Investment Management Regulatory Update

Industry Update

Sen. Dodd Releases Restoring American Financial Stability Act of 2009

On November 10, 2009, Senator Christopher J. Dodd (D–CT), Chairman of the Senate Committee on Banking, Housing, and Urban Affairs, introduced a discussion draft of the Restoring American Financial Stability Act of 2009 (the "**Dodd Discussion Draft**"). The following update will briefly summarize certain titles of the Dodd Discussion Draft, comparing these titles to similar legislative proposals that have been considered and approved by the House Financial Services Committee.

Regulation of Advisers to Hedge Funds and Others

Title IV of the Dodd Discussion Draft ("**Title IV**"), "Regulation of Advisers to Hedge Funds and Others," is similar in most respects to the "Private Fund Investment Advisers Registration Act" (the "**PFIARA**") approved by the House Financial Services Committee on October 27, 2009, as reported in the ***November 11, 2009 Investment Management Regulatory Update***. Title IV, like the PFIARA, would require many investment advisers to private funds to register with the SEC by, among other things, eliminating the "private investment adviser" exemption contained in Section 203(b)(3) of the Investment Advisers Act of 1940 (the "**Advisers Act**"). Currently, the Section 203(b)(3) exemption from registration is available to investment advisers who, among other things, have had fewer than 15 clients over the preceding 12 months and who do not hold themselves out generally to the public as investment advisers. Title IV also aligns with the PFIARA in imposing broad recordkeeping and reporting requirements on investment advisers to private funds and would expand the SEC's rulemaking authority over such investment advisers.

Despite the broad similarities between Title IV and the PFIARA, Title IV deviates in certain significant respects described below.

- *Definition of "private funds."* Title IV includes a narrower definition of "private fund" than the PFIARA. The PFIARA states that any fund that would be an investment company but for the exemptions contained in Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 (the "**Investment Company Act**") is a "private fund." Such a fund would be deemed a "private fund" under Title IV only if it was created under U.S. laws or if 10% or more of its securities were owned by U.S. persons. In both pieces of proposed legislation, the "private fund" definition ties into certain books and records and reporting requirements.

- *SEC registration threshold*. Title IV does not permit registration with the SEC by state-regulated investment advisers unless they have assets under management of $100 million or more. The PFIARA does not contain an analogous provision, but this minimum assets under management requirement is similar to a provision in the Investor Protection Act of 2009 (the "**IPA**"), which was approved by the House Financial Services Committee on November 4, 2009. See the Davis Polk client memorandum ***Investor Protection Act Passes House Financial Services Committee*** for a summary of the IPA. The IPA provides, in relevant part, that investment advisers with assets under management of $25 million or more but less than $100 million in a state that regulates and examines investment advisers must register with and be subject to examination by the state. Although the language of the IPA is unclear, the intent of the legislation seems to be that registration of such investment advisers with a state would be in lieu of registration with the SEC.

- *Registration exemptions*. While both Title IV and the PFIARA provide an exemption from SEC registration for certain foreign investment advisers and advisers to venture capital funds, Title IV provides an additional registration exemption for advisers to private equity funds. Advisers to private equity funds would be required under Title IV to maintain certain records and make annual reports to the SEC. The PFIARA, but not Title IV, would impose such recordkeeping and reporting requirements upon advisers to venture capital funds. The task of defining the terms "venture capital fund" and "private equity fund" is left to the SEC by each of the bills in which such terms appear.

  Title IV does not incorporate other registration exemptions contained in the PFIARA. It does not include an exemption for advisers to small business investment companies, nor does it exempt advisers that advise only smaller private funds (*i.e.*, funds with assets under management in the U.S. of less than $150 million) from registering with the SEC.

- *Family offices*. Title IV excludes family offices from the Advisers Act's definition of the term "investment adviser." Unlike the registration exemptions discussed above, this approach would place family offices entirely outside of the purview of the Advisers Act. Title IV does not define the term "family office" but instead requires the SEC to do so.

- *Recordkeeping and reporting requirements*. Both Title IV and the PFIARA impose extensive information gathering and reporting requirements on registered investment advisers with respect to any private funds that they manage. Title IV, however, requires the disclosure of additional information not called for by the PFIARA. Specifically, under Title IV, registered investment advisers must disclose to the SEC—for each private fund advised—information pertaining to the valuation methodologies of the fund, the types of assets held by the fund and any side arrangements or side letters. Furthermore, Title IV requires that the SEC make an annual report to Congress on how it has used the data collected pursuant to the legislation to further the protection of investors and the integrity of the markets.

- *Public disclosure*. Title IV differs markedly from the PFIARA with respect to the public disclosure of certain private fund information. The PFIARA would require registered investment advisers to provide such reports, records, and other documents as the SEC may prescribe as necessary or appropriate in the public interest or for the protection of investors to "investors, prospective investors, counterparties, and creditors." In sharp contrast, Title IV does not include any requirement for such broad public disclosure.

- *SEC's ability to ascribe different meanings to terms*. Both Title IV and the PFIARA authorize the SEC to ascribe different meanings to terms, including the term "client," used in different sections of the Advisers Act. Unlike the PFIARA, Title IV does not limit the SEC's authority in exercising this authority. The PFIARA states that the SEC may not define the term "client" to include an investor in a private fund managed by an investment adviser, where such private fund has entered into an advisory contract with such investment adviser.

- *Custody of client assets*. Title IV directs the SEC to issue rules to require registered investment advisers to use an independent custodian to hold client assets. The PFIARA does not contain a similar provision, although the IPA does. The IPA would make it unlawful for a registered investment adviser to have custody of over $10 million of client funds or securities unless the funds or securities are maintained with a qualified custodian that does not itself provide investment advice with respect to such funds or securities—a somewhat different approach than that taken by Title IV.
- *Adjustment for inflation*. Both Title IV and the PFIARA require the SEC to adjust certain investor qualification standards for inflation. Title IV instructs the SEC to increase the income and assets thresholds for assessing whether a natural person is an "accredited investor," as that term is defined in Rule 501 of the Securities Act of 1933, to take into account inflation since the original thresholds were determined. The PFIARA requires the SEC to adjust for inflation the assets under management and net worth tests for determining a client's status as a "qualified client" under Rule 205-4 of the Advisers Act. Both the PFIARA and Title IV provide that these standards must subsequently be readjusted for inflation every five years. These inflation-adjustment provisions appear to be aimed at addressing concerns that inflation has eroded the effectiveness of these qualification standards as a means of protecting investors.
- *GAO studies*. Title IV calls on the Comptroller General to conduct several studies not required under the PFIARA, which requires only a study of the costs borne by industry members and investors due to the new registration and reporting requirements. Title IV requires reports on whether the criteria for determining eligibility to invest in hedge funds are appropriate; the feasibility of forming a self-regulatory organization to oversee hedge funds, private equity funds and venture capital funds; and the state of short selling in the market.

Increasing Investor Protection

Subtitle A of Title IX of the Dodd Discussion Draft (the "**IIP Title**"), "Increasing Investor Protection," would introduce further changes to the regulatory ambit of the Advisers Act.

Most notably, by removing the carve-out for broker-dealers from the definition of the term "investment adviser" in the Advisers Act, the IIP Title would effectively subject most broker-dealers to the entirety of the Advisers Act. Thus, under the IIP Title, broker-dealers would, for example, be subject to a fiduciary duty in their dealings with customers and the principal trading restrictions of Section 206(3) of the Advisers Act.

The IPA employs a different, more narrowly crafted approach to ensuring that the same standards are applicable to broker-dealers and investment advisers. The IPA requires the SEC to adopt rules providing that the standard of conduct for broker-dealers shall be the same as the standard of conduct for investment advisers, but only where personalized investment advice about securities is being provided to a retail customer who is a natural person.

While the IPA maintains that the broker-dealer standard be "no less stringent" than the standard applicable to investment advisers under the Advisers Act, it limits the applicable standard to Sections 206(1) and 206(2) and does not include Section 206(3)'s principal trading restriction. The IIP Title does not provide for such a broad carve-out, but instead modifies Section 206 of the Advisers Act to provide the SEC with the authority to exempt "any person or transaction, or any class of persons or transactions" from the principal trade restrictions. The SEC may grant such exemptions if it determines that doing so would be "in the public interest and for the protection of investors" and that the adviser seeking the exemption "protects investors against conflicts of interest or principal transactions that are not in the best interests of the investors."

The IIP Title further modifies the Advisers Act to add to the list of prohibitions contained in Section 206 the failure to disclose actual or potential conflicts of interest. The IPA also requires that, in promulgating rules to unify the standards applicable to investment advisers and broker-dealers, the SEC establish a requirement that any material conflicts of interest shall be disclosed. The IPA explicitly notes that customers may consent to such material conflicts of interest. The IIP Title, however, is silent as to an adviser's ability to obtain such client consent.

In addition to material conflict of interest disclosure, the IIP Title also requires disclosure of any "material limitation on the range of investment products about which the investment adviser gives advice" and disclosure of whether products similar to, but outside of, such range are available. The corresponding IPA provision applies more narrowly to "a broker or dealer [who] sells only proprietary or other limited range of products" and requires such broker or dealer to provide notice to and obtain consent from each retail customer.

We will continue to monitor the Dodd Discussion Draft as it progresses through the legislative process.

- For a thorough overview of the Dodd Discussion Draft and a comparison to the corresponding legislation in the House of Representatives, see the Davis Polk client memorandum ***Summary of the Restoring American Financial Stability Act of 2009, Introduced by Senator Christopher Dodd (D–CT) November 10, 2009 Discussion Draft***.
- See a copy of the Dodd Discussion Draft
- See a copy of the PFIARA and IPA

SEC Commissioner Aguilar Discusses Recent Legislative Proposals

On November 6, 2009, at a conference held at George Washington University Law School, SEC Commissioner Luis A. Aguilar delivered a speech detailing his views on financial services regulatory reform in the wake of the financial crisis. As a general matter, Aguilar expressed hope that recent legislative proposals would lead to sustainable reforms but noted his concern that "piecemeal changes" might "leave us in danger of repeating our recent history."

Aguilar criticized certain aspects of the Investor Protection Act of 2009 (the "**IPA**"), which, as discussed in the ***November 11, 2009 Investment Management Regulatory Update***, the House Financial Services Committee recently approved. In particular, Aguilar singled out for criticism a provision of the IPA that allows for the transfer of regulatory oversight of certain investment advisers to the Financial Industry Regulatory Authority ("**FINRA**"). According to Aguilar, this proposal is flawed because FINRA is less accountable than the SEC, which is subject to Congressional oversight and audits by, for example, the Government Accountability Office.

Nor does FINRA have the appropriate resources, personnel and expertise to perform such a role, claimed Aguilar. A better approach, said Aguilar, would be to "strengthen the SEC by expanding its authority and fortifying its resources, including user fees from advisers." Aguilar lauded news reports that Rep. Barney Frank (D-MA), Chairman of the House Financial Services Committee, plans to remove this provision from the IPA before it is considered by the entirety of the House of Representatives.

Aguilar also indicated that, in his view, legislative proposals calling for the registration of investment advisers to private funds do not provide the SEC with enough "regulatory flexibility" to address changes in such a "dynamic and creative" industry. To address this problem, he urged Congress to authorize the SEC to regulate private funds themselves, not just their investment advisers. This could be accomplished, suggested Aguilar, by "conditioning the use of the exceptions provided by Sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940." Aguilar did not indicate what conditions might be imposed on the use of these exceptions, but he warned that if the SEC is not granted this additional authority, it might "find [itself] looking at two trains about to collide—yet being unable to act."

- See a copy of Commissioner Aguilar's speech

Senate Committee Holds Hearing and Issues Report on Target Date Funds

Recently, the Senate Committee on Aging (the "**Aging Committee**") held a hearing and issued a report on the issues it perceives are associated with target date funds. As discussed in the ***July 1, 2009 Investment Management Regulatory Update***, target date funds were previously the subject of a joint hearing between the SEC and the U.S. Department of Labor ("**DOL**").

Target date funds are savings vehicles that invest in a mix of assets, including stocks, bonds and other instruments, that change over time as the fund approaches a set date in the future—its target date. Generally, a target date fund's asset allocation is marketed as growing more conservative over time. Such funds are popular retirement savings vehicles in light of this asset allocation strategy. Investors generally choose a target date fund with a target date that corresponds with their own retirement date.

Witness Testimony

In addition to officials from the SEC and the DOL, representatives from the target date fund industry also testified at the Senate hearing. Among other topics, the witnesses discussed the general increase in the use of target date funds as retirement savings vehicles, the recent performance of target date funds and the desirability of further regulation of such funds.

During his prepared testimony at the hearing, Andrew J. Donohue, director of the SEC's Division of Investment Management, noted his concern that, in some instances, the limited disclosures made in a target date fund's marketing materials may obscure the nuance of the more fulsome disclosures found in the fund's prospectus, resulting in investors developing "unreasonable expectations" regarding the ability of a target date fund to provide for their retirement. To address this issue, Donohue noted that the SEC is working with the Financial Industry Regulatory Authority to review target date fund sales materials to determine whether new rules governing such materials are necessary or appropriate.

According to Donohue's testimony, the SEC is also investigating whether target date funds that state their target date as part of their names mislead investors. In particular, Donohue noted that investors often mistakenly assume that at its target date, a target date fund will be invested nearly exclusively in a conservative mix of assets. Moreover, investors also often make the mistake of assuming that all target date funds with the same target date will be managed in the same fashion.

Committee Report

The Aging Committee's report on target date funds, released in connection with the hearing, identified three broad areas of concern associated with target date funds: transparency and consistency, fees and conflicts of interest.

- *Transparency and consistency*. The Aging Committee report found that asset allocation among target date funds with the same target date varied greatly and that such differences make comparing and evaluating target date funds difficult for investors.
- *Excessive fees*. The Aging Committee report observed that fees associated with target date funds vary greatly, can have serious effects on an investor's savings and are frequently misunderstood.

- *Conflicts of interest*. The Aging Committee report noted that companies offering target date funds almost always package several of their own "proprietary funds" into their target date funds. This practice, which is currently standard, may result in companies dumping lower-performing proprietary funds into their target date funds "in an effort to garner more assets," observes the Aging Committee report.

According to the report, the Aging Committee is still evaluating "ways to strengthen target date funds" in light of these broad areas of concern.

- See a copy of the witnesses' testimony and a copy of the Aging Committee's report

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SEC's Donohue Discusses Closed-End Fund Takeover Defenses

In a recent speech at the Independent Directors Council's Investment Company Directors Conference, Andrew J. Donohue, Director of the SEC's Division of Investment Management, set forth his views on the challenges faced by independent directors of investment companies. Among other issues, Donohue flagged for independent directors' attention concerns related to certain takeover defenses employed by closed-end funds.

As a general matter, Donohue noted that the implementation of a takeover defense that serves to entrench management, including delaying a fund's annual meeting or exempting existing directors from director qualification requirements, requires careful consideration by closed-end funds' independent directors of whether the defense "is truly in the best interests of fund shareholders."

Poison Pills

More specifically, Donohue expressed doubt that the Investment Company Act of 1940 (the "**Investment Company Act**") permits a closed-end fund's board to use a poison pill as a takeover defense. To effectuate a poison pill, a closed-end fund's board generally would issue each of the fund's shareholders a right to purchase the fund's stock at a specified exercise price. Until the occurrence of a triggering event—most commonly a bidder acquiring 10-20% of the fund's stock—the rights would either not be exercisable or exercisable at an out-of-the-money price. But, upon the occurrence of the triggering event, the rights, other than the rights held by the bidder, would become exercisable at an in-the-money price (generally a substantial discount to market price). Such a poison pill would cause a potential acquirer to suffer significant economic dilution and would serve as a strong takeover deterrent.

In Donohue's view, Sections 18(d) and 23(b) of the Investment Company Act, considered through the lens of Section 1(b), which sets forth certain policy considerations underlying the Act, "call into question the validity of a closed-end fund's use of poison pills." Among other things, Section 1(b) declares that it is contrary to "the national public interest and the interest of investors" to operate or manage investment companies in the interest of a special class of securities holders "rather than in the interest of all classes of such companies' security holders." Section 18(d) generally prohibits a closed-end fund from issuing rights to purchase its securities unless such rights are "issued exclusively and ratably to a class or classes of such company's security holders." Subject to certain exceptions, Section 23(b) prohibits a closed-end fund from selling its common stock at a price below its current net asset value.

According to Donohue, it is difficult to argue that the rights issued pursuant to a typical poison pill meet Section 18(d)'s ratable distribution requirement because any rights distributed to a potential acquirer would, in effect, become void upon its acquisition of more than a limited amount of the closed-end fund's shares. Moreover, poison pills, once triggered, result in a closed-end fund selling its shares below net asset value under circumstances that, in Donohue's opinion, do not satisfy the exceptions to Section 23(b)'s prohibition of such sales.

State Law Control Share Statutes

Donohue also contended that the use of state law control share statutes is, in certain contexts, "likely inconsistent with Section 18(i) of the Investment Company Act." He cited specifically the Maryland Control Share Acquisition Act. That statute, applicable to the many closed-end funds that are domiciled in Maryland, restricts the ability of a holder of 10% of more of a closed-end fund's shares from voting such shares absent the approval of two-thirds of the other, disinterested shareholders at a special meeting. Section 18(i) of the Investment Company Act, noted Donohue, generally requires that every share of a closed-end fund be a voting share and have "equal voting rights with every other outstanding voting stock." According to Donohue, denying "a shareholder deemed to possess 'control shares' the right to vote those shares constitutes a denial of equal voting rights and may violate the fundamental requirement that every share of fund stock be voting stock."

Wrapping up his comments on takeover defenses, Donohue remarked that he and his staff stand ready to answer questions posed by closed-end funds' independent directors on the subject matter.

- See the full text of Donohue's speech

Recent Enforcement Developments

The Interagency Financial Fraud Enforcement Task Force

As a further indication of the federal government's commitment to countering financial crime, on November 17, 2009, President Barack Obama established, by executive order, the interagency Financial Fraud Enforcement Task Force (the "**Task Force**"). According to a November SEC Press Release, the aim of the Task Force is "to investigate and prosecute significant financial crimes, ensure just and effective punishment for those who perpetrate financial crimes, address discrimination in the lending and financial markets and recover proceeds for victims." The Task Force replaces the Corporate Fraud Task Force created in 2002, and is comprised of senior-level officials from a number of departments and agencies, including the Department of Justice, the SEC and the Federal Bureau of Investigation. Commenting on the creation of the Task Force, Treasury Secretary Timothy Geithner noted that its members will work aggressively to curb fraudulent acts before any adverse systemic impacts are felt, using the resources, knowledge and experience of the government's law enforcement.

Insider Trading

Speaking at the Bloomberg Washington Summit held on November 14, 2009, Robert Khuzami, the Director of the SEC's Division of Enforcement (the "**Division**"), commented on the nature of the insider trading cases against hedge funds and their managers that the Division has recently encountered. These cases, remarked Khuzami, reflect an evolution from isolated incidents of opportunistic trading on the basis of material, non-public information to more organized approaches whereby certain funds' business models entail "collect[ing] information from corporate insiders" and then using that information to trade. Khuzami did concede, however, that "the vast majority of hedge funds operate in a lawful manner."

Khuzami also discussed tactics and developments that have bolstered the Division's enforcement efforts. He indicated that the use of wiretaps and other undercover investigative techniques have proved particularly useful and that the Division's newly granted capacity to issue subpoenas with fewer procedural hurdles has "made a significant difference."

Indeed, according to a December 2, 2009 Wall Street Journal article, the SEC recently has issued nearly three dozen subpoenas to hedge funds and brokerage firms in response to suspected insider trading activity. These subpoenas have been far reaching in scope and have included, for example, requests for disclosure of relationships with external bankers as well as requests for the entirety of traders' email correspondence over the past two years or more.

- See a copy of the executive order calling for the establishment of the Task Force
- See a copy of the SEC Press Release on the Task Force

Federal "Red Flags Rules" Enforcement Deadline is Pushed Back to June 1, 2010

As reported in the ***April 7, 2009 Investment Management Regulatory Update***, the Federal Trade Commission (the "**FTC**") has adopted a new set of rules requiring certain "financial institutions" to adopt identity theft protection programs (the "**Red Flag Rules**"). Enforcement of the Red Flag Rules, which were originally set to go into effect starting November 1, 2008, has been subject to numerous postponements, including a three-month delay announced on July 29, 2009, as reported in the ***August 5, 2009 Investment Management Regulatory Update***. On October 30, 2009, the FTC, at the request of members of Congress, announced a further seven-month postponement of enforcement of the rules until June 1, 2010.

- See the FTC's announcement

Federal Regulatory Agencies Release Final Model Privacy Forms

On November 17, 2009, eight federal regulatory agencies, including the SEC and CFTC, (the "**Agencies**") published model privacy notice forms that the Agencies believe will make it easier for consumers to understand how financial institutions collect and share consumers' personal information. The model forms incorporate the results of extensive consumer research and testing by the Agencies. A financial institution that uses a model form obtains a "safe harbor" and will satisfy the disclosure requirements for privacy notices set forth in Section 503 of the Gramm-Leach-Bliley Act. While use of the model forms is voluntary, financial institutions will want to consider using these in order to take advantage of the safe harbor.

- See a copy of the Agencies' joint press release and the model forms

SEC Rules and Regulations

SEC Extends Compliance Date for Regulation S-AM

The SEC has extended the compliance date for Regulation S-AM from January 1, 2010 to June 1, 2010. The regulation's effective date remains September 10, 2009.

As reported in the ***September 3, 2009 Investment Management Regulatory Update***, Regulation S-AM, which was adopted on August 4, 2009, restricts the ability of any SEC-registered investment company, investment adviser, transfer agent or non-notice-registered broker or dealer to use consumer eligibility information obtained from an affiliate to make a marketing solicitation to a consumer, unless certain notice and opt-out conditions are satisfied.

The SEC's release announcing the extension of the compliance date explains that the SEC granted the extension based, in part, on representations made by the Investment Adviser Association and the Investment Company Institute regarding the difficulties being faced by their members in complying with the regulation.

- See a copy of the release granting the extension

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact

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