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COMPREHENSIVE FINANCIAL INDUSTRY REGULATORY REFORM MOVES FORWARD IN THE U.S. HOUSE OF REPRESENTATIVES

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On December 11, 2009, the House of Representatives passed H.R. 4173, a comprehensive financial regulatory reform bill entitled the "Wall Street Reform and Consumer Protection Act of 2009."¹ The House bill is a composite of several financial regulatory reform proposals that have been circulated in the House since the beginning of the recent financial crisis.² The House bill is structured similarly to a current Senate proposal introduced by Senator Chris Dodd in November (although Dodd's proposal contains certain substantive differences from the House bill).³ Certain key aspects of the House bill are as follows: (i) the registration of private fund advisers and increased reporting obligations for such advisers; (ii) the disclosure of incentive-based compensation arrangements for certain financial institutions (including broker-dealers and investment advisers with assets over \$1 billion); (iii) the establishment of financial stability and "too-big-to-fail" regulations affecting the banking industry; (iv) the establishment of a revised regulatory regime for certain derivatives;⁴ and (v) the provision of general investor protections

(including the establishment of a federal uniform fiduciary duty for broker-dealers and investment advisers) and anti-fraud regulations.⁵

Investment Adviser Registration and Reporting

Title V, Subtitle A of the House bill, the "Private Fund Investment Advisers Registration Act," is designed to expand the pool of investment advisers required to register with the Securities and Exchange Commission (the "SEC"). This portion of the House bill affects investment advisers who advise "private funds" (i.e. any investment fund that would be an investment company but for the exemptions provided by Sections 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940), and eliminates that portion of Section 203(b)(3) of the Investment Advisers Act of 1940 that currently exempts from registration investment advisers with fewer than fifteen clients who do not hold themselves out to the public as investment advisers. This portion of the House bill does, however, provide certain exemptions from registration, such as a limited exemption for "foreign private fund advisers." Foreign private fund advisers are investment advisers who have no place of business in the United States, and who, during the preceding twelve months, a) have had fewer than fifteen clients

in the United States; b) have had assets under management in the United States of less than \$25 million; and c) have not held themselves out to the general public in the United States as investment advisers. The House bill also provides an exemption from registration for advisers to venture capital funds. The House bill, however, offers little guidance on the qualifications necessary for this exemption, instead delegating to the SEC the authority to define "venture capital funds."⁶ As with previous legislative proposals in the House (and Dodd's Senate proposal), the House bill eliminates the "intrastate exemption" and "CTA exemption" from registration for advisers to private funds.⁷ The House bill provides an exemption from registration for advisers to private funds having assets under management in the United States of less than \$150 million.⁸ However, the House bill states that any adviser with assets under management below this threshold may still be required to register with the SEC if such advisers are deemed by the SEC to pose systemic risk to the financial system.

Record-Keeping and Reporting Obligations

The House bill also subjects registered investment advisers to certain (i) enhanced

record-keeping requirements; (ii) investor, creditor, and counterparty disclosure requirements; and (iii) regulatory reporting requirements (including the reporting of assets under management, borrowing, investment positions and trading practices, each on a confidential basis). These requirements would apply not only to a registered investment adviser, but also to each "private fund" advised by such investment adviser. Also, even certain private fund advisers that may be exempt from registration, including advisers to venture capital funds and advisers with assets under management of less than \$150 million, may still be subject to mandatory disclosure requirements if the SEC deems such requirements to be in the public interest.

Compensation Disclosure

Title II of the House bill, the "Corporate and Financial Institution Compensation Fairness Act of 2009," contains legislative proposals that would require certain non-binding shareholder votes relating to executive compensation arrangements for public companies. However, this portion of the House bill would also require certain "covered financial institutions" to disclose details of their incentive-based compensation arrangements to federal regulators (although details involving the actual compensation arrangements of individuals would not be required to be disclosed). For the purposes of this portion of the House bill, "covered financial institutions" would include broker-dealers and investment advisers, in each case "with assets of \$1 billion or more."⁹ This portion of the House bill also grants federal regulators the authority to prescribe rules preventing incentive-based compensation arrangements that could have "serious adverse effects on economic conditions or financial stability."

Financial Stability and Banking Regulations

The House bill creates a new federal agency, the Financial Services Oversight Council,

authorized to identify companies that could pose a threat to the financial stability of the economy. The Council will also be authorized to consult with other federal regulators and recommend stricter prudential standards for companies that may pose any threats to financial stability. Among these prudential standards are risk-based capital requirements, recommended leverage limits, and liquidity requirements.

The House bill also contains certain regulatory reforms affecting the banking industry, including (i) merging the Office of Thrift Supervision and the Office of the Comptroller of the Currency to create one regulatory body for both national banks and federal savings associations; (ii) mandating "well capitalized" and "well managed" requirements for bank holding companies and depository institutions; and (iii) establishing a "systemic dissolution fund" to assist with the dissolution of any failed financial company that is deemed to pose a threat to the financial system.

Investor Protection

The House bill contains various regulatory reforms that will affect financial services providers, including broker-dealers and investment advisers. Among these reforms are (i) granting the SEC the ability to prohibit the use of mandatory arbitration clauses in brokerage and investment advisory contracts; (ii) granting the SEC rulemaking authority to impose a uniform fiduciary duty on both broker-dealers and investment advisers; and (iii) establishing certain "whistleblower" protections and granting the SEC the ability to pay "whistleblowers" in connection with regulatory actions that result in monetary sanctions.

Next Steps

The House bill is similar in many respects to the regulatory reform legislation currently under consideration in the Senate. Final

action by the Senate on these proposals is not likely to happen until early 2010, and the proposals could undergo significant changes before final passage. Although it is difficult to predict specific items that will be included in any final legislation, the House's passage of its reform bill and the continued consideration of similar measures in the Senate, confirm a focus on investment adviser registration as a favored method of regulating private investment funds. Moreover, recent SEC rule making actions relating to custody of client funds or securities¹⁰, and other reform proposals put forth on both the federal and state level, are likely to require substantial compliance requirements for our clients. If these regulatory reform actions are adopted, as is expected, many currently unregistered investment advisers will be required to register, and those currently registered will be subject to heightened compliance, record-keeping, and reporting responsibilities. Additionally, SEC rulemaking actions following in the wake of final legislative action are likely to result in additional compliance requirements.

Lowenstein Sandler's Investment Management Regulatory and Compliance Group is available to assist our clients with preparing for anticipated registration requirements and other legislative actions, or to discuss such anticipated requirements and actions in more detail.

Please contact any of the attorneys below, or any other member of Lowenstein Sandler's Investment Management Group, for further information on the matters discussed herein.

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- ¹ The text of the House bill is available [here](#): (last accessed on December 28, 2008).
- ² Lowenstein Sandler's Investment Management Group has continuously monitored and reported on these previous legislative and regulatory proposals. These reports are:
 - October 9, 2009 - Draft Legislation Released Regarding Investment Adviser Registration, available [here](#).
 - October 27, 2009 - SEC and CFTC Issue Joint Report on Harmonization of Regulation, available [here](#).
 - October/November 2009 - Investment Management Group Client Update, available [here](#).
 - August/September 2009 - Investment Management Group Client Update, available [here](#).
 - July, 2009 - Financial Industry Regulatory Reforms Begin to Take Shape: What Has Happened and What It Means for Investment Management Firms and Professionals, available [here](#).
 - July 17, 2009 - Spotlight on Investment Adviser Registration - Obama Administration Moves Forward with Regulatory Reform Agenda, available [here](#).
 - June/July 2009 - Investment Management Group Client Update, available [here](#).
 - May 27, 2009 - SEC Releases Proposed Rules to Strengthen Custody Controls of Investment Advisers, available [here](#).
 - May 15, 2009 - Federal Regulation of the OTC Derivatives Market Takes Shape, available [here](#).
- ³ Senator Dodd's proposal is available [here](#): (last accessed on December 18, 2009).
- ⁴ Lowenstein Sandler's Investment Management Group December 18, 2009 Client Alert, OTC Derivatives Regulatory Reform: What This Could Mean to Hedge Funds, analyzes the derivatives portion of the House bill. The alert is available [here](#).
- ⁵ The House bill also contains other regulatory reform proposals including: (i) the creation of a new Consumer Financial Protection Agency that will have authority over financial products or services that are used by consumers primarily for "personal, family, or household purposes"; (ii) the provision to shareholders of public companies of an advisory "say on pay" vote, including input on executive compensation arrangements and golden parachutes; and (iii) the provision of enhanced funding sources to the SEC, including the ability of the SEC to collect fees from registered investment advisers.
- ⁶ The House bill differs from the Dodd proposal currently under consideration in the Senate, which provides exemptions from registration for advisers to "venture capital funds" and "private equity funds," and removes "family offices" from the purview of the Senate legislation. Interestingly, the Senate proposal also provides the SEC with the authority to define each of these terms.
- ⁷ The intrastate exemption concerns the current exemption available to advisers, all of the clients of which are residents of a single state where such adviser maintains its principal office and place of business. The CTA exemption concerns the current exemption available to advisers who are registered with the Commodity Futures Trading Commission as Commodity Trading Advisors.
- ⁸ Although the text of the House bill states that this exemption will apply "if each of [an investment adviser's] private funds has assets under management in the United States of less than" the threshold, we join most commentators in the belief that the exemption is intended to apply to an investment adviser's aggregate assets under management.
- ⁹ Although the text of the House bill states "with assets of \$1 billion or more," we join other commentators in the belief that the threshold is intended to apply to assets under management of \$1 billion or more.
- ¹⁰ See, December 31, 2009 Final Rule Release, Custody of Funds or Securities of Clients by Investment Advisers, available [here](#).

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