Financial Services Reform

K&L|GATES

June 2010

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Senate Financial Reform Bill Would Dramatically Step Up Regulation of U.S. and Non-U.S. Private Fund Advisers

K&L Gates published this alert prior to July 21, 2010, the date on which President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act into law.

On Thursday, May 20, 2010, the Senate voted 59-39 to adopt the financial services bill now known as H.R. 4173, the "Restoring American Financial Stability Act of 2010" (the "Senate Bill").[1] The Senate Bill is based on the draft Chairman's Mark released by Senate Banking Committee Chairman Chris Dodd (D-CT) on March 15, 2010, as amended by a package of technical amendments. A bipartisan Congressional conference committee has now been constituted[2] to resolve the differences between the Senate Bill and the House bill, which has the same bill number, but is entitled "The Wall Street Reform and Consumer Protection Act of 2009," passed by the House on December 12, 2009 (the "House Bill"). The Democratic Congressional leadership anticipates that these differences can be resolved and a final bill presented to the President for enactment into law by early July.

This Alert provides an overview of those provisions of the Senate Bill that are likely to most directly affect investment advisers to Private Funds, wherever such advisers and funds are domiciled, and highlights those provisions that materially differ from the House Bill.[3] Please see the K&L Gates Newsstand and the K&L Gates Global Financial Market Watch Blog for additional background and detailed analysis about the reform effort.

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[1] The Senate Bill had formerly been known as S. 3217, the "Restoring American Financial Stability Act of 2010."

[2] The following members of the Senate have been named as conferees to negotiate differences with the House: Chris Dodd (D-CT), Tim Johnson (D-SD), Chuck Schumer (D-NY), Tom Harkin (D-IA), Patrick Leahy (D-VT), Jack Reed (D-RI), Blanche Lincoln (D-AR), Richard Shelby (R-AL), Mike Crapo (R-ID), Judd Gregg (R-NH), Saxby Chambliss (R-GA) and Bob Corker (R-TN). The House has not yet named its conference negotiators.

[3] Many other provisions of the Senate Bill differ materially from provisions in the House Bill that address the same issues. An example is the question whether broker-dealers should be subject to the same standard of care as investment advisers in providing personalized investment advice and recommendations to retail customers. The Senate Bill would mandate that, among other things, the Securities and Exchange Commission ("SEC") conduct a study to evaluate the "standards of care for brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers for providing personalized investment advice and recommendations about securities to retail customers . . . ." Then, within one year of the enactment of the legislation, the SEC would be required to submit a report on this study containing findings, conclusions and recommendations. The House Bill, by contrast, provides that the SEC shall promulgate rules to provide "that, with respect to a broker or dealer, when providing personalized investment advice about securities to a retail customer (and such other customers as the Commission may by rule provide), the standard of conduct for such broker or dealer with respect to such customer shall be the same as the standard of conduct applicable to an investment adviser . . . ."

I. Overview of the Senate Bill.

The Senate Bill would require investment advisers to "Private Funds" (with certain exceptions) (see Section II.A., below) to register with the Securities and Exchange Commission ("SEC") and would subject them to regulatory oversight both under the Investment Advisers Act of 1940 (the "Advisers Act") and under a new systemic risk regime administered by the SEC and a new Financial Stability Oversight Council ("FSOC"). As discussed in detail below, the Senate Bill also would:

1. rescind the "Private Adviser Exemption" set forth in the Advisers Act,[4] add new exemptions for "foreign private advisers," advisers to "private equity funds," advisers to "venture capital funds," "family offices" and advisers to "small business investment companies" (as such terms are defined or to be defined), and retain the exemption provided to an adviser that is registered as a commodity trading advisor ("CTA") under the Commodity Exchange Act of 1974 (the "CEA");
2. increase the threshold in assets under management for an investment adviser to be required to register with the SEC;
3. raise the financial threshold for natural persons to qualify as an "Accredited Investor," as defined in Regulation D under the Securities Act of 1933 (the "Securities Act"), and require subsequent reviews by the SEC of the definition and adjustments to this financial threshold;
4. require the SEC to adopt rules and regulations relating to the custody of client assets and records to be maintained and reports to be filed with the SEC;
5. create the FSOC, which would be charged with identifying and monitoring systemic risks to the financial markets, including those posed by U.S. and non-U.S. "nonbank financial companies";
6. expand the authority of the SEC to access confidential client information in certain cases and require records to be maintained and reports to be filed;
7. prohibit the SEC from "defin[ing] the term 'client' for the purposes of [the antifraud provisions of the Advisers Act] to include an investor to a private fund managed by an investment adviser, if such private fund has entered into an advisory contract with such adviser";
8. mandate that the General Accounting Office (the "GAO") and the SEC conduct certain studies and make reports thereon to Congress;
9. place severe limitations on the ability of U.S. and certain non-U.S. financial institutions regulated by the Federal Reserve to sponsor or invest in a "hedge fund" or "private equity fund";[5] and
10. provide for the regulation of derivatives and most participants in the over-the-counter derivatives market, including fund managers, and impose, among other matters, clearing, exchange-trading, and margin requirements and mandatory reporting rules; fund managers that are considered to be "major swap participants" also would be required to register as such with the SEC and/or CFTC and be subject to a number of additional requirements.

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[4] Section 203(b)(3) of the Advisers Act exempts from the registration requirements thereof:

> any investment adviser who during the course of the preceding twelve months has had fewer than fifteen clients and who neither holds himself out generally to the public as an investment adviser nor acts as an investment adviser to any investment company registered under [the Investment Company Act of 1940] or a company that has elected to be a business development company pursuant to [the Investment Company Act of 1940] and has not withdrawn its election.

[5] For these purposes, the Senate Bill defines "hedge fund" and "private equity fund" to mean a company or other entity that is exempt from registration under the Investment Company Act of 1940 pursuant to Section 3(c)(1) or Section 3(c)(7) thereof, or a similar fund, as jointly determined by the appropriate federal banking agencies.

> Please click here for an analysis of these provisions.

The Senate Bill generally follows the regulatory scheme embodied in the House Bill in that it would regulate advisers to Private Funds, rather than require the registration of or directly regulate Private Funds themselves. The most significant differences between the Senate Bill and the House Bill are highlighted in the following discussion.

II. Regulation of Advisers to Private Funds.

A. Definition of "Private Fund."

A "Private Fund" would be broadly defined as an issuer that would be an "investment company" under the Investment Company Act of 1940 (the "Company Act"), but for Section 3(c)(1) or Section 3(c)(7) thereof, without regard to whether the fund is formed in a non-U.S. jurisdiction or the percentage of its securities held by U.S. persons. This is the same definition found in the House Bill.

B. Exempt Advisers.

1. "Foreign Private Advisers." The Senate Bill would provide an exemption from the registration requirements of the Advisers Act to any "Foreign Private Adviser," defined to mean:

> any investment adviser who (A) has no place of business in the United States; (B) has in total fewer than 15 clients who are domiciled in or residents of the United States; (C) has aggregate assets under management attributable to clients in the United States and investors in the United States in private funds advised by the investment adviser of less than $25,000,000, or such higher amount as the [SEC] may, by rule, deem appropriate . . .;[6] and (D) neither (i) holds itself out generally to the public in the United States as an investment adviser; nor (ii) acts as (I) an investment adviser to any investment company registered under [the Company Act]; or (II) a company that has elected to be a business development company pursuant to [the Company Act] and has not withdrawn its election.

The Senate Bill definition of Foreign Private Adviser differs from the definition of that term in the House Bill in its computation of U.S. clients and investors in two key respects.[7] First, the Senate Bill does not provide a time frame for calculating the number of clients for purposes of the 15 client limit, as does the House Bill and the existing Private Adviser Exemption. Accordingly, it is not clear under the Senate Bill whether non-U.S. domiciled advisers would be able to rely upon the Foreign Private Adviser exemption after they have an aggregate of 15 U.S. clients over an unlimited period of time, regardless of whether such clients remain active clients. Unless addressed in the final version of the legislation, this omission will create uncertainty for non-U.S. advisers until it is resolved through interpretative relief or enforcement action. Second, the House Bill is clear that in calculating the number of its clients a Foreign Private Adviser must "look through" the Private Funds it advises to count the number of investors in the United States in such funds; the Senate Bill does not explicitly address this issue.

2. Advisers to Private Equity Funds. The Senate Bill would provide a new exemption from registration for advisers to "private equity funds," a term to be defined by the SEC within six months after the enactment of the legislation. Within the same time frame, the SEC would be required to issue final rules requiring records to be maintained

[6] This language is intended to make clear that advisers would be required to aggregate the assets of U.S.-based clients and investors in private funds they manage for purposes of the assets under management test. It is not as clear that U.S.-based clients in such private funds would not be required to be counted toward the 15 client limit.

[7] The House Bill provides that, to qualify for the exemption, a Foreign Private Adviser must:

> during the preceding 12 months [have had] in total fewer than *15 clients and investors in the United States in private funds advised by the investment adviser [and] aggregate assets under management attributable to clients and investors in the United States in private funds advised by the investment manager* of less than $ 25,000,000, or such higher amount as the [SEC] may, by rule, deem appropriate in the public interest or for the protection of investors. . . . *(emphasis added.)*

by such advisers and reports to be provided by such advisers to the SEC. The House Bill does not contain comparable provisions.

3. Advisers to Venture Capital Funds. The Senate Bill would provide an exemption from registration, as would the House Bill, for advisers to "venture capital funds," a term to be defined by the SEC within six months after the enactment of the legislation. It would not require the SEC to impose any recordkeeping and reporting obligations on venture capital funds, as would the House Bill.

4. Family Offices. The Senate Bill would provide a new exemption from the definition of "investment adviser" under the Advisers Act for a "family office," a term to be defined by the SEC. It also would require the SEC to implement this exemption in a manner consistent with regulatory relief granted in the past and to "recognize the range of organizational management and employment structures and arrangements employed by family offices." The House Bill does not contain comparable provisions.

5. Advisers to "Small Business Investment Companies." The Senate Bill would provide, as would the House Bill, an exemption from the requirement to register under the Advisers Act for advisers to small business investment companies ("SBICs") that are licensed, or are in the process of being licensed, under the Small Business Investment Act of 1958.

In addition, the House Bill includes an exemption, not found in the Senate Bill, for an adviser who advises solely private funds and has "assets under management in the United States of less than $150,000,000."

6. CTA Exemption. The Senate Bill would not rescind, as would the House Bill, the exemption from registration under the Advisers Act for an adviser that is registered as a CTA under the CEA and that does not primarily act as an investment adviser or act as an investment adviser to specified persons, *e.g.*, registered investment companies.

III. Financial Thresholds for Registration of an Adviser under the Advisers Act.

The Senate Bill would raise to $100 million the threshold in assets under management for non-exempted investment advisers to be required to register with the SEC. It also would provide an exemption from the threshold test for an adviser to any company that has elected to be a business development company pursuant to the Company Act and has not withdrawn its election. The House Bill contains a provision that would require an investment adviser that is not exempt from registration, and is regulated and examined in the state where it maintains its principal place of business, to register with such state if it has assets under management of between $25 million and $100 million.

IV. Financial Threshold for Natural Person "Accredited Investors."

The Senate Bill would direct the SEC to adjust the net worth standard for a natural person to qualify as an "accredited investor," as defined in Regulation D under the Securities Act, authorize the SEC to undertake a review of the definition to determine whether other requirements of the definition should be adjusted or modified "for the protection of investors, in the public interest, and in light of the economy," and upon completion of such review make any such adjustments. Initially, and for a four-year period from the enactment of the legislation, the net worth standard for any natural person, or joint net worth with the spouse of the person, would be $1,000,000, excluding the value of the primary residence of the person. Every four years after enactment of the legislation, the SEC would be required to review the definition and again determine if adjustments should be made, based upon the same criteria, and make any such adjustments.

In addition, not later than one year after enactment of the legislation, the SEC would be required to issue rules that would prohibit the offer and sale of securities under Regulation D to enumerated categories of "felons and other 'bad actors.'"

The House Bill does not provide for changes to the definition of "accredited investor." Also, the House Bill would establish that broker-dealers providing

personalized investment advice about securities to a retail customer are subject to the same standard of care as investment advisers.

V. Custody.

The Senate Bill would require registered advisers to take steps to safeguard client assets over which they have custody, including, without limitation, "verification of such assets by an independent public accountant, as the [SEC] may, by rule, prescribe." The House Bill would require the SEC to adopt a rule that would make it unlawful for a registered investment adviser to have custody of funds or securities that have a value of more than $10 million unless: (1) the funds and securities are maintained with a qualified custodian that does not provide investment advice with respect to such assets; and (2) the assets are held in separate accounts for each client or in accounts that contain only client assets under the name of the investment adviser as agent or trustee for the client.

VI. FSOC Supervision and Systemic Risk-Related Records and Reports.

The FSOC would be charged with identifying and monitoring systemic risks to the financial markets, including those posed by certain U.S. and non-U.S. "nonbank financial companies," a term defined in the Senate Bill broadly enough to encompass Private Funds and their advisers. Under the Senate Bill, the FSOC could require, by a two-thirds vote, that any nonbank financial company (including a non-U.S. nonbank financial company that "has substantial assets or operations in the United States") – whose material financial distress is determined to pose a threat to the financial stability of the United States[8] – register with the Federal Reserve and be placed under its supervision. The Senate Bill contemplates that the Federal Reserve would regulate systemically significant companies under stringent prudential standards based on those recommended by the FSOC or that it establishes on its own. The recommendations of the FSOC with respect to U.S. nonbank financial companies could include: (1) risk-based or contingent capital requirements; (2) leverage limits; (3) liquidity requirements; (4) concentration limits; (5) enhanced public disclosures; and (6) overall risk management requirements, although in making such recommendations, the FSOC is required to take into account differences among nonbank financial companies and bank holding companies and any other factors that the FSOC determines to be appropriate.[9] These enumerated requirements are primarily oriented toward the regulation of banks and broker-dealers, and hedge fund advisers would find it difficult to operate within such a framework, unless it is tailored to their particular circumstances.

The Senate Bill would require the SEC to issue rules requiring each adviser to a Private Fund to maintain records and file reports containing such information that the SEC deems necessary and appropriate in the public interest and for the protection of investors or for the assessment of systemic risk by the FSOC. The Senate Bill also would require the SEC to provide or make available to the FSOC any such reports or records or the information contained therein, and it includes provisions regarding the obligations of the SEC, the FSOC and any department, agency or self-regulatory organization that receives reports or information from the SEC to maintain the confidentiality of these reports, records and information. The provisions of the House Bill that address confidentiality are not as robust.

At the same time, the Senate Bill does not include a controversial provision set forth in the House Bill that would require registered investment advisers to provide reports, records and other documents to "investors, prospective investors, counterparties, and creditors" as the SEC may prescribe as "necessary or appropriate in the public interest and for the protection of investors or for the assessment of systemic risk."

Both the Senate Bill and the House Bill would require that records and reports include, for each

[8] The Senate Bill would require the Federal Reserve to promulgate regulations on behalf of, and in consultation with, the FSOC that set forth the criteria "for exempting certain types or classes of U.S. nonbank financial companies or [non-U.S.] nonbank financial companies" from supervision by the Federal Reserve.

[9] In making recommendations concerning the prudential standards applicable to such non-U.S. nonbank financial companies, the FSOC would be required to "give due regard to the principle of national treatment and competitive equity."

Private Fund advised by the adviser: (1) the amount of assets under management; (2) counterparty credit risk exposure; (3) trading and investment positions; (4) trading practices; and (5) such other information that the SEC, in consultation with the FSOC, determines is necessary and appropriate in the public interest and for the protection of investors or for the assessment of systemic risk. However, unlike the House Bill, the Senate Bill also would require such records or reports to include: (1) valuation policies and practices of the fund; (2) types of assets held; and (3) side arrangements or side letters whereby certain investors in a fund obtain more favorable rights or entitlements than other investors. The House Bill, unlike the Senate Bill, would require information to be maintained and filed relating to "off-balance sheet leverage."

VII. Client Confidentiality.

The Senate Bill would amend the client confidentiality protections set forth in Section 210(c) of the Advisers Act to add an exception to allow the SEC to require an adviser to disclose the identity, investments or affairs of any client "for purposes of assessing potential systemic risk." The House Bill would rescind Section 210(c) in its entirety.

VIII. Fund Investors as "Clients."

The Senate Bill would prohibit the SEC from "defin[ing] the term 'client' for the purposes of [the antifraud provisions of the Advisers Act] to include an investor to a private fund managed by an investment adviser, if such private fund has entered into an advisory contract with such adviser." The provision would make clear that fund managers owe fiduciary duties to the fund itself and not to fund investors. The House Bill contains a comparable provision.

IX. Studies and Reports to Congress.

The Senate Bill would direct the GAO to conduct studies and submit reports to specified House and Senate Committees on two subjects and the SEC to do so for a third subject:

A. Notwithstanding that the SEC would be required periodically to review the definition of "accredited investor" and make any necessary adjustments,[10] the GAO would be required to study the appropriate criteria for determining the financial thresholds or other criteria needed to qualify as an "accredited investor" and eligibility to invest in any Private Fund and issue a report within one year of the enactment of the legislation;

B. The GAO would be required to study the feasibility of forming a self-regulatory organization to oversee "private funds" and issue a report within one year of the enactment of the legislation; and

C. The SEC would be required to study the state of short selling in the stock market, with particular attention to the impact of recent rule changes and the incidence of the failure to deliver shares sold short, *i.e.*, "naked" short selling, and report within two years of the enactment of the legislation. The House Bill, by contrast, would impose reporting obligations on institutional investment managers to provide daily reports of their short sales of equity securities to the SEC on a confidential basis. At least monthly, the SEC would make certain information regarding the short sales available to the public.

Regarding studies and reports, the House Bill would require only that the GAO: (1) conduct a study to assess the annual costs on industry members and their investors due to the registration requirements and ongoing reporting requirements resulting from the legislation; and (2) submit a report to Congress within two years of the enactment of the legislation setting forth its findings and recommendations.

X. Sponsoring or Investing in Hedge Funds or Private Equity Funds.

The Senate Bill also would enact a version of the "Volcker Rule," which would require the federal banking regulators to adopt rules that would: (1) prohibit any insured depository institution, a company that controls an insured depository institution or is treated as a bank holding company,[11] and any subsidiary of such institution

[10] *See* Section IV, above.

[11] Under the Senate Bill, a non-U.S. bank or company that is treated as a bank holding company for purposes of the Bank Holding Company Act of 1956, pursuant to Section 8(a) of the

or company (collectively, "Covered Institutions") from sponsoring or investing in a “hedge fund” or “private equity fund”;[12] and (2) place strict limitations on relationships and transactions between Covered Institutions and hedge funds and private equity funds by subjecting them to existing rules regulating affiliated transactions under Sections 23A and 23B of the Federal Reserve Act. The Senate Bill also would require the Federal Reserve to adopt rules imposing additional capital requirements and additional quantitative limits (*e.g.*, on leverage and liquidity) for nonbank financial companies[13] that would be supervised by the Federal Reserve (*i.e.*, companies designated as systemically significant by the FSOC) and that sponsor and invest in hedge funds and private equity funds. The House Bill does not contain comparable provisions.

Within six months of the enactment of the legislation, the FSOC would be required to complete a study of the impact of the “Volcker Rule” provisions. Within nine months of the completion of such study, the appropriate federal banking agencies and the Federal Reserve would be required to issue final regulations reflecting their recommendations. These final regulations would be required to provide that, effective two years after the date of their issuance, no Covered Institution may “retain any investment or relationship prohibited under such regulations,” subject to possible extensions upon application. Unless a Covered Institution is exempted by such regulations, it would be required to divest or shut down its hedge fund and private equity fund activities.

XI. Analysis of Selected Issues.

A detailed analysis of the following issues raised by the Senate Bill and the House Bill is set forth in the K&L Gates Alert, dated March 23, 2010: (i) the definition of a “hedge fund” for purposes of the proposed legislation; (ii) the treatment of non-U.S. domiciled advisers and Private Funds; (iii) the expanded jurisdiction of state regulation of advisers; and (iv) the impact of the proposed legislation on the structure of the Private Fund industry.

International Banking Act of 1978, is treated as a bank holding company.

[12] *See* note 5, above. These prohibitions would not apply to the activities or investments conducted by a Covered Institution pursuant to Sections 4(c)(9) or 4(c)(13) of the Bank Holding Company Act of 1956 solely outside of the United States if the Covered Institution is not directly or indirectly controlled by a company that is organized under the laws of the United States or of a state.

[13] Under the Senate Bill, the authority of the Federal Reserve with respect to a non-U.S. nonbank financial company includes only the U.S. activities and subsidiaries thereof.

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