aggregate money market and liquidity fund RAUM.

Major swap participant (MSP). This is a person that is not a swap dealer but that has a substantial position in swaps in any of the major swap categories, meaning that it would owe amounts upon default

Covered transactions. The Volcker rule also prohibits banking entities and their affiliates from entering into covered transactions with covered funds that the banking entity advises, manages, sponsors, or organises and offers, subject to an exemption for certain prime brokerage transactions (*see box, Glossary*). In addition, all permitted transactions (including prime brokerage transactions) between a banking entity and a covered fund must be conducted on an arm's-length basis (*section 23B, Federal Reserve Act*).

JOBS Act

Under the JOBS Act, the SEC has adopted rules to, among other things, remove the prohibition under Rule 502(c) of Regulation D under the US Securities Act of 1933, as amended (Securities Act), against general solicitation and advertising in connection with offers and sales of securities made under Rule 506 (which provides an exemption from registration under the Securities Act for private offerings), provided that all purchasers of such securities are "accredited investors".

New Rule 506(c). The new Rule 506(c) permits an issuer to engage in general solicitation and advertising provided that both:

- All purchasers of the issuer's securities are accredited investors.
- The issuer takes reasonable steps to verify that all purchasers of its securities are accredited investors.

If an issuer does not wish to take advantage of the ability to engage in general solicitation and advertising (and thereby become subject to the requirement to take reasonable steps to verify the accredited investor status of purchasers), the old Rule 506(b) will remain available.

Principles-based method of determining accredited investor status. Under the new Rule 506(c), the "reasonableness" of the verification is

GLOSSARY (Continued)

under all its swaps that exceed thresholds set by the CFTC (for example, US$3 billion in daily average aggregate uncollateralised outward exposure for rate swaps).

Non-deliverable forwards (NDFs). These are transactions similar to regular FX forwards except that, at maturity, NDFs settle with a net cash payment instead of physical delivery of the relevant currencies.

Principal. While the definition of "principal" is complex, generally, a principal is any natural person or entity that has the ability to "control" the CPO (including any owner of 10% or more of interests in the CPO).

Private equity fund. This is a private fund that is not a hedge fund, liquidity fund, real estate fund, securitised asset fund (*see below*) or venture capital fund and does not provide investors with redemption rights in the ordinary course.

Prime brokerage transaction. This is a transaction that generally includes one or more products or services provided by a banking entity to a covered fund.

Private fund. These are funds that are excluded from the definition of investment company by §3(c)(1) or §3(c)(7) of the 1940 Act. Advisers of funds that rely on other exclusions from the definition of an investment company can choose to treat those funds as private funds.

Qualified eligible person (QEP). This is a sophisticated person who participates in a commodity pool or opens a managed account. The categories of persons who qualify as QEPs are listed in CFTC Rule 4.7(a).

Regulatory asset under management (RAUM). These are gross assets in "securities portfolios" and private funds for which the adviser provides continuous and regular supervisory or management services. When calculating RAUM, the investment manager must include assets attributable to clients (whether such clients are domiciled in the US or outside of the US), proprietary assets, assets managed without compensation and uncalled capital commitments.

Retail forex. This is an off-exchange transaction in foreign currency entered into with persons who are not ECPs.

Rolling spot. This is generally a transaction that takes the form of a spot (*see below, Spot*) but functions as a futures contract. A rolling spot nominally requires delivery of the relevant currencies within two days, like a spot, but a rolling spot is indefinitely renewed every other day and no currency is actually delivered until one party closes out of the position.

Securitised asset fund. These are funds whose primary purpose is to issue asset backed securities and whose investors are primarily debt holders. These funds are not deemed "hedge funds".

Spot. This is a foreign exchange transaction settled through actual delivery of the relevant currencies within two business days, provided however, that a transaction with a longer settlement period can be considered a bona fide spot transaction, depending on the customary timeline of the relevant market.

Swap. This is a contract between two parties (the counterparties) that has a theoretical principal amount (notional amount) and an agreed set of cash flows at least one of which is defined by reference to an event, circumstance or financial measure or index.

Swap dealer (SD). This is a person that holds itself out as, or is commonly known in trade as, as dealer or market-maker in swaps and has executed a notional amount of swaps in the preceding 12 months that exceeds a *de minimis* level of activity set by the CFTC.

Swap execution facility (SEF). This is a trading system or platform in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by multiple other participants.

- The nature of the purchaser and the type of accredited investor that the purchaser claims to be.
- The amount and type of information that the issuer has about the purchaser.
- The nature of the offering (such as the manner in which the purchaser was solicited to participate in the offering).
- The terms of the offering (such as a minimum investment amount).

Non-exclusive specific methods of determining accredited investor status. In addition to the principles-based method of verification described above, the new Rule 506(c) also includes four specific non-exclusive methods of verifying accredited investor status for natural persons that, if used, are deemed to satisfy the verification requirement in Rule 506(c). These specific methods address situations where the purchaser:

- Is an accredited investor on the basis of income.
- Is an accredited investor on the basis of net worth.
- Obtains a written confirmation of its status as an accredited investor from certain regulated professionals.
- Has previously purchased securities in an issuer's Rule 506(b) offering as an accredited investor.

Form D revisions. The SEC has revised Form D to include a check box for issuers to indicate whether they will be relying on Rule 506(c) to use general solicitation or general advertising in connection with a Rule 506 offering.

Implications. These amendments have a variety of implications for both issuers and investors. When using general solicitation, issuers may be able to reach a greater number of investors, therefore increasing their access to capital and potentially reducing their cost of capital. To the extent issuers can reach investors directly, the ability to use general solicitation may also mitigate the need to use intermediaries, potentially reducing the costs of private offerings for issuers.

However, the JOBS Act also holds perils for advisers to funds. While the JOBS Act required the SEC to amend Regulation D, the JOBS Act did not address or require amendments to the other laws and regulations that apply to many funds and their advisers, including:

- The US Investment Company 1940 Act, as amended (1940 Act).

- The US Commodity Exchange Act.
- The Advisers Act.
- US state regulation of investment advisers or securities offerings.

For example, advisers offering funds that engage in both securities and commodities trading will be unable to rely on the new Rule 506(c) to engage in general solicitation, as both CFTC Rules 4.13 and 4.7 prohibit general solicitation in relation to pools relying on those exemptions.

In addition, even assuming a lack of legal issues, many advisers may choose to forego general solicitation for purely business reasons. For example, many advisers use heightened investor standards (such as "qualified client" for advisers charging performance fees under Rule 205-3 of the Advisers Act, or "qualified purchaser" for funds relying on the 3(c)(7) exception under the 1940 Act) that will limit the usefulness of the new Rule 506(c) under the JOBS Act.

Moreover, depending on the "brand" of the adviser and/or the fund, utilising general solicitation could potentially "cheapen" the adviser's and/or the fund's brand or reputation, hurting the adviser and/or the fund overall. Now that the final rules have been adopted, advisers have to think strategically about whether and under what circumstances they should utilise general solicitation.

Proposed rules and amendments. The SEC has proposed (but not yet adopted) a number of additional rules and amendments that could affect an adviser's decision whether to take advantage of the ability to engage in general solicitation and advertising under the new Rule 506(c).

In this regard, the SEC has proposed the following:

- An amendment to Regulation D that would require issuers that intend to engage in general solicitation in a Rule 506(c) offering to file an initial Form D in advance of conducting any general solicitation activities. Currently, Regulation D requires an issuer to file a Form D not later than 15 calendar days after the first sale of securities in a Regulation D offering.
- A new Rule 509 that would require all issuers to include:
  - legends in any written general solicitation materials used in a Rule 506(c) offering; and
  - additional disclosures for private funds if such materials include performance data.
- Amendments to Rule 156 under the Securities Act that would extend the guidance contained in Rule 156 to the sales literature of private funds. Rule 156 provides guidance on the types of information in investment company sales literature that could be misleading for purposes of the US federal securities laws.
- A new Rule 510T of Regulation D that would require an issuer conducting an offering in reliance on Rule 506(c) to submit to the SEC any written general solicitation materials prepared by or on behalf of the issuer and used in connection with the Rule 506(c) offering. Under the proposed rule, the written general solicitation materials must be submitted no later than the date of first use of such materials in the offering. The SEC has proposed this rule as a temporary rule that would expire two years after its effective date.

SUMMARY

Managers of US alternative investment vehicles now face a vastly more intrusive and complex legal and regulatory landscape, due to the:

- Expansive increase in compulsory registration with the SEC or CFTC.
- Enhanced regulation of swaps.
- Volcker rule.

*Thanks and acknowledgment to Wendy Cohen, Guy Dempsey, Jack Governale, Raymond Mouhadeb, Marilyn Okoshi, Fred Santo and Allison Yacker for their contribution to this article.

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- Panelist, *"Innovative Distribution Models: Which Are Working and Which Are Not," IBC Global Conferences' Fourth Annual Private Placement Life Insurance and Annuities Conference, 30 April 2013*.
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