Potential Effects on Funds and Investment Advisers of The Wall Street Reform and Consumer Protection Act of 2009

On December 11, 2009, the House of Representatives approved *The Wall Street Reform and Consumer Protection Act of 2009*. The bill proposes to restructure the U.S. financial regulatory system by providing for more extensive regulation of banks and other large financial institutions, over-the-counter derivative markets, consumer financial products and services, certain investment advisers, short sales, credit rating agencies, and mortgage lending. Although the bill, for the most part, is not intended to restructure the regulatory scheme applicable to investment companies and investment advisers, a number of its provisions, if they become law, would have a significant effect on investment companies, private investment funds such as hedge funds, and registered and unregistered investment advisers. A summary of those provisions of the House bill of greatest significance to funds and investment advisers appears below:

Provisions Intended to Maintain Financial Stability

In large part, the House bill aims to regulate financial companies, which are broadly defined as companies engaged in "financial activities." Although not explicitly defined as such, financial companies could include investment companies, business development companies (BDCs), hedge funds, and investment advisers. Certain pooled investment vehicles, including hedge funds and registered investment companies, could qualify as financial companies because of their investment types (*e.g.*, money market funds), strategies (*e.g.*, use of leverage, short sales, or acting as a significant swap counterparty), or asset size[1]. Investment advisers could qualify because of their relationships and connections with other financial companies or because they are a part of a larger financial institution. The Financial Stability Improvement Act of 2009, included in the House bill, would create a Financial Services Oversight Council (the "Council"), which would identify financial companies that the Council believes may pose a threat to the economy based upon factors such as the extent and nature of the company's financial assets, liabilities, leverage, off-balance sheet exposures and transactions, and relationships with other financial companies; the nature, scope, and mix of the company's activities; the extent to which financial assets are simply managed and not owned by the financial company and the extent to which ownership of assets under management is diffused; and any other factors that the Council deems appropriate.

If the Council were to determine that a financial company could pose a threat to the economy, the bill would allow the Federal Reserve Board (the "Board") to impose "stricter prudential standards" on the institution[2]. Stricter prudential standards could include risk-based capital requirements and leverage limits, liquidity requirements, concentration and credit exposure requirements (*e.g.*, credit exposure to an unaffiliated company may not exceed 25% of capital stock and surplus of the financial company), short-term debt limits, prompt corrective action requirements, resolution plan requirements[3], and overall risk management requirements. Stricter prudential standards, if imposed on an investment company directly or

[1] The Investment Company Institute has sent a letter to House leaders objecting to certain of the bill's provisions that would have the potential to affect investment companies.

[2] The Council could also subject financial activities and practices of a financial company to stricter prudential standards by requiring other regulatory agencies overseeing such companies to enforce such standards.

[3] These would include reports regarding the financial company's "plan for rapid and orderly resolution in the event of severe financial distress" and its credit exposure to significant financial companies and financial companies subject to the stricter prudential standards.

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indirectly (through the imposition of these standards on the investment company's adviser or other service providers), have the potential to change the way it is managed. Similarly, if an investment adviser becomes subject to such stricter standards, directly or indirectly, its management of investment companies and other funds and accounts, including non-U.S. funds and accounts, may be impacted.

The Dissolution Authority for Large, Interconnected Financial Companies Act of 2009 (the "Dissolution Act"), included in the House bill, would create a systemic dissolution fund to facilitate the dissolution of failed financial companies[4]. Financial companies with at least $50 billion in assets and hedge fund managers with at least $10 billion in assets under management, on a consolidated basis, would have to contribute to the systemic dissolution fund based on the Federal Deposit Insurance Corporation's (FDIC) risk-based assessment of the applicable entity. The Dissolution Act does not specify how the asset threshold would apply to investment managers that do not manage hedge funds, or that manage both hedge fund and non-hedge fund accounts.

Registration and Reporting Requirements Under the Advisers Act

The Private Fund Investment Advisers Registration Act of 2009 (the "Advisers Registration Act"), included in the House bill, would substantially alter the registration and reporting schemes under the Investment Advisers Act of 1940 (the "Advisers Act").

Registration

The Advisers Registration Act would narrow the registration exemptions available under the Advisers Act in three significant ways. First, the Advisers Registration Act would eliminate the exemption from registration for advisers that have fewer than 15 clients and do not hold themselves out to the public as investment advisers. Second, the Advisers Registration Act would eliminate the exemption used by private fund advisers whose clients all reside in one state. Third, the Advisers Registration Act would eliminate the exemption used by certain private fund advisers who are registered with the Commodity Futures Trading Commission (CFTC). In place of these exemptions, the Advisers Registration Act would add four new exemptions. First, any adviser that (i) has no place of business in the U.S., (ii) does not generally hold itself out as an investment adviser to the public in the U.S., (iii) has fewer than 15 clients in the U.S., and (iv) has less than $25 million in assets under management attributable to U.S. clients would be exempted from both registration and the new reporting requirements described below.

The Advisers Registration Act does not provide guidance on how to determine the domicile of an adviser or its clients. Second, the Advisers Registration Act would exempt advisers to "venture capital funds" from registration under the Advisers Act. Such advisers would also be exempt from the reporting requirements described below, but the Securities and Exchange Commission (SEC) would be required to both define "venture capital funds" and to formulate a separate reporting regime for advisers to such funds. Third, advisers with total assets under management of less than $150 million who act solely as advisers to private funds would be exempt from registration under the Advisers Act and the reporting requirements described below. However, the SEC would be required to formulate a separate reporting regime for advisers to such funds. Fourth, advisers licensed under the Small Business Investment Act of 1958 would be exempt from registration as well as from the new reporting requirements.

Reporting and Disclosure

The new reporting scheme would give the SEC the power to require periodic reporting by advisers registered under the Advisers Act in an attempt to give regulators better tools to monitor systemic risk. Reports required to be filed by advisers would include the amount of assets under management, the use of leverage (including off-balance sheet leverage), counterparty credit risk exposures, trading and investment positions, and trading practices. The information provided to the SEC would be exempt from various federal and state freedom of information acts.

[4] For purposes of the Dissolution Act, a financial company is more narrowly defined to be one that predominantly engages in financial activities.

However, the SEC would be obligated to provide such information to the Board, Congress, any Federal department, and any self-regulatory organization. In conjunction with the new reporting requirements, the Advisers Registration Act would give the SEC the power to require registered advisers to provide certain reports, records, and other documents to investors, prospective investors, counterparties, and creditors.

Regulation of Over-the-Counter Derivatives Markets

The Derivative Markets Transparency and Accountability Act of 2009 (the "Derivatives Act"), included in the House bill, closely tracks a proposal released by the U.S. Treasury in August 2009. (The U.S. Treasury proposal was the subject of an earlier Ropes & Gray Client Alert.) In general, the Derivatives Act aims to increase transparency in the over-the-counter derivatives market by (i) requiring clearing and exchange trading of certain derivatives, and requiring reporting of other derivatives to the regulators and (ii) by requiring swap dealers and major users of derivatives to register with the CFTC and/or the SEC.

Major Swap Participants

Broadly, the Derivatives Act would require non-bank "major swap participants" to register with the CFTC and non-bank "major security-based swap participants" to register with the SEC, treating buy-side participants in many ways like dealers. For example, the Derivatives Act would impose on registered dealers and buy-side participants alike mandatory minimum capital and margin requirements, business conduct standards, and recordkeeping and reporting requirements, among other rules to be set by the relevant federal regulator.

A "major swap participant" and a "major security-based swap participant" are defined as a person who is not a dealer and who either (i) maintains a substantial net position in outstanding swaps (or security-based swaps), excluding positions held primarily for hedging, reducing, or otherwise mitigating commercial risk or (ii) whose outstanding swaps (or security-based swaps) create substantial net counterparty exposure that could have a substantial adverse affect on the financial stability of the U.S. banking system or financial markets. The CFTC and SEC are directed to define "substantial net position" at a threshold that includes entities that are systematically important or can significantly impact the financial system, in particular, considering an entity's relative position in uncleared, as opposed to cleared, swaps.

Regulatory Authority

The Derivatives Act also would grant the CFTC greater authority over OTC derivatives than the SEC. Under the Derivatives Act, the SEC would be authorized to regulate "security-based swaps," which encompass swaps primarily based on a narrow-based securities index, a single security or loan, or on the occurrence, non-occurrence or extent of occurrence of an event relating to a single issuer (or issuers in a narrow index) that directly affects the financial statements, condition, or obligations of the issuer or issuers. The CFTC would be authorized to regulate most other OTC derivatives, including interest rate swaps, commodity swaps, and swaps based on broad-based securities indices. In addition, OTC foreign exchange options would be subject to CFTC oversight as "swaps." Although foreign exchange swaps and forwards are excluded from the statutory definition of "swaps," these derivative contracts could become CFTC-regulated "swaps" if the CFTC determines that either or both of these contracts should be regulated as "swaps" and the U.S. Secretary of the Treasury concurs with the CFTC's determination. In any event, the Derivatives Act also directs that all foreign exchange forwards and swaps must be reported to a swap repository registered with the CFTC.

Regulation of Derivatives

The Derivatives Act would require "swaps" and "security-based swaps" to be cleared with a registered clearinghouse or agency if such an organization accepts the contracts for clearing, and the CFTC (with respect to "swaps") or the SEC (with respect to "security-based swaps") has determined they are required to be cleared. Contracts not required

to be cleared must be reported to a swap repository or the relevant regulator. The Derivatives Act follows the U.S. Treasury proposal noted above in authorizing the CFTC and the SEC to establish position limits for swaps and security-based swaps (with such limits potentially including direct holdings of the underlying security or other underlying asset). The Derivatives Act also would authorize the SEC to adopt rules under which a holder of a security-based swap could, under certain circumstances, be the beneficial owner of the underlying security for purposes of filings and the short-swing profit rules under Sections 13 and 16 of the Securities Exchange Act of 1934 (the "Exchange Act").

Credit Risk Retention

The Credit Risk Retention Act of 2009 (the "Retention Act"), included in the House bill, would require the adoption of regulations that would require any creditor that makes a loan and any securitizer of a loan to retain at least 5% of the credit risk on any loan that is transferred, sold or conveyed by such creditor or securitizer. It is not clear how these requirements would apply to loan participations, syndicated loans, and loan assignments, in part because the term "loan" is not defined; however, the bill does provide for specific exemptions (i.e., loans insured, guaranteed, or administered by the Secretary of Education or the Small Business Administration, among others) and the possibility of regulatory exemptions. Depending on how the regulations under the Retention Act are drafted, investment companies, BDCs, and hedge funds that make or invest in loans could be affected by this provision. It is unclear how the Retention Act would interact with other regulations applicable to investment companies, BDCs, and hedge funds. New regulations also would be required under the Retention Act for securitizers of asset-backed securities.

Short Sale Regulation

Expanding on the emergency orders issued by the SEC in September and October of 2008 that required weekly reporting of certain short sales (which have since expired or have been withdrawn), the bill seeks to further regulate short sales of securities. To this end, *The Investor Protection Act of 2009* (the "Investor Protection Act"), included in the House bill, would amend the Exchange Act to require daily reporting by any institutional investment manager (i.e., Form 13F filer) that effects a short sale of an equity security. Such reports would include the name of the institutional investment manager and, for each security sold short, the name of the issuer, title, class, CUSIP number, number of shares, aggregate fair market value, and any additional information the SEC may require by regulation. These daily reports would be subject to the same confidentiality regime as reports filed by investment advisers outlined above under "Registration and Reporting Requirements Under the Advisers Act." However, the Investor Protection Act would require the SEC to publicize reports outlining the aggregate amount of short interests on any given issuer's securities on a monthly basis.

The Investor Protection Act would also outlaw "a manipulative short sale of any security." A manipulative short sale is not defined; rather the SEC is required to issue rules necessary to enforce this ban. Finally, the Investor Protection Act would require registered brokers and dealers to provide notice to their customers so that the customers may forbid a broker/dealer from lending securities held in such client's account in connection with short sales.

Effects of FDIC Receivership

The bill includes provisions that could impact recovery in the event of insolvency of derivatives or other trading counterparties. For example, the Dissolution Act would authorize FDIC receivership for any financial company whose failure under Chapter 11 would be "systematically destabilizing." As receiver, the FDIC would have many of the powers currently held by the FDIC in a bank receivership, including the power to transfer the assets or liabilities of the insolvent company, including certain financial contracts, such as securities lending agreements and derivatives agreements. To the extent an investment company, BDC, hedge fund, or investment adviser is a party to such a contract, the investment company or other such party could not object to such transfer or terminate the agreement

because of the appointment of a receiver or the insolvency or financial condition of the financial company until 5 pm ET the business day following the appointment of the receiver or after notice that the contract has been transferred.

The Dissolution Act also contains a revised version of the "Miller-Moore Amendment," which would limit the claims of certain secured creditors of financial institutions subject to FDIC receivership. This proposal specifies that if any "covered financial company" (generally expected to include banks and other financial institutions that, if in economic distress, could pose a threat to the financial stability or economic conditions of the United States) is put into receivership by the FDIC, the secured claims of creditors under qualified financial contracts with a term of 30 days or less may be subject to a discount (a "Haircut") of up to 10% at the discretion of the FDIC. The portion of any claim made subject to the Haircut would be treated as a general unsecured claim. The Haircut would apply only if amounts realized from the resolution of the receivership are insufficient to satisfy in full any amounts owed to the federal government or the systemic dissolution fund and no funds are available to satisfy any claims of unsecured creditors or shareholders. This could have significant implications for the repo market in particular. This proposal does not apply to transactions secured by U.S. Treasury or agency securities.

Adoption of Fiduciary Standards for Brokers and Dealers

The Investor Protection Act would require the SEC to promulgate rules imposing an identical fiduciary standard on brokers, dealers, and investment advisers that provide personalized investment advice to retail persons (natural persons or their legal representatives). The bill contemplates the SEC rules would provide that such standard "shall be to act in the best interest of the customer without regard to the financial or other interest of the broker, dealer or investment adviser" and such standard shall be no less stringent than the standard applicable to investment advisers under Section 206(1) and (2) of the Advisers Act.

Enhancement of SEC Enforcement Powers

The Investor Protection Act, is intended to enhance the SEC's inspection, examination, and enforcement powers and to allow for self-funding of investment adviser regulation through assessments on advisers. The following are some of the changes that would be made by the bill:

- The SEC would be permitted to prosecute for aiding and abetting under the Securities Act of 1933, the Investment Company Act of 1940 (the "1940 Act"), and the Advisers Act.
- The standard of knowledge for aiding and abetting liability could be satisfied by recklessness.
- The SEC would have authority to impose civil penalties in cease-and-desist proceedings.
- Section 31(b) of the 1940 Act would be amended to permit the SEC to inspect all records of each registered investment company and each underwriter, broker, dealer, or investment adviser that is a majority-owned subsidiary of such company. Section 31(b) currently provides that "records required to be maintained and preserved in accordance with [Section 31(a)]" are subject to SEC examination, which has led to uncertainty over the SEC's right to examine records that are not required to be maintained and preserved, but which are, in fact, maintained by the registered investment company or other specified entities.
- The SEC would also be permitted to make periodic, special, or other information and document requests of investment companies and investment advisers as it "deems necessary or appropriate to conduct surveillance or risk assessments of the securities markets [and] persons registered with" the SEC.
- The Investor Protection Act would impose a 180-day deadline after the service of a "Wells notice" for the SEC to either file an action against the recipient or determine not to file. However, this deadline may be extended indefinitely for multiple 180-day periods for complex enforcement investigations.

- The Investor Protection Act also would impose a 180-day deadline for the SEC either to notify an entity it has concluded a compliance examination or inspection without findings, or to request corrective action. In this case, the bill allows only one additional 180-day extension.

Miscellaneous Provisions

In addition to the topics described above, the bill also would:

- Require the adoption of rules to reduce "perverse incentives," meaning incentive-based compensation arrangements that could threaten the safety and soundness of financial institutions or have serious adverse effects on economic conditions or financial stability, at investment advisers and such other financial institutions as Federal regulators determine.
- Remove statutory references to credit ratings from certain sections of the 1940 Act, the Advisers Act, and the Exchange Act, among others, and require applicable Federal agencies, including the SEC, to remove any references to credit ratings in their regulations.
- Amend the 1940 Act definition of "interested person" to provide the SEC with the authority to promulgate rules defining who would be an interested person as a result of material business or professional relationships or familial relationships, and delete two current provisions defining an interested person based on certain principal transactions with, or loans to, the investment company. In addition to the new ability to promulgate rules, the SEC would retain the authority to issue an order determining a natural person to be an interested person by reason of certain material business or professional relationships; but it would be permitted to look at the past five years—current law permits a two-year look back.
- Amend the 1940 Act to allow the SEC to promulgate rules regulating the extent to which an open-end investment company may hold illiquid securities.
- Require the SEC to promulgate rules making it unlawful for a registered investment adviser to have custody of client funds in excess of $10 million, unless a qualified custodian that is not involved directly or indirectly in providing investment advice with respect to those accounts holds such funds.
- Amend Section 10 of the Exchange Act to make it illegal to engage in securities lending in contravention of SEC rules and allow for the promulgation of regulations restricting the lending and borrowing of securities.

Unlike the white paper released by the Obama administration, the House bill does not propose additional or revised regulations specific to money market funds. (The Obama administration white paper was the subject of an earlier Ropes & Gray Client Alert.)

The House bill will now go to the Senate for consideration, which is expected to occur early in 2010. Senate Banking Committee Chair, Christopher Dodd, who released a discussion draft bill a few weeks prior to the passage of the House bill (and recently announced that he would not stand for reelection), is expected to lead the Senate consideration. It is impossible to predict whether the bill will pass the Senate and which provisions will survive to become law.

If you have any questions about the House bill, please contact the Ropes & Gray attorney who normally advises you.

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