Investment Funds Alert

Governance Provisions and Prudential Regulation Targeted at "Too Big to Fail" Entities Could Affect Fund Industry

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The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") includes new governance requirements and operational restrictions to address both the risks that large financial institutions pose to the financial stability of the United States and the conflicts of interests faced by deposit institutions and other large financial institutions. Several of those provisions could affect the investment fund industry, especially the (1) restrictions on proprietary trading by banks and non-bank financial companies (NBFCs) subject to regulation by the Board of Governors of the Federal Reserve System (the "Federal Reserve Board"), (2) restrictions on investment in, or ownership or sponsorship of, hedge funds and private equity funds by banks and NBFCs subject to supervision by the Federal Reserve Board ("Supervised NBFCs"), (3) requirements for the reporting and the possible prohibition of incentive-based compensation for financial institutions (which may include fund managers), (4) extra level of prudential regulation for certain bank holding companies and NBFCs[1] that could pose systemic risk and (5) the appointment of the Federal Deposit Insurance Corporation (FDIC) as receiver for financial entities. A "financial company" is defined as a company, with certain exceptions, that satisfies either of two 85 percent tests: (1) a gross revenues test (it derives at least 85 percent of its gross revenues from activities that are financial in nature (which activities include, among other things, advising an investment company, lending activities or investing money or securities for others) together, if applicable, with revenues from the ownership of an insured depository institution) or (2) an assets test (at least 85 percent of the consolidated assets of the company relate to activities that are financial in nature or are related to ownership of such depository institution).

Many of the above requirements will be implemented and/or recommended by the Federal Reserve Board, by a newly formed super-regulator called the Financial Stability Oversight Council (the "Council") and other banking and other regulators over a period of nine months to two years from the date of enactment.

The Volcker Rule

Applicability

The "Volcker Rule" bans certain banking entities from (1) engaging in proprietary trading and (2) sponsoring hedge funds or private equity funds or acquiring or retaining equity, partnership or other ownership interests in hedge or private equity funds, subject to certain exceptions. The Volcker Rule applies to insured depository institutions, companies that control an insured depository institution, companies treated as bank holding companies under Section 8 of the International Banking Act of 1978 and subsidiaries of any such companies (each a "Banking Entity"), including former securities firms that have converted to bank holding companies and then financial holding companies, such as Morgan Stanley and Goldman Sachs. The Volcker Rule is not, however, applicable to the activities of a non-U.S. banking organization that is not directly or indirectly controlled by a Banking Entity that is organized under the laws of the United States or of one or more states and whose activities occur "solely outside of the United States." The Volcker Rule's restrictions do not apply to any Supervised NBFC, but the Volcker Rule subjects Supervised NBFCs to potential additional capital requirements for, and additional quantitative limits with regards to, such activities (to be subsequently promulgated by rules and regulations).

[1] While bank holding companies may also be subject to extra regulation, this alert focuses on the impact of the Dodd-Frank Act on advisers to funds.

Proprietary Trading

As stated above, the Volcker Rule prohibits a Banking Entity from engaging in "proprietary trading" other than trading specified under the permitted activities below. It also subjects a Supervised NBFC to capital requirements and quantitative limits for its proprietary trading activities. The Volcker Rule defines proprietary trading as purchasing or selling, or otherwise acquiring or disposing of any security, derivative, commodity future or any option on any security, derivative or commodity future for its own account for the purpose of selling investments in the near term.

The Volcker Rule allows the following proprietary trading activities as "permitted activities" (subject to any restrictions or limitations that federal bank regulators, the Securities and Exchange Commission (SEC) or the Commodity Futures Trading Commission (CFTC) may subsequently impose)—

- investments in obligations of the United States or any agency of the United States, a state or a municipality, certain instruments issued by Ginnie Mae, Fannie Mae, Freddie Mac or a Farm Credit System institution
- purchasing, selling or otherwise acquiring or disposing of securities or instruments in connection with underwriting or as part of market-making activities
- risk-mitigating hedging activities in connection with positions of a Banking Entity that are designed to reduce specific risk to such entity from such positions, contracts or holdings
- purchasing, selling or otherwise acquiring or disposing of securities or other instruments on behalf of a customer
- certain investments in small business investment companies
- under certain conditions, the purchase, sale, acquisition or disposition of securities or other instrument by an insurance company or an affiliate for the general account of the company
- other activities as the appropriate federal banking agencies, the SEC and the CFTC determine.

Sponsorship of, and Investment in, Private Equity and Hedge Funds

The Volcker Rule prohibits a Banking Entity from acquiring or retaining "any equity, partnership or other interest in" or sponsoring a hedge or private equity fund. As with proprietary trading, it also subjects a Supervised NBFC to capital requirements and quantitative limits for its ownership, acquisition or sponsorship of a hedge or private equity fund if it conducts any of those activities. The Volcker Rule defines sponsorship of a fund to include any of the following activities: (1) serving as a general partner, managing member or trustee of a fund; (2) selecting or controlling (or having employees, officers, directors or agents who constitute) a majority of the directors, trustees or management of the fund; or (3) sharing the same name or a variation of the same name with the fund for corporate, marketing, promotional or other purposes. Sponsoring is **not** defined to include serving as an investment adviser to a hedge or private equity fund (although a Banking Entity serving in such role would be subject to the restrictions under Sections 23A and 23B of the Federal Reserve Act as further discussed below).

A "private equity fund" and a "hedge fund" are each defined as "an issuer that would be an investment company but for the exemption from registration Sections 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940" as well as a "similar" fund "as jointly determined by the appropriate Federal banking agencies" (i.e., the appropriate federal banking regulators, the SEC or the CFTC, as applicable).

The Volcker Rule allows Banking Entities to organize, sponsor and offer hedge and private equity funds under the following circumstances—

- the Banking Entity provides bona fide trust, fiduciary or investment advisory services
- the fund is organized and offered only in connection with the provision of those services, and only to customers of the Banking Entity that use such services

- the Banking Entity does not acquire or retain an equity interest or other ownership interest in the fund other than for establishing the fund or making a de minimis investment, each of which is subject to the following limitations—:
  - not later than one year after the establishment of the fund, the Banking Entity owns not more than 3 percent of the fund's total ownership interests
  - its investment in the fund is immaterial to the Banking Entity (to be defined by regulators), and, in the aggregate, all such investments do not exceed 3 percent of such Banking Entity's Tier 1 capital.
- the Banking Entity and affiliates comply with the requirements of sections 23A and 23B of the Federal Reserve Act
- the Banking Entity does not share with the fund, for corporate, marketing, promotional or other purposes, the same name or a variation of the same name
- other than a director or employee who is directly advising the fund, no Banking Entity director or employee takes an ownership interest in the fund
- the Banking Entity discloses to investors, in writing, that any losses in the fund will be borne solely by the investors and not the Banking Entity.

Conflicts and Risks

No permitted activity or permitted sponsorship of a hedge or private equity fund is permitted if such activity would (1) involve or result in a material conflict of interest between the Banking Entity and its clients, customers or counterparties, (2) result, directly or indirectly, in a material exposure by the Banking Entity to high-risk assets or high-risk trading strategies, (3) pose a threat to the safety and soundness of such Banking Entity or (4) pose a threat to the financial stability of the United States. It is expected that rules will be enacted to provide more clarity on these conflicts and risks.

Sections 23A and 23B Compliance

The Volcker Rule bans certain "covered transactions" (as such term is defined in Section 23A of the Federal Reserve Act) between a hedge or private equity fund and the Banking Entity that serves, directly or indirectly, as the fund's investment manager, investment adviser or sponsor of that fund, or if the Banking Entity organizes and offers the fund as a permitted activity in connection with bona fide trust, fiduciary or investment advisory services.

Examples of covered transactions include the following—

- a loan or extension of credit to the fund
- a purchase of, or an investment in, securities issued by the fund;[2]
- a purchase of assets, including assets subject to repurchase, from the fund
- the acceptance of securities issued by the fund as collateral for a loan or extension of credit to any third party
- a guarantee, acceptance, or letter of credit on behalf of the fund.

The Volcker Rule also subjects such Banking Entities to Section 23B of the Federal Reserve Act, which requires that all transactions between an insured depositary institution and its affiliates be on an arm's-length basis or on better terms from the perspective of the insured depositary institution. Hence, transactions that are not "covered transactions" (which are, per se, not allowed) would need to be on market terms, that is, on terms that would be offered to an unaffiliated third party.

[2] We believe that the specifically permitted investment levels in the Volcker Rule will trump this provision incorporated by reference from the Federal Reserve Act, but the Volcker Rule is not clear on this point.

Notwithstanding the prohibition on covered transactions under Section 23A, the Federal Reserve may permit "any prime brokerage transaction" between a Banking Entity or an NBFC and a hedge fund or private equity fund that is managed, sponsored or advised by such Banking Entity or NBFC if the Federal Reserve determines that such transaction is consistent with the "safe and sound operation and condition" of such Banking Entity or NBFC. Any exemption of prime brokerage arrangements from the "covered transactions" ban does not exempt such transactions from any Section 23B requirement that otherwise applies thereto.

Review, Rules and Regulations

Within six months of the enactment of the Volcker Rule, the Council will study and issue recommendations on implementing the Volcker Rule (addressing, among other things, conflicts of interest, financial stability concerns, minimization of risks and appropriate timing for certain divestitures to be required under the rule). No later than nine months thereafter, the federal banking agencies, securities and commodities regulators are to issue rules implementing the Volcker Rule's provisions. Such provisions will then become effective on the earlier of (1) 12 months after the final rules are issued or (2) two years after the enactment of the Volcker Rule.

Divestment of Nonconforming Investments and Activities

A Banking Entity or a Supervised NBFC needs to conform with the Volcker Rule within the later of two years following (1) the effective date of the rules (which cannot be more than four years from enactment) and (2) the date on which it became a Banking Entity or a Supervised NBFC. The Federal Reserve Board, by rule or order, may extend this two-year transition period, one year at a time, for up to three additional years (i.e., up to seven years from enactment of the Volcker Rule) if it determines such extensions to be consistent with the purposes of the Volcker Rule and not detrimental to the public interest.

Extensions for Illiquid Funds

The Federal Reserve may approve an additional extension (not in excess of five years) to the period during which the Banking Entity may take or retain its equity, partnership or other ownership interest in, or otherwise provide additional capital to, an illiquid fund (i.e., a fund that is primarily invested in illiquid assets, such as portfolio companies, real estate investments and venture capital investments), but only to the extent necessary to fulfill a contractual obligation that was in effect on May 1, 2010. Regardless, divestiture is required once the contractual obligation to invest in the illiquid fund terminates. This potential five-year extension for illiquid investments is in addition to the basic two-year period (and up to three one-year extension) for divestitures.

Incentive-Based Compensation for Covered Financial Institutions

The Dodd-Frank Act requires appropriate federal regulators to jointly prescribe regulations or guidelines to require each "covered financial institution" with assets of $1 billion or more to disclose to the appropriate federal regulator the structures of all incentive-based compensation arrangements offered by such institution sufficient to determine whether the compensation structure provides an executive officer, employee, director or principal shareholder with excessive compensation, fees or benefits or could lead to material financial loss to the institution. "Covered financial institutions" are defined to include investment advisers, registered broker-dealers, credit unions, depository institutions, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation and any other financial institution determined by rule. Reporting of actual compensation of particular individuals is not required.

The regulators must also prescribe regulations or guidelines that prohibit any types of incentive-based payment arrangement, or any feature of any such arrangement, that the regulators determine encourage inappropriate risks by covered financial institutions (1) by providing an executive officer, employee, director or principal shareholder with excessive compensation, fees or benefits or (2) that could lead to material financial loss to the institution. The Dodd-Frank Act provides the regulators with nine months after the enactment of the Act to prescribe the regulations or guidelines discussed above.

Prudential Regulation

Becoming a Supervised NBFC

The Dodd-Frank Act creates two new entities, the Council, a super-regulatory body consisting of the heads of many financial regulators, and the Office of Financial Research (OFR), a data-collecting research agency supporting the Council to, among other things, identify risks to the financial stability of the United States. As part of that task, the Council and the OFR will monitor the activities of NBFCs and large interconnected bank holding companies. Advisers to hedge and private equity funds are considered NBFCs and, depending on their size and other risk factors, may be monitored by the Council and the OFR.[3]

If two-thirds of the voting members of the Council (including the secretary of the Treasury as chairperson) determine that material financial distress at an NBFC or the "nature, scope, size, scale, concentration, interconnectedness or mix of the activities" at the NBFC could pose a threat to the financial stability of the United States, the Council will require an NBFC to register with the Federal Reserve Board. In reaching that conclusion, the Council is required to consider (1) the extent of leverage of the company; (2) the extent and nature of the off-balance-sheet exposures of the NBFC; (3) the extent and nature of the transactions and relationships of the NBFC with other NBFCs and significant bank holding companies; (4) the NBFC's importance as a source of credit for households, businesses and state and local governments and as a source of liquidity for the U.S. financial system; (5) the importance of the NBFC as a source of credit for low-income, minority or underserved communities and the impact that the failure of such NBFC would have on the availability of credit in such communities; (6) the extent to which assets are managed, rather than owned, by the NBFC and the extent to which ownership of assets under management is diffuse; (7) the nature, scope, size, scale, concentration, interconnectedness and mix of the NBFC's activities; (8) the degree to which the NBFC is already regulated by one or more primary financial regulatory agencies; (9) the amount and nature of the NBFC's financial assets; (10) the amount and types of the NBFC's liabilities, including the degree of reliance on short-term funding; and (11) any other risk-related factors that the Council deems appropriate.

Bank holding companies may only be subject to additional regulation if they have $50 billion or more in assets. No minimum asset threshold applies for being determined to be a Supervised NBFC, but the Council may take into account the level of assets for a bank holding company to be subject to additional regulation (i.e., $50 billion). In addition, the Federal Reserve Board is required, in consultation with the Council, to adopt rules providing a safe harbor for types and classes of NBFCs from being deemed a Supervised NBFC.

Once the Council determines that an NBFC shall be a Supervised NBFC, the Council will provide notice of its determination to the NBFC, which can be appealed to the Council within 30 days. Upon receiving notice of an NBFC's request for an appeal, the Council must set a hearing date within 30 days and provide a final determination within 60 days of the hearing. A final determination can be appealed in the appropriate District Court within 30 days. An NBFC shall register with the Federal Reserve Board within 180 days of final determination per the above process. Once an NBFC becomes a Supervised NBFC, it will become subject to assessments to fund the QFC and the Liquidation Fund (as defined below).

Prudential Standards for NBFCs

The Council will recommend prudential standards and reporting and disclosure requirements for Supervised NBFCs and large, interconnected bank holding companies to the Federal Reserve Board. The Council's prudential recommendations may include (1) risk-based capital requirements, (2) leverage limits, (3) liquidity requirements, (4) resolution plan and credit exposure reporting requirements, (5) concentration limits, (6) contingent capital requirements, (7) enhanced public disclosure and (8) overall risk management requirements. The Dodd-Frank Act authorizes the Council to recommend to the Federal Reserve Board more stringent standards and requirements for certain large bank holding companies and Supervised NBFCs, based on the type or extent of risks to the financial stability of the United States that such companies pose in light of their capital structure, financial activities and size. The Council is also required to study imposing contingent capital requirements, which will be convertible into equity in times of financial distress.

Irrespective of whether the Council makes recommendations, the Federal Reserve Board is required to impose (1) risk-based capital requirements (through minimum consolidated leverage capital limits and consolidated risk-based capital requirements), (2) leverage limits of no more than 15-to-1 upon determination by the Council that the Supervised NBFC poses a grave threat to the financial stability of the United States, (3) liquidity requirements, (4) overall risk management requirements, (5) resolution plan filing requirements that set forth the Supervised NBFC's plan for rapid and orderly resolution in the event of material financial distress or failure, (6) credit exposure reporting requirements and (7) limits on

[3] The Council consists of the secretary of the Department of the Treasury, the chairman of the Federal Reserve Board, the comptroller of the Currency, the director of the Bureau of Consumer Financial Protection, the chair of the Securities and Exchange Commission, the chairperson of the FDIC, the chairperson of the Commodity Futures Trading Commission, the director of the Federal Housing Finance Agency, the chairman of the National Credit Union Administration Board, an independent member with insurance expertise appointed by the president and several non-voting members.

exposure to any nonaffiliated company to 25 percent of the capital stock plus surplus.[4] In addition, the Federal Reserve Board may impose (1) contingent capital requirements, (2) limits on short-term debt, (3) enhanced public disclosures and (4) other prudential standards that the Federal Reserve Board determines are appropriate. In exercising the above powers, the Federal Reserve Board has the power to stress-test the Supervised NBFC. The Federal Reserve Board also may, in consultation with the Council, require the amendment of a resolution plan and the divestiture of assets if the Supervised NBFC has failed to revise its resolution plan within two years of the Federal Reserve Board's request.

If the Federal Reserve Board determines that a Supervised NBFC poses a "grave threat to the financial stability" of the United States, and two-thirds consent of the voting members of the Council is obtained, the Federal Reserve Board may (1) limit the ability of that company to acquire or become affiliated with another company, (2) restrict the ability of that company to offer financial services, (3) terminate one or more financial activities of that company, (4) impose conditions on the conduct of activities or (5) sell or otherwise transfer assets or off-balance-sheet items to non-affiliates upon making such determination. The Federal Reserve Board will provide a notice to such entity, as well as an opportunity for a hearing. The Federal Reserve Board may also impose early remediation requirements for Supervised NBFCs, which may include limitations on distributions, acquisitions and asset growth and, in later stages of financial decline, capital raising, affiliate transaction limitations, management changes and asset sales.

The Federal Reserve Board may examine any Supervised NBFC to assess (1) the operations and financial condition of the Supervised NBFC and its subsidiaries, (2) the risks posed by that NBFC and its subsidiaries, (3) the systems for monitoring any controlling risks and (4) compliance with requirements of the Dodd-Frank Act. The Federal Reserve Board may also require any Supervised NBFC to file reports under oath regarding the Supervised NBFC or any subsidiary, including a summary of the operating, financial condition and any risk-based controls. The Council may require reports to be filed, to the extent that the information is not already contained in reports that are already required to be filed with any member of the Council.

Several provisions of the Bank Holding Company Act of 1956 will apply to Supervised NBFCs, including (1) limitations on acquisitions of 5 percent of the voting securities of a bank or bank holding company without prior notice and approval by the Federal Reserve Board, (2) prohibitions against management interlocks and (3) the Federal Reserve Board's ability to require the use of an intermediate holding company.

Effect on Foreign Entities

While the standards and regulations set forth in the Dodd-Frank Act would apply to foreign companies, there would be certain safeguards in place to ensure fair application. First, when supervising and imposing stricter standards on foreign NBFCs, the Council is required to consult with the relevant foreign regulatory authorities as it deemed appropriate and would only look to the foreign NBFC's U.S. activities. Second, the Council would consider the extent to which the foreign company is subject to comparable standards in its home country. Finally, the Council would be required to give due regard to the principle of national treatment and equality of competitive opportunity.

FDIC Receivership

The Dodd-Frank Act provides for the appointment of the FDIC as a receiver to liquidate a bank holding company, a Supervised NBFC, any financial company or any subsidiary of the above (a "Covered Financial Company").[5] Broker-dealers, insurance companies and insured depository institutions are subject to separate requirements for liquidation. Given the procedural hurdles required to appoint the FDIC as a receiver, the Bankruptcy Code may continue as the primary means of winding down most financial companies.

Placing a Financial Company in FDIC Receivership

The Federal Reserve Board and the FDIC, either on their own initiative or at the request of the secretary of the Treasury, may make a recommendation to appoint the FDIC as a receiver for a Covered Financial Company upon the vote of not fewer than

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[4] In prescribing prudential standards above, the Federal Reserve Board shall take into account the factors used by the Council in determining whether to make an NBFC subject to regulation by the Federal Reserve Board and whether the entity subject to regulation owns an insured depository institution, along with the non-financial activities and affiliations of the Supervised NBFC.

[5] The following are excluded from the definition of Covered Financial Company: (1) a Farm Credit System institutions, (2) governmental entities and (3) regulated entities under the Federal Housing Enterprises Financial Safety and Soundness Act of 1992.

two-thirds of the members of the Federal Reserve Board **and** not fewer than two-thirds of the members of the board of directors of the FDIC. The Treasury secretary will then consider (in consultation with the president) if (1) the financial company is in default or in danger of default;[6] (2) the failure of the financial company and its resolution under otherwise-applicable federal or state law would have serious adverse effects on financial stability in the United States; (3) no viable private sector alternative exists; (4) any effect on the claims or interests of creditors, counterparties and shareholders of the financial company and other market participants as a result of actions to be taken under this title is likely or appropriate; (5) any action for liquidation of the financial company by the FDIC as a receiver would avoid or mitigate such adverse effects, taking into consideration the costs and potential moral hazard; and (6) all of the financial company's convertible debt instruments that are subject to the regulatory order have been converted.

Once the secretary of the Treasury has determined that the factors have been satisfied, he or she will request the consent of the board of directors of the Covered Financial Company or, if the board of directors of the Covered Financial Company objects, an order from U.S. District Court for the District of Columbia through a confidential petition process. The request will be automatically granted unless said District Court determines within 24 hours of the petition that the determination was arbitrary and capricious.[7]

FDIC as Receiver

Once the FDIC is appointed as a receiver, all cases under the Bankruptcy Code shall be dismissed. The FDIC will act to liquidate the financial company so that creditors and shareholders bear the financial loss, all responsible parties for the financial condition of the financial company bear financial losses and management is removed and replaced.

While the financial company is in FDIC receivership, the FDIC will operate the Covered Financial Company and its failing subsidiaries and may provide some funding out of a fund that is created by assessment. Similar to the FDIC's authority under the Federal Deposit Insurance Act, the FDIC has broad powers under the Dodd-Frank Act and will be able to unilaterally take many actions that are only allowed with court approval under the Bankruptcy Code. The FDIC may, among other things (1) reject executory contracts subject to limited damages, (2) enforce contracts, (3) accept or reject claims, (4) avoid fraudulent transfers and preference payments, (5) sell or transfer any portion or all of a Covered Financial Company's assets to a third party without consent, (6) merge the Covered Financial Company with another company or (7) set off obligations. Additionally, the FDIC is permitted to create a federally chartered bridge financial company. This bridge financial company assumes such liabilities, transfers such customers purchases such assets and, succeeds to and assumes such rights as the FDIC deems appropriate. The bridge financial company will be operated for two years with a view to spinning out the bridge financial company or merging it with another entity. The term of the FDIC's receivership shall terminate within three years of its appointment, subject to two one-year extensions.

Qualified Financial Contracts

The Dodd-Frank Act contains special provisions for "qualified financial contracts (QFC)," defined to include securities contracts, commodity contracts, forward contracts, repurchase agreements, swap agreements or similar agreements as determined by the FDIC. First, if the FDIC repudiates a QFC, the counterparty shall be entitled to the cost of cover or other appropriate damages. Second, clauses for the termination of the QFC upon the appointment of a receiver in a QFC are enforceable, along with any rights under a security agreement, to offset payment amounts. Third, payment obligations falling under a QFC are suspended from the time the FDIC is appointed as receiver until the earlier of (1) the counterparty's receipt of notice that the QFC has been transferred to another financial institution and (2) 5 p.m. (EST) on the fifth business day following the date of appointment of the FDIC as receiver. Fourth, the Dodd-Frank Act provides that QFCs may be transferred to another financial institution during the business day after the appointment of the FDIC as a receiver. If QFCs are transferred, however, all QFCs between any person, or an affiliate thereof, must be transferred to the same financial

[6] A financial company shall be considered to be in default or in danger of default if, (1) a case has been, or likely will promptly be, commenced with respect to the financial company under the Bankruptcy Code; (2) the financial company has incurred, or is likely to incur, losses that will deplete all or substantially all of its capital, and there is no reasonable prospect for the company to avoid such depletion; (3) the assets of the financial company are, or are likely to be, less than its obligations to creditors and others; or (4) the financial company is, or is likely to be, unable to pay its obligations (other than those subject to a bona fide dispute) in the normal course of business.

[7] The order from the District Court may be appealed on an expedited basis, but the order of the District Court shall not be stayed during the pendency of the appeal.

institution. Fifth, if the FDIC wishes to disaffirm or repudiate a QFC held by a person, it must disaffirm or repudiate all other QFCs held by that person or an affiliate thereof.

Orderly Liquidation Fund

In order for the FDIC to be able to carry out its obligations for the liquidation of Covered Financial Companies, the Department of the Treasury shall establish an orderly liquidation fund (the "Liquidation Fund"). Contrary to previous versions of the financial reform bills, the Liquidation Fund will not be pre-funded. Instead, if the FDIC needs funds from the Liquidation Fund, the FDIC will issue debt to the Department of the Treasury. In order to repay that debt, an assessment will be made on financial companies. The assessment will be paid as a waterfall by (1) those who received more through the above FDIC resolution process than they would have received through a Chapter 7 proceeding under the Bankruptcy Code, (2) Supervised NBFCs and bank holding companies with more than $50 billion in assets and (3) financial companies other than Supervised NBFCs that have more than $50 billion in assets. The amount of the assessment will be risk-based and progressive. The FDIC will also have the right to collect a portion of its outlays from the compensation of the management of the covered financial institution within the two years preceding such payment.

Conclusion

The portions of the Dodd-Frank Act targeted at "too big to fail" institutions will likely impact investment funds and some investment advisers to those funds. The Volcker Rule may shrink the potential investor base for private funds. Restrictions and possible prohibitions on incentive compensation may end up reducing the compensation that fund managers are accustomed to receiving. Investment advisers that the Council deems to present special risks to the U.S. economic system may become Supervised NBFCs subject to increased restrictions on their operations. Finally, an investment adviser to a fund or a hedge or private equity fund may be pulled into the FDIC's liquidation authority.

CONTACT INFORMATION

If you have any questions concerning this alert, please contact —

Mark H. Barth
mbarth@akingump.com
212.872.1065
New York

Barry Y. Greenberg
bgreenberg@akingump.com
214.969.2707
Dallas

Eliot D. Raffkind
eraffkind@akingump.com
214.969.4667
Dallas

Wiliam L. Sturman
wsturman@akingump.com
212.872.1035
New York

Stephen M. Vine
svine@akingump.com
212.872.1030
New York

David M. Billings
dbillings@akingump.com
44.20.7012.9620
London

Prakash H. Mehta
pmehta@akingump.com
212.872.7430
New York

Fadi G. Samman
fsamman@akingump.com
202.887.4317
Washington, D.C.

Simon W. Thomas
swthomas@akingump.com
44.20.7012.9627
London

