WILLKIE FARR & GALLAGHER LLP

CLIENT MEMORANDUM

IMPLICATIONS OF SENATOR DODD'S FINANCIAL REFORM PROPOSAL FOR PRIVATE FUND MANAGERS AND OTHER MONEY MANAGERS

Yesterday afternoon, the Senate Committee on Banking, Housing, and Urban Affairs approved on a party-line vote financial services reform legislation proposed last week by Committee Chairman Senator Christopher Dodd (D-CT) ("Dodd Proposal" or "Proposal").[1] The Proposal is ready for consideration by the full Senate, which could take it up as early as mid-April.

The Dodd Proposal is a comprehensive financial services reform initiative that, among other things, would significantly increase regulation of investment advisers, principally hedge fund managers, currently not registered with the Securities and Exchange Commission under the Investment Advisers Act of 1940 in reliance on the so-called "private adviser exemption" under that Act ("Private Managers"). The Private Managers provisions included in the Dodd Proposal are similar, though not identical, to those in a financial services reform bill passed by the U.S. House of Representatives in late 2009 (the "House Bill"). Both the Dodd Proposal and the House Bill would eliminate the private adviser exemption from registration—Section 203(b)(3) of the Advisers Act—and would provide new, but more narrow, exemptions from registration as an investment adviser under the Advisers Act, including an exemption for an investment adviser to one or more venture capital funds. Unlike the House Bill, the Dodd Proposal also would provide an exemption from Advisers Act registration for an investment adviser to one or more private equity funds. Both the Dodd Proposal and the House Bill would impose new recordkeeping and reporting requirements on all managers of "private funds," which are defined as those exempt from regulation under the Investment Company Act of 1940 by virtue of Section 3(c)(1) or 3(c)(7) of the 1940 Act. Defined in this manner, the term would include hedge funds, venture capital funds, and private equity funds.

The Dodd Proposal contains, in addition to adviser registration provisions, important and controversial new regulations relating to systemic risk, including the creation of a "Financial Stability Oversight Council," which would, among other things, designate financial institutions as systemically important and give the Federal Reserve Board of Governors new powers to regulate those institutions. The Dodd Proposal also would provide the Federal Deposit Insurance Corporation with broad new authority to liquidate a failing, systemically important financial institution, resembling the FDIC's existing authority with respect to banks. The Dodd Proposal includes a version of what has come to be known as the "Volcker Rule," which generally would prohibit a bank, a bank holding company, and any of their subsidiaries from engaging in proprietary trading or from investing in or sponsoring hedge funds and private equity funds and would ban a nonbank financial company supervised by the Federal Reserve from engaging in certain transactions with a hedge fund or private equity fund for which the company acts directly

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[1] The staff of the Senate Banking Committee published a summary of the proposal, which is available at: http://banking.senate.gov/public/_files/FinancialReformSummary231510FINAL.pdf. The text of the full bill as proposed by Senator Dodd is available at: http://banking.senate.gov/public/_files/ChairmansMark31510AYO10306_xmlFinancialReformLegislationBill.pdf.

or indirectly as investment adviser. The Dodd Proposal's systemic risk provisions differ significantly from both the House Bill and those appearing in the earlier version of a financial reform package published by Senator Dodd last year.[2]

The reach of the Dodd Proposal extends far beyond investment advisers and banking institutions. The Dodd Proposal would give states increased authority over private placement offerings and would provide the SEC with enhanced general rulemaking and enforcement authority. In addition, the Dodd Proposal would supplement or provide new authority to federal regulators in a host of other areas including: the over-the-counter derivatives markets; insurance; systemically important payment, clearing, and settlement activities of financial institutions; and consumer financial products and services. Unlike Senator Dodd's earlier draft legislation, the Dodd Proposal would not subject broker-dealers to an express fiduciary duty, but would instead require the SEC to conduct a study of the regulation of broker-dealers and investment advisers.

A detailed discussion of all of the areas of financial services regulation that would be affected by the Dodd Proposal is well beyond the scope of this Memorandum. Our attorneys, though, stand prepared to discuss those provisions with you if you so desire. The remainder of this Memorandum is a more detailed discussion of the Dodd Proposal provisions relating to the regulation of Private Managers and certain other provisions of interest to money managers.

Private Manager Registration and Recordkeeping and Reporting Requirements under the Advisers Act

The Dodd Proposal, as noted above, would largely eliminate Section 203(b)(3) of the Advisers Act, the "private adviser exemption" from registration under that Act. That provision exempts a natural person or entity meeting the Advisers Act's definition of "investment adviser" from registration under the Act if, among other things, the person or entity advised 14 or fewer clients during the preceding 12-month period.[3] The Dodd Proposal narrows another existing exemption from registration under the Advisers Act by restricting the ability of a person or entity that manages a private fund (as defined above) to rely on the Act's "intrastate exemption." Under that exemption, a person or entity is not subject to registration under the Advisers Act if the person or entity does not provide advice regarding securities listed on a national exchange and has clients all of which are residents of the same state in which the adviser has its principal office and place of business.[4]

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[2] Senator Dodd published a "discussion draft" financial services reform bill in November 2009. According to media reports, the proposal published this month is intended to supersede the previous proposal.

[3] Advisers Act Section 203(b)(3). Section 203(b)(3) is not the exclusive means for a money manager to avoid registration as an investment adviser with the SEC. Non-U.S. private fund managers are required to count only U.S. clients toward the 14-client limitation.

[4] Advisers Act Section 203(b)(1).

Unlike the House Bill, the Dodd Proposal would retain the "CTA exemption" from registration. That exemption would be available to, among others, a commodity trading advisor registered with the Commodity Futures Trading Commission whose business does not consist primarily of acting as an investment adviser (as that term is defined in the Advisers Act) and who does not advise an investment company registered with the SEC under the 1940 Act.[5]

New Exemptions from Registration under the Advisers Act

The Dodd Proposal provides four new, generally narrow, exemptions from registration with the SEC under the Advisers Act. They are exemptions for:

- an investment adviser to one or more venture capital funds;
- an investment adviser to one or more private equity funds;
- an investment adviser to one or more small business investment companies; and
- a "foreign private adviser."

A person or entity relying on any of these exemptions from registration with the SEC as an investment adviser would appear under the text of the Dodd Proposal to remain subject to the provisions of the Advisers Act applicable to unregistered investment advisers, such as the Act's general antifraud provisions, Sections 206(1) and (2), and Rule 206(4)-8 under the Act, as well as certain other provisions such as the limitation on principal trades under Section 206(3) of the Advisers Act.

Adviser to a Venture Capital Fund and/or a Private Equity Fund. The Dodd Proposal would exempt from registration under the Advisers Act any investment adviser "with respect to the provision of investment advice relating to a venture capital fund" or "with respect to the provision of investment advice relating to a private equity fund or funds." The Proposal directs the SEC to define the terms "venture capital fund" and "private equity fund" for purposes of the exemptions. The SEC would have six months after the enactment of the Dodd Proposal to issue final rules defining these terms. The SEC has authority, under the Proposal, to prescribe records and annual reports that an adviser relying on the private equity fund adviser exemption would need to maintain and file with the SEC. The text of the Dodd Proposal's venture capital and private equity adviser exemptions appears to be intended to provide an exemption from registration for an investment adviser that manages one or more venture capital and/or private equity funds; that is, the exemptions would seem to be able to be relied on concurrently.

Adviser to Small Business Investment Companies. Under the Dodd Proposal, an investment adviser to a "small business investment company" licensed under the Small Business Investment Act of 1958 could rely on a new statutory exemption from registration as an investment adviser under the Advisers Act. The exemption would be available to an investment adviser whose

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[5] Advisers Act Section 203(b)(6).

business is limited to managing one or more SBICs. An SBIC for purposes of the Dodd Proposal includes: a small business investment company that is a licensee under the SBIA; an entity that has received from the Small Business Administration notice to proceed to qualify for a license as a small business investment company under the SBIA, which notice or license has not been revoked; or an entity with a pending application for a license under the SBIA that is affiliated with one or more licensed small business investment companies.

Foreign Private Advisers. An investment adviser that meets the definition of a "foreign private adviser" under the Dodd Proposal would not need to register as an investment adviser under the Advisers Act. The Proposal defines such an adviser as one that:

- has no place of business in the United States; and
- during the preceding 12 months has had fewer than 15 clients in the United States and has had 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 million (subject to increase by the SEC); and
- does not hold itself out generally to the public in the United States as an investment adviser or act as an investment adviser to a 1940 Act-registered investment company.

The foreign private adviser exemption from registration would require an investment adviser to count all types of clients for purposes of the exemption's client-count test and include towards its assets under management those attributable both to U.S. clients and U.S. investors in private funds managed by the adviser for purposes of the exemption's assets-under-management test. To determine its eligibility for a similar exemption in the House Bill, a non-U.S. investment adviser would need to have, in total, fewer than 15 U.S. clients and U.S. investors in private funds managed by the adviser and, like under the Dodd Proposal, would need to count assets under management attributable to both U.S. clients and investors in private funds it manages for the assets-under-management test.

Additional House Bill "De Minimis" Exemption. The House Bill provided for an exemption from registration with the SEC under the Advisers Act not included in the Dodd Proposal available to an investment adviser that manages one or more private funds and that has assets under management in the United States of less than $150 million. The House Bill exemption appears to be unavailable, however, for an investment adviser that provides advice to any client that is not a private fund, even if the adviser has less than $150 million of assets under management.

Additional Recordkeeping and Reporting Requirements for Registered Investment Advisers to Private Funds

The Dodd Proposal imposes new reporting and recordkeeping requirements on registered investment advisers to private funds. Such an adviser would need to maintain and make available for SEC inspection records and reports for each private fund it manages. These records and reports would contain for each fund a description of:

- side arrangements or side letters;
- trading and investment positions;
- amount of assets under management and use of leverage;
- counterparty credit risk exposures;
- trading practices;
- valuation policies and practices;
- the types of assets held; and
- other information as deemed appropriate by the SEC in consultation with the Federal Reserve.

The SEC would be expressly authorized to require a registered investment adviser to file with the SEC reports regarding a private fund it advises "as are necessary or appropriate in the public interest and for the protection of investors, or for the assessment of systemic risk." In addition, *all* records of a private fund, not just those required to be maintained, would be subject to SEC examination authority.

Increased Threshold for SEC Registration

The Dodd Proposal would increase the threshold for registration as an investment adviser with the SEC under Section 203A of the Advisers Act from $25 million to $100 million of assets under management. The House Bill contains no similar provision but instead includes the *de minimis* exemption described above. The effect of the increased threshold contemplated by the Dodd Proposal would be to dramatically reduce (by an estimated 40 percent or about 4,100) the number of investment advisers currently registered with the SEC under the Advisers Act.

Family Offices

The Dodd Proposal would authorize the SEC by "rule, regulation, or order" to exempt a "family office" from the definition of investment adviser under the Advisers Act. The Proposal requires that any such rule, regulation, or order be consistent with the SEC's previous exemptive policy with respect to family offices and the Advisers Act. The SEC has in the past provided exemptive

orders to family offices—albeit at an oftentimes glacial pace—taking the position that under certain circumstances, a family office does not fall within the definition of investment adviser under Section 202(a)(11) of the Advisers Act. The text of the Dodd Proposal would not expressly exempt all family offices from the Advisers Act and does not direct the SEC to issue any such exemptions, so it is unclear whether the provision will lead to the SEC's providing additional Advisers Act exemptive relief generally to family offices. The SEC could instead continue its current practice of exempting family offices on a case-by-case basis.

Study on a Self-Regulatory Organization for Private Funds and on Short Selling

The Dodd Proposal requires the U.S. Government Accountability Office to conduct a study on the feasibility of forming a self-regulatory organization that would oversee private funds. This study would need to be completed within one year of enactment of the Dodd Proposal. A second GAO study mandated by the Dodd Proposal would address the state of short selling on national securities exchanges and over-the-counter markets. The study would evaluate the effect of recently issued SEC rules on short sales and the incidence of certain short selling practices in the market. The GAO would be required to complete this study within two years of the enactment of the Dodd Proposal.

Systemic Risk and Investor Protection Provisions

The Dodd Proposal contains a number of provisions designed to answer systemic risk concerns posed by financial institutions and to provide for more orderly dissolution of systemically important financial institutions that are failing. The Proposal, as noted above, would also implement the "Volcker Rule." Senator Dodd has indicated that the intent of the systemic risk provisions in the Proposal is to prevent financial institutions from forming or existing that are "too big to fail."

General Approach

The Dodd Proposal contemplates the formation of a "Financial Stability Oversight Council" that would designate financial institutions as systemically important. Under the Proposal, the Federal Reserve would be given general systemic risk oversight responsibilities with respect to bank holding companies that have $50 billion or more in assets and nonbank financial companies designated by the Council as systemically important. A "nonbank financial company" as defined in the Dodd Proposal could include an investment adviser or a mutual fund, hedge fund, private equity fund, or other investment fund.

The Council would have responsibility for determining that a nonbank financial company should be supervised by the Federal Reserve on the basis of criteria generally designed to assess whether the material financial distress of the company "would pose a threat to the financial stability of the United States." The determination would be subject to annual review by the Council and appeal to the Council and additional judicial review at the behest of a designated company. Bank holding companies with $50 billion or more in assets and nonbank financial companies supervised by the Federal Reserve would be subject to a number of requirements and

regulations, including: registration with the Federal Reserve; capital, liquidity and other prudential requirements; reporting requirements; governance requirements; and prohibitions on certain investments in other financial institutions.

Federal Deposit Insurance Corporation Liquidation Authority

The Dodd Proposal would provide the FDIC and the Federal Reserve with the authority to determine that a systemically important financial company is failing and should be placed into liquidation. That determination would be based on criteria relating to the financial health of and systemic risk posed by the company. An SEC vote also would be required for a broker-dealer registered with the SEC to be placed into involuntary liquidation. Nonbank financial companies supervised by the Federal Reserve and bank holding companies with assets of $50 billion or more would need to pay into a "Liquidity Fund" for purposes of supporting failing financial companies that enter this liquidation process.

"Volcker Rule" Reforms

The Dodd Proposal would require federal banking regulators to issue rules to prohibit a bank, a bank holding company, and their subsidiaries from engaging in proprietary trading and from sponsoring or investing in hedge funds and private equity funds. An asset management firm that is a subsidiary of a bank or bank holding company would be subject to the same prohibitions. The Volcker Rule provisions would be subject to a two-year implementation period, which could be extented of up to three additional years at the discretion of federal banking regulators.

The Dodd Proposal defines the term "proprietary trading" to include "purchasing or selling, or otherwise acquiring and disposing of" financial instruments by a bank, bank holding company, or any of their subisidiairies for "the trading book of [the company or subsidiary]." Certain types of trading, including trading for a customer or trading in U.S. government securities, are exempted from the proprietary trading prohibition. The term "sponsoring" is defined in a broad manner with respect to sponsoring a hedge fund or private equity fund to include: serving as a general partner, managing member, or trustee of a fund; selecting or controlling a majority of the fund's directors, trustees, or management; or sharing the same name or variation of the same name as the fund. The terms "hedge fund" and "private equity fund" are each defined for purposes of the prohibition as an entity that is exempt from the definition of investment company under the Investment Company Act of 1940 in reliance on Section 3(c)(1) or 3(c)(7) of that Act. The Volcker Rule provisions, unlike the Dodd Propoal's definition of "private fund," would permit federal banking regulators to include other entities in the definition of hedge fund and private equity fund as they deem appropriate.

These Volcker Rule provisions include a prohibition against a nonbank financial company supervised by the Federal Reserve from engaging in certain transactions with a hedge fund or private equity fund for which the company serves directly or indirectly as investment adviser. The provisions also enable the Federal Reserve to place capital requirements and quantitiative limits on a nonbank financial company supervised by the Federal Reserve.

State Authority over and SEC Review of Private Placement Offerings

The Dodd Proposal would significantly scale back federal preemption of state regulation of private placement securities offerings exempt from registration under the Securities Act of 1933 in reliance on Rule 506 of Regulation D under the 1933 Act. Private placement securities offerings made under Rule 506 of Regulation D have since 1996 been subject to almost full federal preemption of state regulation, with the result that issuers engaging in such offerings have not needed to comply with a patchwork of substantive regulations imposed by the states in which the offerings are made.

The SEC, under the Dodd Proposal, would have the authority to designate by rule, on the basis of the offering size, the number of states in which the securities were to be offered, and the nature of the persons to whom the securities are to be offered, a class of securities as not being "covered securities" for purposes of Regulation D. The Proposal directs the SEC to conduct a study within one year of the enactment of the Proposal to determine whether to designate a class of securities as not covered. Covered securities would not be subject to regulation by state securities regulators in those states in which securities are offered. Non-covered securities, on the other hand, would be subject to such regulation.

The SEC would be required under the Dodd Proposal to review filings for offerings of covered securities made in reliance on Regulation D. A particular offering of covered securities could lose that status if the SEC failed to review the filing within 120 days, subject to two exceptions: an offering would not lose its covered status if the SEC determined that a good faith and reasonable attempt had been made by the security's issuer to comply with all applicable terms and conditions of the SEC filing; and the SEC determined that any failure to comply with the terms and conditions of the filing was insignificant to the offering as a whole. The SEC would have 120 days after a filing was made to make such a determination—the same time period allotted under the provisions for the SEC to review a filing.

Additional SEC Rulemaking and Enforcement Authority

The Dodd Proposal gives the SEC authority to define terms used in the Advisers Act, but prohibits the SEC from defining the term "client" for purposes of Sections 206(1) and (2) of the Advisers Act to mean an investor in a private fund managed by an investment adviser. Under this authority, it would appear that the SEC could define the term "client" to mean an investor in a private fund for other purposes under the Advisers Act, such as for purposes of the limitations on principal trading under Section 206(3) of the Act.

The SEC, under the Dodd Proposal, would be required by rule to adjust for inflation the "accredited investor" provisions of Regulation D under the 1933 Act. The Proposal directs the GAO to conduct a study on criteria for determining financial thresholds that should be applied to

investors in private funds. The House Bill would require the SEC to adjust for inflation the "qualified client" standard in Rule 205-3 under the Advisers Act.[6]

The Dodd Proposal expands the SEC's enforcement authority by giving it the authority, upon a determination that a person violated a federal securities law, to bar that person from associating with all other persons or entities registered under the securities laws. Under existing law, the SEC's authority to impose a so-called collateral bar is narrower. The SEC today, for example, could not bar a person from associating with a broker-dealer if the person's conduct resulting in an SEC enforcement proceeding did not occur while that person was associated with or seeking association with a broker-dealer.

Other Provisions of Interest

The Dodd Proposal's financial reform initiatives include the following additional provisions of general interest to asset management industry participants:

- The Proposal would require certain swaps to be traded and cleared through a central clearing house and generally would increase the regulatory authority of the SEC and the CFTC over the derivatives markets. The Proposal would also impose margin and capital requirements for swap dealers and entities that fall within the definition of "major swap participant."

- The Proposal would give the Federal Reserve authority over systemically important payment, clearing, and settlement activities of financial institutions. Once designated as systemically important, these activities would be subject to extensive supervision by the Federal Reserve.

- The Proposal would establish a Consumer Financial Protection Bureau in the Federal Reserve System, which would regulate the offering and provision of consumer financial products or services. Entities and natural persons registered with the SEC, including investment advisers and investment companies, and those registered with the CFTC, including commodity pool operators and commodity trading advisors, would not be subject to the CFPB's jurisdiction. The activities of Private Managers would appear generally not to fall within the scope of the CFPB's authority, so long as Private Managers do not provide services or products to retail customers.

- The Proposal, as mentioned above, would require the SEC to conduct studies on the effectiveness of existing legal and regulatory standards of care for broker-dealers for providing personalized investment advice and recommendations about securities to retail customers and to assess whether legal or regulatory gaps exist with respect to the standards that should be addressed by rule or statute.

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[6] Rule 205-3 under the Advisers Act provides an exception from the general prohibition in Section 205(a) of the Advisers Act against an investment adviser registered with the SEC under the Act from charging a performance-based fee to its clients. The Rule permits an investment adviser to charge a performance-based fee to a person or entity that meets the definition of "qualified client" as defined by the Rule.

- The Proposal would create an Office of National Insurance within the Treasury Department that would exercise limited authority over the insurance industry, including the ability to recommend to the Financial Stability Oversight Council insurers that are systemically important. The ONI's authority would be narrow, but would represent a major change in the oversight of the insurance industry in the United States, which has historically been left to the states.

- The Proposal mandates studies of: point-of-sale disclosures for retail investors; mutual fund advertising; financial literacy among retail investors; improving access to information about investment advisers and broker-dealers registered with the SEC; and the regulation of financial planners.

The full Senate could begin its consideration of the Dodd Proposal as early as mid-April. In the meantime, Senators from both political parties have indicated that they will continue to negotiate towards compromises for certain of the more controversial portions of the Proposal. The various provisions of the Dodd Proposal also may be modified not only when the full Senate considers the Proposal, but during the process by which the Proposal, if passed by the full Senate, is reconciled with the House Bill. We will continue to monitor and report on such developments as well as on any other regulatory and legislative initiatives relating to financial reform that are considered by the U.S. Congress and financial regulatory agencies in the future.

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If you have any questions concerning the matters described in this Memorandum, please contact Barry P. Barbash (202-303-1201, bbarbash@willkie.com); Russell L. Smith (202-303-1116; rsmith@willkie.com); David W. Blass (202-303-1114, dblass@willkie.com); Jai Massari (202-303-1133, jmassari@willkie.com); or the Willkie attorney with whom you regularly work.

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