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Clients&FriendsMemo

The Changing Face of Hedge Fund Regulation

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On May 20, 2010 the Senate passed the Restoring American Financial Stability Act of 2010 (the "**Senate bill**") by a vote of 59 to 39. The Senate bill is a bulk amendment of the financial reform bills contained in H.R. 4173, which was passed by the House of Representatives on December 11, 2009 (the "**House bill**") by a partisan vote of 223 to 202. The House of Representatives and the Senate are expected to present a final reconciled bill to the President by July 2, 2010.

These bills significantly affect the regulatory regime governing hedge fund managers, asset managers and other investment advisers. In particular, the bills require SEC registration for most investment advisers, impose new government filing requirements on investment advisers and certain funds, require certain funds to perform periodic stress tests, prohibit certain financial institutions from sponsoring funds, and raise the net worth threshold for the "accredited investor" standard. Some of these provisions are likely to have a material impact on operational and compliance costs and may create barriers to entry in the hedge fund industry.

The following discussion highlights some of the changes the bills may have on the regulatory regime in which hedge fund and other asset managers operate:

Private Funds Definition

The House and Senate bills each define a "private fund" as any fund that would be an investment company (including foreign entities offering securities in the U.S.) but for the exemptions contained in Section 3(c)(1) or 3(c)(7) of the Investment Company Act. This "private fund" concept is used throughout both the House and Senate bills whenever new regulation is meant to apply to hedge funds, asset managers and other firms involved in the hedge fund industry. The bills are unclear in many instances in distinguishing between investment advisers, on the one hand, and the funds they manage, on the other hand. Clarification of this distinction in the final statute and related regulations will be important in determining how the bills' provisions affect the hedge fund industry and to whom the bills' provisions apply.

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Investment Adviser Registration

The bills will result in SEC registration being required for a broader range of investment advisers than are currently required to register. In general, each adviser with $100 million or more of assets under management, regardless of its number of clients, must register with the SEC unless an exemption is available. Advisers with less than $100 million under management will not be permitted to register with the SEC and will thus, along with any adviser availing itself of an exemption from SEC registration, remain subject to regulation in the various states in which they operate.

The primary registration exemption used by hedge fund managers to date has been the "private investment adviser" exemption in Section 203(b)(3) of the Investment Advisers Act, which exempts private advisers with fewer than 15 clients. Both the House and Senate bills eliminate this exemption. Instead, the bills contain various other exemptions, some of which are in one bill but not the other, and some of which appear in both bills but with variations from one bill to the other. These exemptions cover the following significant types of asset managers:

- advisers whose sole clients are private funds with aggregate assets under $150 million (House bill only);
- "family office" advisers (Senate bill only);
- "foreign private advisers;"
- advisers to "venture capital funds;"
- advisers to "private equity funds" (House bill only);
- intrastate advisers with no private fund clients;
- certain commodity trading advisers (Senate bill only); and
- advisers to "small business investment companies."

Under the Senate bill (but not the House bill), "family offices" are specifically carved out from the definition of "investment advisor" in the Investment Advisors Act. The Senate bill requires the SEC to define the term "family office" in a manner consistent with its prior exemptive orders, which are generally limited to single-family offices that provide a wide range of services in addition to investment advice.

Both bills exempt from registration "foreign private advisers," which are investment advisers with no place of business in the U.S. that do not hold themselves out to the public as investment advisers and do not advise investment companies or business development companies registered under the Investment Company Act. The Senate bill also requires a foreign private adviser to have fewer than 15 clients who are domiciled in or residents of the U.S. and less than $25 million of assets under management attributable to such clients and any U.S. investors in "private funds" (discussed below)

managed by such adviser.[1] The House bill, on the other hand, includes U.S. investors in an adviser's private funds for purposes of the fewer than 15 client test.

Both bills exempt advisers whose sole clients are "venture capital funds," and the Senate bill extends this exemption to advisers whose sole clients are "private equity funds." The bills require the SEC to promulgate definitions for such terms within six months after the enactment date of the final bill.

Both bills eliminate the exemption in Section 203(b)(1) of the Investment Advisers Act for an otherwise intrastate adviser if the adviser has one or more private funds as clients, even if the private fund and all of its investors are in the same state as the adviser's principal office.

The House bill eliminates the exemption in Section 203(b)(6) of the Investment Advisers Act for registered commodity trading advisors with one or more private fund clients.

Both bills add an exemption for advisers whose sole clients are "small business investment companies" under the Small Business Investment Act of 1958, provided the adviser is not a "business development company" under Section 54 of the Investment Company Act.

Records and Reports

Among other provisions, the House bill and the Senate bill require advisers to private funds[2] to maintain records for SEC inspection and/or file reports with the SEC, in each case pursuant to rules to be promulgated by the SEC, pertaining to the following information:

- amount of assets under management;
- use of leverage;
- counterparty exposure;
- trading and investment positions;
- valuation policies and practices;
- types of assets held;
- side arrangements or side letters;
- trading practices; and
- other information deemed necessary by the SEC, in consultation with the to-be-established Financial Stability Oversight Council.[3]

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1 In the investment fund context, both bills require the SEC to maintain the current Investment Advisers Act understanding that the "client" is the fund and not the investors in the fund.

2 Depending on how the bills are reconciled, these requirements may apply to all advisers to private funds or only registered advisers to private funds.

Although hedge fund managers and other asset managers maintain much of this information on a routine basis and disclose some of this information to their investors and counterparties, this information has never before been subject to compulsory disclosure to regulators outside of investigatory or enforcement proceedings.

The Senate bill also amends the provision in Section 210(c) of the Investment Advisers Act to permit the SEC to require investment advisers to disclose the identity, investments or affairs of their clients for the purpose of assessing potential systematic risk. The House bill does not limit the purposes for which such disclosure can be required. Although in the investment adviser registration context the term “client” refers to funds and not the investors in such funds, the information maintenance, filing and disclosure provisions of both bills are sufficiently vague that it is unclear whether the SEC or another regulator could rely on these provisions to require disclosure of investor names and other details that to date has been considered highly confidential by advisers.

The bills do, however, provide enhanced protection with regard to the confidentiality of certain “proprietary information” provided to the SEC and other government agencies pursuant to the new information maintenance, filing and disclosure provisions. In particular, such information is not subject to FOIA, and the SEC is only required to disclose such information to other government agencies and self-regulatory organizations who request such information pursuant to their respective areas of jurisdiction or pursuant to a court order or confidential Congressional information request. Any government agency or self-regulatory organization and Congress—but not necessarily a court—receiving such information is in turn subject to the same restrictions.

In this context, the bills define proprietary information to include: (i) sensitive, non-public information regarding the investment or trading strategies of the investment adviser; (ii) analytical or research methodologies; (iii) trading data; (iv) computer hardware or software containing intellectual property; and (v) any additional information that the SEC determines to be proprietary. Investor identity and other investor information is not specifically protected in either bill, the significance of which will depend on whether the SEC can compel disclosure of such information under the information maintenance, filing and disclosure provisions of the bills.

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[3] The bills establish a Financial Stability Oversight Council (referred to as the Financial Services Oversight Council in the House bill) consisting of the Treasury Secretary, the respective heads of the SEC, FDIC, CFTC, OCC, Federal Reserve, Federal Housing Finance Agency and (new) Bureau of Consumer Financial Protection, and an independent insurance expert named by the President and confirmed by the Senate.

Custody of Client Assets

The Senate bill allows for, but does not require, the SEC to promulgate rules requiring registered investment advisers to safeguard client assets over which the adviser has custody and suggests verification of client assets by independent public accountants as a possible means. It is not clear from the bill's text whether these rules are expected to be different from the existing "custody rule" under the Investment Advisers Act.

Prudential Safeguards

The House bill establishes "financial holding companies subject to stricter supervision" as a new class of regulated firms ("**Significant Firms**") that may cover certain hedge funds and other private funds. A Significant Firm is a firm that directly or indirectly engages in financial activities if the Financial Stability Oversight Council determines that either (a) material financial distress at the firm could pose a threat to financial stability or the economy or (b) the nature, scope, size, scale, concentration and interconnectedness or mix of the firm's activities pose such a threat. Significant Firms are subject to the following regulations:

- Leverage restrictions;
- Limits on investments in voting securities of non-financial firms;
- Restrictions on counterparty credit exposures;
- Limits on short-term debt, including margin and repurchase financing;
- Quarterly stress tests; and
- "Living will" plans to facilitate the firm's rapid, orderly liquidation.

Although the Significant Firm designation is seemingly intended to cover large, traditional financial institutions and certain insurance companies, it is possible that the Financial Stability Oversight Council could extend Significant Firm treatment to large hedge funds. Also, the Council may seek to extend this treatment to a group of smaller private funds that separately do not pose any threat to the economy but, because they follow substantially similar investment strategies or are managed by a single manager, do pose such a threat when viewed in the aggregate. While the language in the House bill seems to target private funds as potential Significant Firms, it remains unclear whether Significant Firm treatment could also be applied to investment advisory firms.

Stress Testing

The House bill requires any financial company, including a hedge fund or other private fund, with more than $10 billion in total assets that is engaged, in whole or in part, directly or indirectly in financial activities to conduct semi-annual stress tests. Although not specifically provided in the bill,

the SEC or other regulators may seek to apply this requirement to a group of funds which are managed by a single manager and have aggregate assets of more than $10 billion.

If the results of a company's stress test show that such company is significantly or critically undercapitalized under a "baseline" or "adverse" scenario, but not necessarily a "severely adverse" scenario, such company will be required to file a "living will" plan to facilitate such company's rapid, orderly liquidation. While the bill does not define "undercapitalized" in this context, the bill uses a 2% tangible equity to total assets test in the Significant Firm context, and regulators may adopt this test across the board.

Volcker Rule

The Senate bill includes the so-called "Volcker Rule" which would, among other things, generally prohibit all U.S. banks and their affiliates (as well as foreign banks operating in the U.S. and their affiliates) from "sponsoring" or "investing in" private funds or any similar fund as determined by federal banking regulators. The rule also limits the extent to which systemically important non-bank financial companies, as determined by the Financial Stability Oversight Council (i.e., certain insurance companies), can sponsor or invest in funds.

The term "sponsoring" is defined as: (i) serving as a fund's general partner, managing member or trustee; (ii) selecting or controlling a majority of the fund's directors, trustees or management; or (iii) sharing the same name, or a variation thereof, with the fund for corporate, marketing or other purposes. It is unclear whether a bank or bank-affiliate would be permitted to serve as a sub-adviser or as an investment manager that is subject to removal at will by a third party (i.e., an independent general partner or board of directors).

The phrase "investing in" is not defined. Accordingly, while fund investments made by a bank or bank-affiliate with proprietary money would be prohibited, it is unclear whether the prohibition also covers investments of third-party money controlled by the bank or bank-affiliate, such as investments by client accounts over which the bank or bank-affiliate holds discretion.

The interpretation and the implementation of the Volcker Rule will ultimately be determined by new regulations issued by federal banking regulators, subject to guidance from the Financial Stability Oversight Council. The Senate bill provides that the provisions of the Volcker Rule will not become effective until at least two years after the date such regulations are promulgated.

Accredited Investor Standard

The Senate bill adjusts the net worth threshold for "accredited investor" status with respect to natural persons under the Securities Exchange Act and notably eliminates the bill's earlier requirement to also adjust the annual income alternative to the net worth standard.

Upon enactment of the bill, and for 4 years thereafter, the net worth threshold will be $1 million, excluding the value of the investor's primary residence.

The Senate bill also authorizes the SEC to conduct an initial review the definition of "accredited investor," as applied to natural persons, and to promulgate rules adjusting the provisions of the definition that do not relate to the net worth threshold.

Every four years, the Senate bill requires the SEC to review the definition of "accredited investor," as applied to natural persons, and authorizes the SEC to modify the definition as appropriate for the protection of investors, in the public interest, and in light of the economy. In connection with such review, the SEC may change the net worth threshold, subject to a minimum of $1 million.

Although this new standard significantly reduces the potential investor base for private funds, the Senate bill does not require existing investors to withdraw from private funds if such investors do not meet the new standard.

Effects of Other Provisions

The House and Senate bills contain other financial market regulatory provisions that may directly or indirectly affect various aspects of the investment management industry, including with respect to the following:

- trade reporting;
- swaps and other derivatives;
- asset-backed securities;
- banks and bank holding companies;
- margin requirements;
- mortgage loans; and
- insurance.

Studies for Future Regulation

The House bill and the Senate bill commission several government studies that could lead to new or different regulation with respect to the registration of investment advisers, the accredited investor standard, self-regulation of private funds and short selling.

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While it is clear that the House bill and the Senate bill will have significant effects on the regulation of hedge fund and other asset managers, the scope and depth of these remain uncertain as the bills themselves await reconciliation by Congressional conference and many particular provisions require clarification and implementation by regulatory agencies.

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