

FINANCIAL REGULATORY REFORM

US Financial Reform

The Impact of the Dodd-Frank Wall Street Reform and Consumer Protection Act on Financial Services Companies Outside of the United States

In response to the significant financial difficulties experienced in the United States, and globally, since late 2007, President Obama is expected to sign into law on 21 July 2010 the "Dodd-Frank Wall Street Reform and Consumer Protection Act" (the "Act"), a far-reaching piece of legislation designed to effect a broad range of reforms to the US financial regulatory system.

While the Act's principal focus is on US financial services institutions and US financial markets, a number of its provisions will impact non-US financial services companies operating in the United States or providing products and/or services to US consumers. This article provides a brief summary of certain of the Act's provisions that are most relevant to our financial services clients that are located outside of the United States, but which do business in the United States or with US clients and investors. However, this article does not provide an exhaustive discussion of all of the Act's provisions, and non-US financial service companies and banks are encouraged to consult counsel to ascertain the extent to which their organisation and operations may be subject to these and other provisions of the Act.

Types of Non-US Entities that May be Affected

The following types of non-US entities are most likely to be affected by the Act's provisions.

- Non-US nonbank financial companies¹ (a term that is broadly defined, and which could include, among others, fund managers and broker-dealers) deemed systemically important in regard to US financial stability by a newly-created Financial Stability Oversight Council will be subject to heightened prudential standards and US regulatory supervision.

¹ "Foreign nonbank financial companies," the term that is used in the Act, are defined as companies: (i) incorporated or organised outside the United States; and (ii) predominantly engaged in, including through a branch in the United States, financial activities. Note that the second clause does not limit the calculation of financial activities to activities occurring in the United States. Nonbank financial companies are "predominately engaged in financial activities" if 85% or more the company's (and all of its subsidiaries') annual gross revenues and consolidated assets are attributable to activities "financial in nature" (as defined in Section 4(k) of the Bank Holding Company Act (the "Bank Holding Company Act") and, if applicable, attributable to the ownership and control of one or more insured depository institutions. As there are no apparent geographical limitations on such activities, a non-US company that is predominantly engaged in financial activities could satisfy this test and qualify as a foreign nonbank financial company regardless of the location of such activities. However, the factors that the Financial Stability Oversight Council is to consider when determining whether to designate a foreign nonbank financial company, focus on its US activities and holdings. Notwithstanding this general standard, a newly created Financial Stability Oversight Council has the ability under its "anti-evasion" authority to subject the financial activities of any company to supervision and prudential standards discussed herein.

- Non-US banking organisations² that are bank holding companies or treated as bank holding companies (e.g., non-US banks that have US branches, agencies or commercial lending subsidiaries) will be subject to certain of the reforms targeted generally at bank holding companies. However, the extent to which, and how, these reforms will apply is largely subject to future rule making by US regulators. “Large” non-U.S bank holding companies and non-US entities treated as bank holding companies (e.g., bank holding companies with US\$50 billion or more in assets with US operations³) will likely also be subject to heightened prudential standards and US regulatory supervision.
- Non-US investment advisers with more than 14 US clients and US investors in private funds, or that manage US\$25 million or more of assets attributable to US clients and US investors in private funds, may be required to register with the US Securities and Exchange Commission (“SEC”) if they do not qualify for any other exemption from the requirement to register. Non-US investment advisers that do not qualify for any of the exemptions from the requirement to register will be subject to the registration requirements of the US Investment Advisers Act of 1940 (the “Advisers Act”).
- Non-US entities that have substantial positions in swap transactions with US market participants or who otherwise may significantly impact the US banking system or financial markets will be subject to new capital, margin and other requirements.⁴ The SEC and the US Commodity Futures Trading Commission (“CFTC”) will likely look to exert jurisdiction over these non-US entities, and will be authorised to prohibit these entities from participating in swaps with US

² The Act refers to “foreign banks,” which are defined as companies organised under the laws of a foreign country or a territory of the United States, which engage in the business of banking, or any subsidiary or affiliate, organised under such laws, of any such company.

³ Note that the Act does not expressly tie the US\$50 billion threshold to US assets. Therefore, it is unclear whether a non-US entity’s non-US assets will be considered when calculating the US\$50 billion threshold.

⁴ However, the Act’s provisions relating to swaps generally do not apply extraterritorially to activities outside the United States, unless those activities have a direct and significant connection with activities in, or effect on, commerce of the United States, or contravene such rules and regulations that the SEC and/or CFTC may prescribe.

counterparties if necessary to the stability of the US financial system.

The remainder of this article provides a summary of the most relevant provisions of the Act, and their impact on non-US entities’ operations.

Overview of the Act

The Act is intended to be a comprehensive response to the recent financial crisis, and will significantly change the US federal regulatory framework applicable to many types of financial services companies, and particularly banks and other deposit taking institutions. Highlights of the proposed reforms reflected in the Act include, without limitation:

- Creation of a Financial Stability Oversight Council, chaired by the US Secretary of the Treasury and including key US regulators, whose role is to identify potential risks to US financial stability and manage such risks through measures such as increased monitoring and enhanced prudential standards applicable to systemically important financial services companies;
- Systemically important nonbank financial companies and large banking organisations will be subject to heightened prudential standards and regulatory supervision, including, among others things, new requirements with respect to leverage and risk-based capital requirements;
- Implementation of the “Volcker Rule,” which prohibits (subject to certain exceptions) “bank entities”⁵ from engaging in proprietary trading and sponsorship of and/or investment in hedge funds and private equity funds. In addition, the Board of Governors of the Federal Reserve System (the “Federal Reserve”) may impose capital requirements and quantitative limits on a systemically important nonbank financial company’s proprietary trading and sponsorship of and/or investment in hedge funds and private equity funds;
- Increased authority on the part of federal regulators to oversee the orderly liquidation of failing US nonbank financial services

⁵ A “banking entity” is defined as any insured bank or thrift, any company that controls an insured bank or thrift, any company that is treated as a bank holding company under Section 8 of the International Banking Act of 1978, and any affiliate or subsidiary of such an entity.

companies and US bank holding companies whose collapse may have serious adverse repercussions for the US economy;

- Broadened registration requirements applicable to investment advisers, and particularly advisers to hedge funds and private equity funds; and
- Significantly enhanced oversight of the over-the-counter financial derivatives markets, and separation of banks' derivatives businesses from core banking activities.

Financial Stability and Systemic Regulation

Nonbank Financial Companies

In order to identify and manage potential risks to US financial stability, Title I of the Act, entitled "Financial Stability", creates a Financial Stability Oversight Council (the "Council"), which will be an interagency council chaired by the US Treasury Secretary. The Council, in consultation with the appropriate primary financial regulator, is charged with identifying "systemically important" nonbank financial companies (including non-US financial companies with substantial assets or operations in the United States) and financial activities that could pose a threat to US financial stability.

The Council's determination of whether a nonbank financial company may pose a threat to US financial stability will be based on considerations such as:

- the degree of the company's leverage;
- the amount and nature of its financial assets;
- the amount and type of liabilities of the company (e.g., reliance on short-term funding); and
- the extent and type of off-balance sheet exposure and interrelationships with other financial companies.

With respect to non-US nonbank financial companies, the Council will focus its consideration to the non-US company's US operations and activities (e.g., the amount and nature of US financial assets, and the amount and types of liabilities used to fund activities and operations in the United States). Any company so designated by the Council will be provided with notice, and an opportunity for hearing and judicial review. The Act calls for the Council to consult with foreign

regulatory authorities in regard to matters relating to non-US nonbank financial companies, non-US bank holding companies and cross-border activities and markets to the extent appropriate.

Heightened Prudential Standards

Any entity designated as systemically important must register with the Federal Reserve within 180 days, and will be subject to heightened prudential standards, reporting and disclosure requirements and supervision by the Federal Reserve. In order to prevent or mitigate risks to the US financial system that could arise from the material financial distress at a systemically important nonbank financial company, the Federal Reserve (on its own or pursuant to recommendations from the Council) is required to establish heightened prudential standards addressing the following substantive areas:

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| ■ Risk-based capital | ■ Concentration limits |
| ■ Leverage limits | ■ Resolution Plan (i.e., living wills) ⁶ |
| ■ Liquidity requirements | ■ Credit exposure reporting |

Systemically important nonbank financial companies that are publicly traded will be required to establish a risk committee of their board of directors. Systemically important nonbank financial companies also will be subject to periodic stress tests to evaluate capital adequacy in adverse economic conditions. The Federal Reserve has discretion (upon completion of a study and report to the US Congress) to establish standards regarding contingent capital requirements, and also has the authority to require enhanced public disclosures.

In addition, federal banking agencies are required to establish minimum leverage capital and risk-based capital requirements for systemically important nonbank financial companies that are at least as strict as those imposed on insured depository institutions at the time the Act was enacted. Additional capital requirements also may be established with respect to systemically risky activities, including derivative trades, securitised products, securities borrowing and lending and repurchase agreements. Similarly, as discussed

⁶ Systemically important nonbank financial companies will be required to prepare and maintain extensive resolution plans, which must be acceptable to the Federal Reserve.

below, the so-called “Volcker Rule” permits the Federal Reserve to impose capital requirements and quantitative limits on the proprietary trading activities of systemically important nonbank financial companies, and their sponsorship of and/or investments in hedge funds and private equity funds.

Reporting Requirements, Regulatory Examinations and Enforcement

The Act also subjects systemically important nonbank financial companies (as identified by the Council) and their subsidiaries to reporting requirements, the assessment of fees, and expanded regulatory examination and enforcement powers. These companies and their subsidiaries will be required to submit reports disclosing, among other things, the financial condition of the relevant company and its systems for monitoring and controlling financial, operating and other risks. The Act also establishes a “Financial Research Fund” that will assess fees on systemically significant companies to defray costs associated with operating the Council and the related Office of Financial Research.

The Federal Reserve is able to examine these companies and their subsidiaries to determine, among other things, the risks within a company that may pose a threat to the safety and soundness of the relevant company or the financial stability of the United States. Furthermore, the Act extends the enforcement provisions under certain federal laws to systemically important nonbank financial companies and their non-depository subsidiaries.⁷

Large Bank Holding Companies

“Large and interconnected” bank holding companies (i.e., bank holding companies with total consolidated assets of at least US\$50 billion)⁸ are automatically subject (i.e., without the need of a Council determination) to the heightened prudential standards, supervision and other requirements discussed above under “Heightened Prudential Standards”. These heightened prudential standards, supervision and other requirements also apply to

⁷ Under the Act, systemically important nonbank financial companies and their non-depository subsidiaries that are subject to Federal Reserve supervision are subject to the enforcement provisions in the Federal Deposit Insurance Act as if the relevant company were a bank holding company.

⁸ Aside from providing a minimum asset test, the Act does not define which bank holding companies are “large and interconnected.”

large non-US bank holding companies and non-US entities treated as bank holding companies with operations in the United States.

Anti-Evasion Provisions

In order to prevent financial entities from evading the provisions of the Act, the Council may subject any company (both US and non-US non-financial companies) to the heightened prudential standards and Federal Reserve supervision discussed above. In order to extend these requirements to other institutions, the Council must determine that, among other things:

- material financial distress related to financial activities conducted directly or indirectly by a US company (or the financial activities conducted in the United States by a non-US company) would pose a threat to US financial stability; and
- the company is organised and operated in such a manner as to avoid application of the Act.

These companies must be provided with the same notice, and opportunity for hearing and judicial review, as nonbank financial companies. However, the prudential standards and Federal Reserve supervision will only apply to the financial activities of the company. These companies will be permitted to establish intermediate holding companies through which to conduct their financial activities.⁹

Regulation of Systemically Important Activities

If the Council determines that a particular financial activity or practice could increase the risk of significant liquidity, credit or other problems spreading among US nonbank financial companies, bank holding companies or the US financial markets, the Council is permitted to recommend to a primary financial regulatory agency (e.g., a state insurance authority) that the agency apply new or heightened prudential standards and safeguards to such financial activity or practice. The primary financial regulatory agency will be required to adopt the Council’s recommendations, or explain its reason for not doing so.

⁹ The Federal Reserve also may require these companies to establish an intermediate holding company to facilitate supervision of the company’s financial activities. For purposes of these rules, “financial activities” include activities that are financial in nature (see note 1), and include the ownership or control of depository institutions, but do not include internal financial activities (e.g., internal treasury, investment and employee benefit functions).

Implications for Non-US Entities

The heightened prudential standards and other provisions of Title I of the Act generally apply to systemically important non-US nonbank financial companies (as identified by the Council) and large non-US bank holding companies and non-US entities treated as bank holding companies with operations in the United States. While the exact scope of the enhanced prudential standards and regulatory supervision will be subject to the Federal Reserve's future determination, these non-US entities presumably will be subject to some form of leverage, liquidity, concentration and other requirements imposed by the Federal Reserve and/or by other relevant regulatory authorities.

The Federal Reserve is expected to modify the application of these rules to non-US entities to take into consideration principles of national treatment (e.g., regulation of these entities under the laws of their home jurisdiction) and equality of competitive opportunity (i.e., concerns with creating competitive disadvantages among US and non-US entities), and the extent to which home country standards are comparable to those applied in the United States. However, currently it is not clear whether the heightened prudential standards and other requirements of the Act will extend to a non-US entity's operations outside the United States, or whether the application of any new rules will be limited to a non-US entity's US operations.¹⁰

When implementing provisions of the Act, the Act permits US regulators to consult with non-US regulators and, where appropriate, rely on information currently being collected by such regulators. However, the Act also permits the Federal Reserve to terminate the activities of the US branches, agencies or commercial lending subsidiaries of a non-US entity that presents systemic risk to the United States if the Federal Reserve determines that the home country has not adopted appropriate systems to mitigate risk.¹¹

¹⁰ With respect to non-US nonbank financial companies, the Act provides that references to the Federal Reserve's authority over a "company" or its "subsidiaries" include only such company's US activities and subsidiaries. We believe this is consistent with the Federal Reserve's traditional position of limiting US regulation of non-US banking organisations to their US operations and activities. However, this provision is not entirely clear, and the scope of this provision depends upon future rulemaking.

¹¹ See Section 173(b) of the Act, which amends Section 7(e)(1) of the International Banking Act of 1978.

In addition, under the anti-evasion provisions, the US financial activities of any non-US entity can be made subject to heightened prudential standards and other requirements of the Act if the Council determines that the non-US entity is organised or operated in a manner that evades the application of the Act, and such financial activities in the United States are determined to pose a threat to US financial stability. These anti-evasion provisions do not appear to be extraterritorial in scope, and likely will be limited to financial activities in the United States.

Remediation and Resolution Provisions – "Too Big To Fail"

Early Remediation

Title I of the Act also provides permits the Federal Reserve, in consultation with the Council and the Federal Deposit Insurance Corporation ("FDIC"), to issue regulations establishing early remediation requirements for systemically important nonbank financial companies and large bank holding companies in financial distress. This approach is similar to the prompt corrective action requirements that currently apply to insured depository institutions. These regulations are required to:

- define measures for the financial condition of the company (e.g., regulatory capital, liquidity measures and other forward-looking indicators); and
- establish requirements that increase in stringency as the financial condition of the company declines (e.g., limits on capital distribution and acquisitions, and at advanced stages of financial decline, management changes and asset sales).

If the Federal Reserve determines that a systemically important US nonbank financial company or large bank holding company poses a "grave threat" to US financial stability, the Federal Reserve, with the consent of the Council, can require the company to terminate certain activities, impose conditions on those activities and/or sell or transfer assets to unaffiliated entities.

Orderly Liquidation Authority

Title II of the Act, entitled "Orderly Liquidation Authority," establishes a system for the orderly liquidation of entities that are referred to as covered financial companies. In order to potentially qualify as a covered financial company, an entity must be

incorporated under US law. The term extends to four categories of entities:

- systemically important nonbank financial companies;
- bank holding companies;
- a nonbank financial company that has not been designated as a systemically important financial company, but which is predominantly engaged in activities that are financial in nature under Section 4(k) of the Bank Holding Company Act; and
- any subsidiary of one of the foregoing (other than a depository institution or insurance company) that is predominantly engaged in financial activities.

Upon recommendation of the Federal Reserve and FDIC boards, such companies in financial distress can be subject to an orderly liquidation process if the Treasury Secretary, in consultation with the President, determines that, among other things:

- the company's failure and resolution under otherwise applicable law could have a serious adverse effect on US financial stability; and
- there is no viable private sector alternative to prevent default.

Upon such a determination, the FDIC will be appointed as receiver of the company and charged with liquidating the company. If challenged by the company, these determinations will be subject to judicial review and confirmation.

As a practical matter, this provision does not address the continuing uncertainty as to whether a company that could be treated as a covered financial company will be subject to possible reorganisation or liquidation under US bankruptcy law or liquidation under the receivership provisions of the Act.

Implications for Non-US Entities

With respect to the early remediation provisions, US regulators are required to prescribe rules regarding the application of these provisions to non-US financial companies that may pose a threat to US financial stability. As noted in other contexts, it is unclear whether these rules will extend extra-territorially to a non-US entity's operations outside the United States, or whether the application of these rules will be limited to a non-US entity's US operations.

The Volcker Rule and Other Bank Holding Company Provisions

Volcker Rule

Title VI of the Act, entitled "Improvements to Regulation of Bank and Savings Association Holding Companies and Depository Institutions," requires federal banking agencies (through joint rulemaking that reflects Council recommendations) to implement the Volcker Rule.¹² Subject to limited exceptions, the Volcker Rule prohibits any banking entity from engaging in proprietary trading and from sponsoring and/or investing in hedge funds and private equity funds.¹³

- Under the Act, "proprietary trading" includes purchasing or selling stocks, bonds, options, commodities, derivatives or other financial instruments for the "trading account" or other such portfolio of the entity. However, the term excludes, subject to any subsequent Federal Reserve restrictions, trading in certain securities and certain categories of trading activities, including, trading on behalf of a customer, risk-mitigating hedging activities, and trading as a market maker.
- Under the Act, "sponsoring" includes: (1) serving as a general partner, managing member or trustee of the fund; (2) selecting or controlling a majority of the directors, trustees or management of the fund; and (3) sharing the same name (or a variation of the same name) with a fund for marketing and promotional purposes.

However, pursuant to last minute amendments to the legislation, the Act permits banking entities and their affiliates to organise, sponsor and offer private equity funds and hedge funds if the banking entities meet certain enumerated conditions. Banking entities also are permitted to make seed investments (e.g., investments for purposes of establishing the fund and providing the fund with sufficient initial equity for investment to attract unaffiliated investors) and other *de minimis*

¹² The "Volcker Rule" refers to proposals made by former Federal Reserve Chairman Paul Volcker relating to restrictions on proprietary trading and hedge fund activity by banks and bank holding companies.

¹³ The terms "hedge fund" and "private equity fund" are defined as funds excepted from registration under Sections 3(c)(1) or 3(c)(7) of the US Investment Company Act of 1940 (the "Investment Company Act"), or a "similar fund" as determined by the appropriate federal banking agency.

investments in private equity and hedge funds, provided that the following conditions are met:

- The banking entity actively seeks unaffiliated investors to reduce its investment;
- The banking entity's investment is reduced to not more than 3% of the total ownership of the fund within one year after the fund's establishment (with possible extensions) and maintained at or below that level thereafter; and
- The investment is "immaterial" to the banking entity, but in no case may the aggregate amount of all such investments in funds by the banking entity exceed 3% of the entity's Tier 1 capital.

In addition to these (and other requirements), banking entities organising and sponsoring funds are required to explicitly disclose to investors that any losses in the funds are borne solely by investors in the fund and not by the banking entity. While the effective date of the Volcker Rule provisions is contingent upon future rulemaking (and not likely for two years following the effective date of the Act), banking entities may wish to begin updating their disclosures in light of this requirement.

The Volcker Rule also prohibits banking entities and their subsidiaries that act as investment managers or advisers to hedge funds or private equity funds from engaging (directly or indirectly) in credit and other transactions with those funds.¹⁴ Furthermore, the Act permits the Federal Reserve to impose additional capital requirements and quantitative limits on a systemically important nonbank financial services company's proprietary trading and sponsorship of and/or investments in hedge funds and private equity funds.

Other Notable Provisions Relating to Bank Holding Companies

In addition to the heightened prudential standards and other requirements discussed above (including capital and leverage requirements), the Act imposes several restrictions on, or significantly modifies existing regulation of, bank holding companies. For example, the Act requires, among other things:

- increased regulation of certain regulated subsidiaries of bank holding companies by

¹⁴ However, the Federal Reserve may grant exemptions from these restrictions to permit banking entities to enter into, on behalf of a fund, prime brokerage transactions under certain conditions.

removing current restrictions on the ability of the Federal Reserve to examine and/or bring enforcement actions against these subsidiaries;

- regulatory examination of non-depository subsidiaries to determine whether their activities present safety or soundness risks to the depository institution holding company;
- the Federal Reserve, in connection with bank holding company acquisitions, is to consider whether a bank holding company's acquisition of a bank would result in greater or more concentrated risks to the stability of the US financial system or whether a bank holding company's acquisition of a non-bank entity would have an impact on US financial stability;¹⁵ and
- expanded restrictions on a bank's ability to engage in certain transactions with affiliates.

Implications for Non-US Entities

With respect to the Volcker Rule, the restrictions generally do not apply to investments or activities conducted solely outside the United States by non-US banks and their subsidiaries, unless the non-US banking entity is directly or indirectly controlled by a banking entity organised in the United States. However, it is not clear whether, or the extent to which, these restrictions will be applied to activities conducted by non-US banks and their subsidiaries outside the United States that involve US investments or investors.

With respect to other provisions relating to bank holding companies, non-US banking organisations treated as bank holding companies generally will be subject to most of the Act's reforms applicable to bank holding companies. For example, a non-US banking organisation that owns insured depository institutions in the United States may be required to comply with US capital standards (in addition to the standards applied in the entity's home jurisdiction).

Private Fund Advisers

Title IV of the Act, entitled "Registration of Advisers to Hedge Funds and Others," sets forth revised parameters for federal and state registration of investment advisers and, significantly, narrows the

¹⁵ The Act requires all financial holding companies to obtain prior Federal Reserve approval before acquiring a financial company with assets of more than US\$10 billion.

US registration exemption available to investment advisers to private funds,¹⁶ including those located outside of the United States. The Act also contains provisions relating to advisers to venture capital funds, changes general US investor accreditation standards, and requires further studies and reports relevant to the private fund industry.

The Act makes a number of significant changes affecting US regulation of investment advisers located outside of the United States, the most important of which include:

- Investment advisers to many private funds will have to register with the SEC within one year of the enactment of the Act, if not already registered, and conduct a comprehensive review of their policies and procedures to ensure compliance with best practice standards and the applicable provisions of the Advisers Act, as modified by the Act, prior to registration.
- Private funds must promptly revise their offering materials and subscription monitoring procedures to screen for a revised “accredited investor” standard, which will particularly impact investment advisers whose funds offer interests to US investors in reliance on the Section 3(c)(1) exception under the Investment Company Act.

These provisions, and others, are discussed in more detail below.

Changes to General Adviser Registration Requirements

Currently, many investment advisers, including many advisers to private funds, may avoid registration as an investment adviser with the SEC in reliance on the so-called “private adviser exemption” set forth in Section 203(b)(3) of the Advisers Act. This provision provides a registration exemption to an investment adviser that:

- does not publicly hold itself out as an investment adviser;
- does not serve as investment adviser to a US-registered investment company; and
- has fewer than 15 clients during the prior 12 month period.

¹⁶ A “private fund” is defined broadly under the Act as any issuer that would be an “investment company” under the Investment Company Act, but for the exceptions set forth in Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act.

For purposes of this exemption, a private fund generally will count as a single “client”, and investment advisers located outside of the United States must only count their US clients.

The Act effectively rescinds the private adviser exemption, with the result that US-based advisers may no longer avoid regulation by limiting the number of clients to which they provide advisory services.¹⁷ The Act also raises the threshold for permitted federal registration of an investment adviser under Section 203A of the Advisers Act from US\$25 million to US\$100 million in assets under management. Accordingly, the states will have the exclusive responsibility for supervising most investment advisers with less than US\$100 million in assets under management, unless such an adviser otherwise is required to register with the SEC.¹⁸

The Act also makes private fund advisers ineligible to rely on the current exemption from registration for intra-state investment advisers set forth in Section 203(b)(1) of the Advisers Act, by requiring intra-state investment advisers to private funds to register with the SEC. However, the Act retains, in modified form, an exemption from registration available to registered commodity trading advisers whose advice does not predominantly relate to securities.

Foreign Private Adviser Exemption

Under the Act, the current Section 203(b)(3) private adviser exemption is replaced by an exemption from registration for any investment adviser that is a “foreign private adviser,” which is defined as an investment adviser that:

- has no place of business in the United States;
- has less than US\$25 million in aggregate assets under management that are attributable to clients in the United States and investors in the United States in private funds advised by the investment adviser;¹⁹

¹⁷ As discussed below, investment advisers located outside of the United States that source a small amount of assets from US investors will retain a limited exemption from registration.

¹⁸ Unless otherwise exempt from registration, an investment adviser whose principal office and place of business is outside of the United States is required to register with the SEC, rather than state regulators, regardless of the amount of assets under management.

¹⁹ The SEC is granted the authority to raise the US\$25 million dollar threshold.

- has, in total, fewer than 15 clients and private fund investors in the United States;²⁰ and
- neither (i) holds itself out generally to the public in the United States as an investment adviser nor (ii) advises US-registered investment companies or business development companies.

Accordingly, any non-US adviser with more than 14 US clients and US investors in private funds, or that manages US\$25 million or more of assets attributable to US clients and US investors, may be required to register with the SEC if they do not qualify for any other exemption.

As a result of the imposition of significant limits on the number of US clients/investors and assets that may be sourced from US clients/investors, the Act may require the registration of many non-US advisers that engage in fundraising efforts in the United States on more than a sporadic or opportunistic basis.²¹

Other Exemptions from Registration

The Act provides several other important exemptions from the registration requirements of the Advisers Act, all of which potentially may be available to non-US investment advisers:

- Investment advisers to venture capital funds – Investment advisers whose only clients are one or more venture capital funds will be exempt from registration. Within one year of the date of enactment of the Act, the SEC is required to define the term “venture capital fund.” The SEC will impose such record-keeping and reporting obligations on venture capital fund advisers as it determines to be necessary or appropriate.
- “Family office” exemption – Family offices will be excluded from the definition of “investment adviser” under the Advisers Act, and thus from the registration requirements

²⁰ Unlike the current private adviser exemption, the foreign private adviser exemption’s numerical limitation on the number of permitted clients or investors is not determined with reference to any particular time period. However, this oversight may be addressed via regulatory or interpretive guidance from the SEC and its staff.

²¹ While the Act does not specifically address this point, US-registered investment advisers domiciled outside of the United States presumably will still be able to rely on the “regulation lite” regime, under which the substantive provisions of the Advisers Act do not apply with respect to such advisers’ management of non-US client accounts.

thereunder, with the SEC to define the term “family office” in a manner consistent with regulatory relief granted in the past and that “recognizes the range of organizational, management and employment structures and arrangements employed by family offices.”

- Small Private Fund Advisers – Investment advisers whose sole clients are private funds and who have assets under management in the United States of less than US\$150 million will be exempt from registration, although they will be subject to recordkeeping and reporting requirements. This exemption is subject to SEC rulemaking. Presumably as part of that rulemaking, the SEC will provide further clarity around whether a non-US adviser who has clients that are not private funds (e.g., funds and/or managed accounts not offered to US investors) would be able to utilise this exemption and how the threshold amount of US\$150 million of assets under management in the United States should be calculated by non-US advisers.

While not exempt from registration, investment advisers whose sole clients are “mid-sized private funds” will be subject to registration and examination procedures tailored to reflect the level of systemic risk posed by such advisers and their funds. The Act does not define what will constitute a mid-sized private fund, which presumably will be defined during the rulemaking process.

Recordkeeping and Reporting Obligations

Under the Act, the SEC will be able to require a registered adviser to a private fund to maintain and file with the SEC certain information relating to each private fund it advises that is relevant to the protection of investors and assessment of systemic risk. Such information will include:

- assets under management;
- information on the use of leverage (including off-balance-sheet leverage);
- counterparty credit risk exposure;
- trading and investment positions;
- valuation policies and procedures;
- types of assets held;
- side letters;
- trading practices; and

- such other information as the SEC, in consultation with the Council, may determine, which may vary based on the type of or size of the private fund advised by the investment adviser.

The SEC is required to promulgate rules requiring registered investment advisers to private funds to file reports with the SEC containing such information as is determined to be necessary and appropriate for the protection of investors and the assessment of systemic risk. The SEC also is required to periodically examine records maintained by registered advisers to private funds, and may examine records at such other times as it may determine.

For non-US investment advisers it is not clear whether these recordkeeping and reporting requirements will apply to all private funds advised by the non-US investment adviser or just those private funds which have US investors.

Private funds' "proprietary information," as defined in the Act, is not considered public information and is strictly shielded from public disclosure, although the SEC is required to make available to the Council copies of all documents and information filed that the Council considers to be necessary for the purpose of assessing systemic risk. The SEC also must report annually to the US Congress on how the SEC has used the data it has collected. Information gathered and shared with the Council or any department, agency, or self-regulatory organisation that receives such reports or information from the SEC, generally must be handled in a manner consistent with provisions for confidential treatment of such records and reports that are added under the Act in order to shield this information from disclosure pursuant to US Freedom of Information Act requests.

Other Noteworthy Provisions

Accredited Investor Definition

Private funds generally offer and sell their interests only to investors that qualify as "accredited investors" under applicable SEC regulations (in addition to other qualifications that the private fund may impose). Effective immediately upon approval of the Act, US "accredited investor" standards will be boosted to require that individuals and couples must have a net worth in excess of US\$1 million **excluding** the value of their primary residence before investing in a private placement. The current standard includes the value of the primary residence. Accordingly, funds and administrators

should promptly revise their offering materials and subscription monitoring procedures to screen for this revised standard.

The SEC also will be required to periodically review and (potentially) adjust the net worth and other requirements for natural persons to qualify as accredited investors not less frequently than once every four years. However, the SEC may not adjust the "net worth" component of the accredited investor standard during the first four years after enactment of the Act.

The impact of the initial or any subsequent change to the accredited investor standard on existing investors in private funds who no longer qualify under the revised standard while making a subsequent investment is unclear, and may need to be addressed during subsequent SEC rulemaking or SEC staff interpretations.

Qualified Client Standard

US registered investment advisers may charge performance-based compensation, such as an incentive allocation or performance fee, only to clients that meet the definition of "qualified client" in Rule 205-3 under the Advisers Act. The following categories of investors are qualified clients:

- A natural person or company with at least US\$750,000 under management by the investment adviser;
- A natural person or a company that the investment adviser reasonably believes is either (i) a "qualified purchaser" or (ii) has a net worth (together, in the case of a natural person, with assets held jointly with a spouse) of more than US\$1.5 million; or
- An executive officer, director, trustee, general partner, or certain key personnel of the investment adviser.

For a private fund that offers interests to US investors without registration in reliance on the exception from registration as an investment company pursuant to Section 3(c)(1) of the Investment Company Act, a registered investment adviser of that fund must look through to the investors in the fund and verify that only those fund investors who qualify as "qualified clients" pay performance-based compensation.²²

²² A private fund that relies on the Section 3(c)(7) exception generally must sell interests only to "qualified purchasers", which by definition are also "qualified clients".

The Act requires that the SEC, within one year of the Act's enactment, and every five years thereafter, adjust the above dollar amount tests to reflect the effects of inflation. The revised test would be rounded to the nearest US\$100,000.

As with the revised accredited investor standard (above), the impact of any change to the qualified client standard on existing investors in private funds who no longer qualify under the revised standard is unclear, and likely will have to be addressed during subsequent SEC rulemaking or SEC staff interpretation.

Remuneration Restrictions

The Act contains a provision that requires US regulators to adopt rules requiring covered financial institutions (including investment advisers) with more than US\$1 billion in assets to disclose the structures of all incentive-based compensation arrangements offered by the covered financial institution so that regulators may determine whether the compensation structure (i) provides an executive, officer, employee, director or principal shareholder of the financial institution with excessive compensation, fees or benefits; or (ii) could lead to a material financial loss to the covered financial institution. The provision also requires US regulators to adopt rules that prohibit any types of incentive-based payment arrangements that the regulators determine encourage those sorts of inappropriate risks.

While the scope of the extraterritorial application of these provisions may be limited during the course of regulatory implementation, it is likely that large non-US investment advisers to private funds that are required to register with the SEC will be subject to any restrictions placed on incentive-based compensation schemes.

Custody Rules

The Act adds a new provision to the Advisers Act that requires a registered investment adviser to safeguard any client assets over which the adviser has custody in accordance with SEC rules. The SEC currently regulates investment adviser custody under the anti-fraud provisions of the Advisers Act.

Industry Studies

The Act calls for a number of industry studies that will ultimately impact the operation of US registered investment advisers:

- The Comptroller General of the United States must conduct a study and compile a related report regarding the compliance costs of custody rules applicable to custody of client assets and related recordkeeping obligations.
- The General Accounting Office ("GAO") is required to conduct a study on the feasibility of creating a self-regulatory organisation governing private funds. The GAO also will be required to conduct a study on the appropriate criteria for determination of "accredited investor" status and investment in private funds.
- Finally, the Division of Risk, Strategy, and Financial Innovation of the SEC is required to conduct a study on the impact of short selling on national securities exchanges and over-the-counter markets.

Effective Date

The investment adviser registration provisions of the Act become effective one year after the date of enactment, with the expectation that investment advisers will comply with the provisions of the Act prior to the expiration of the one-year transition period.

Derivatives Regulation

Title VII of the Act, entitled the "Wall Street Transparency and Accountability Act of 2010", includes a set of provisions aimed at over-the-counter ("OTC") derivatives reform which require, among other things, clearing and exchange trading for most OTC derivatives contracts, and impose new capital and margin requirements and various reporting and record-keeping obligations on OTC swap dealers ("Swap Dealers") and most large OTC swap participants ("Major Swap Participants"). Title VII also requires Swap Dealers and most Major Swap Participants, depending on whether their derivatives business involves securities or commodities, to register with the SEC or CFTC.

If a non-US company meets the definition of Swap Dealer or Major Swap Participant, these provisions will apply. The SEC and the CFTC will likely look to exert jurisdiction over these non-US entities, and will be authorised to prohibit these entities from participating in swaps with US counterparties if necessary to the stability of the US financial system.

What OTC Derivatives Are Covered

For these purposes a “swap” is defined broadly to cover most commonly traded OTC derivatives, including: forwards and options on interest rates, currencies, commodities, securities, indices and various other financial or economic interests or property; contracts in which payments and deliveries are dependent on the occurrence or non-occurrence of certain contingencies (e.g., a credit default swap); and swaps on rates and currencies, total return swaps and various other common swap transactions.

Major Swap Participants

The Act defines a “Major Swap Participant” as any person who is not a Swap Dealer (see below), and:

- who maintains a “substantial position” in swap transactions, excluding positions held for hedging or mitigating the participant’s commercial risk and positions held by employee benefit plans for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan;
- whose outstanding swaps create “substantial counterparty” exposure that could have serious adverse effects on the financial stability of the US banking system or financial markets; or
- who is a financial entity, other than an entity predominantly engaged in providing financing for the purchase of an affiliate’s manufactured goods, that: (A) is “highly leveraged relative to the amount of capital it holds” and is not subject to capital requirements established by an appropriate Federal banking agency and (B) maintains a substantial position in outstanding swaps transactions (a “Covered Financial Entity”).

Title VII excludes from the major swap participant definition any entity whose primary business is providing financing, and uses derivatives for the purpose of hedging underlying commercial risks related to interest rate and foreign currency exposures, 90% or more of which arise from financing that facilitates the purchase or lease of products, 90% or more of which are manufactured by the parent company or another subsidiary of the parent company.

The SEC and CFTC are required to define “substantial position” as the amount the agencies determine prudent for the effective monitoring, management and oversight of market participants that are systemically important or can significantly impact the financial system of the United States.

However, there is no indication as to whether the “substantial position” will be determined across affiliated entities, such as across multiple funds advised by a single manager, or whether it will be determined on a person-by-person basis (e.g., long positions against short positions within a single portfolio). It is also unknown whether posted margin will be considered or relevant in determining whether a large swap position constitutes a substantial position.

The determination of what will constitute “substantial counterparty exposure” is also unclear. For example, while a hedge fund may have US\$10 billion in outstanding swaps facing an individual dealer, a US\$10 billion counterparty exposure to a dealer with a US\$1 trillion balance sheet—i.e., 1% of the dealer’s assets—might not be considered “substantial.”

Swap Dealers

A “Swap Dealer” is defined as any person who: (i) holds itself out as a dealer in swaps; (ii) makes a market in swaps; (iii) regularly enters into swaps with counterparties as an ordinary course of business for its own account; or (iv) engages in activity causing the person to be commonly known in the trade as a dealer or market maker in swaps. However, an insured depository institution will not be considered to be a swap dealer to the extent it offers to enter into a swap with a customer in connection with originating a loan with that customer.

Clearing

The Act requires clearing of most categories of swap transactions by a “derivatives clearing organization” or “DCO.” Parties to a swap that is not accepted by a DCO are required to report the swap to a “swap data repository” or “SDR.” An SDR is generally defined as any person that collects, calculates and prepares information or records related to transactions or positions in, or the terms and conditions of, swaps entered into with third parties.

Exchange Trading of Certain Swaps

The Act mandates that a swap that is cleared on a DCO must be traded on a board of trade designated as a “contract market” (i.e., a futures exchange) or a “swap execution facility” (“SEF”). An SEF is a facility in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by other participants, through any means of interstate commerce. Given that the initial exchange

trading of swaps is likely to be relatively illiquid, it is unclear whether swap participants will be required to transact directly with the relevant exchange or if participants will be able to contact dealers off the exchange to initiate a transaction, provided that the execution of the swap prints on the relevant exchange.

Capital and Margin Requirements

The Act imposes on registered Swap Dealers and Major Swap Participants new regulatory capital requirements and initial and variation margin requirements on non-cleared swaps. Initial margin and variation margin will be set at levels that, at a minimum, address counterparty “safety and soundness” concerns. Swap Dealers and Major Swap Participants will face initial and variation margin requirements on cleared swaps through the relevant derivatives clearing organisation.

Push-out Provisions

Title VII prohibits federal financial assistance from being provided to any “swaps entity,” which generally means any Swap Dealer or Major Swap Participant that is registered with the CFTC or SEC, but does not include any Major Swap Participant that is also an insured depository institution. The prohibition prevents the Federal Reserve or FDIC from (i) making any loans to, or purchasing any stock, equity interest, or debt obligation of, any swaps entity; (ii) purchasing the assets of any swaps entity; (iii) guaranteeing any loan or debt issuance of a swaps entity; or (iv) otherwise entering into any assistance arrangement (including tax breaks), loss sharing, or profit sharing with any swaps entity. In light of the Swap Dealer definition, banks that operate a traditional lending business, together with limited and related swap activities, appear to be permitted to continue these functions without being affected by the swap push-out rules.

Segregation Requirements for Cleared Swaps

All monies, securities or property from a swap customer to margin, guarantee or secure a swap cleared by a DCO or a clearing agency (for security-based swaps) must be held with a futures commission merchant (“FCM”), or a broker, dealer or security-based swap dealer (for security-based swaps). The FCM, broker, dealer or security-based swap dealer must separately account for and must not commingle all such customer property with its own funds. However, any such customer property may be commingled and deposited in the same account with any bank, trust company or DCO/clearing agency.

Segregation Requirements for Uncleared Swaps

A Swap Dealer or Major Swap Participant must notify a counterparty at the beginning of a swap transaction that the counterparty has the right to require segregation of the funds or other property supplied to margin, guarantee, or secure the obligations of the counterparty.

At the request of the counterparty, the Swap Dealer or Major Swap Participant must segregate the funds or other property and maintain such funds or other property in a segregated account separate from the assets of the Swap Dealer or Major Swap Participant. The segregated account must be carried by an independent third-party custodian and designated as a segregated account for and on behalf of the counterparty. The foregoing segregation requirements, however, do not apply to variation margin payments.

Extraterritorial Jurisdiction

If the CFTC or the SEC determines that the regulation of swaps or security-based swaps in a foreign jurisdiction undermines the stability of the United States financial system, the CFTC or SEC, as applicable, in consultation with the Department of Treasury, may prohibit an entity domiciled in such foreign jurisdiction from participating in the United States derivatives markets.

Conclusion

As highlighted above, the Act significantly changes the US federal regulatory framework applicable to many types of financial services companies, and particularly banks and other deposit taking institutions. While the Act’s principal focus is on US financial services institutions and US financial markets, a number of its provisions impact financial services companies operating in the United States or providing products and/or services to US clients and consumers. Such entities may wish to begin consideration of the extent to which the Act could effect their current operations.



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