WRITTEN STATEMENT

OF

MICHAEL R. BUTOWSKY, PARTNER
MAYER BROWN LLP

FOR THE JOINT MEETING ON HARMONIZATION OF REGULATION BEFORE THE COMMODITY FUTURES TRADING COMMISSION AND SECURITIES AND EXCHANGE COMMISSION

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Good morning, Chairman Gensler, Chairman Shapiro, and Commissioners of the CFTC and of the SEC. I am Michael Butowsky, a partner with the law firm of Mayer Brown LLP and I thank you for this opportunity to speak before you today.[1] In my law practice, I advise investment advisers (both registered and unregistered) to investment funds, including hedge funds and private equity funds. I am here to speak to you today about the regulation by the Securities and Exchange Commission ("SEC") of investment advisers to private investment funds and to suggest some potential areas to be considered for the harmonization of the regulation of investment advisers by the SEC and of commodities trading advisors by the Commodity Futures Trading Commission ("CFTC"). Please note that the views I am presenting today are my own and not the views of my firm or any of its clients.

I. Regulation of Private Funds

A. Investment Advisers.

Under the Investment Advisers Act of 1940, as amended (the "Advisers Act") an "investment adviser" means "any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities."[2] An entity or person who manages the investments of a private

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[1] My thanks to Michele ("Mitch") Gibbons, my partner, and Allyson Burg, an associate, at Mayer Brown for their assistance with this written statement.

[2] Advisers Act Section 202(a)(11). For reference, a "commodity trading advisor " is defined under Section 1a(6) of the Commodity Exchange Act, as amended (the "CEA") to include: (1) any person, who for compensation or profit, engages in the business of advising others – either directly or through publications, writings or electronic media – about trading in futures contracts, commodity options or certain so-called "leverage transactions" or (2) any person who, for compensation or profit, and as part of a regular business, issues or promulgates analyses or reports concerning these activities. The exemptions from registration as a commodity trading advisor under the CEA include an exemption for investment advisers that are registered with the SEC under the Advisers Act, whose business does not consist primarily of acting as a commodity trading advisor and that does not act as a commodity trading advisor to any investment trust or similar enterprise that is primarily engaged in trading commodities that are traded on or governed by a commodity exchange. See CEA Section 4m(3).

investment fund that involves securities is therefore an investment adviser. An investment adviser who has more than $25 million in client assets under management must register with the SEC or qualify for an exemption from registration.[3] Any person who meets the definition of an "investment adviser" under the Advisers Act (whether or not the person is required to be registered) is a fiduciary to its clients and is subject to the antifraud provisions of Section 206 of the Advisers Act.[4]

An investment adviser's fiduciary duty goes above and beyond that of just honesty and good faith. As a fiduciary, an investment adviser owes its clients the general duty to always act in the best interest of the client.[5] An investment adviser may be held liable for rendering less than disinterested advice, even in cases where it did not intend to injure the client and the client did not suffer monetary loss. An investment adviser must not trade on the basis of inside information, must allocate trades fairly and equitably among clients on an overall basis and must receive client consent when engaging in principal or agency cross-transactions.[6] In addition, this duty includes, among other things, the duty to seek best execution for client transactions. Under the antifraud provisions of the Advisers Act, an investment adviser is prohibited from making false or misleading statements or material omissions.[7] The SEC staff has also noted that an investment adviser's fiduciary duty may require the adviser to have policies and procedures that

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[3] Advisers Act Section 203A.

[4] *See SEC v. Capital Gains Research*, 375 U.S. 180 (Dec.9, 1963).

[5] *SEC v. Capital Gains Research,* 375 U.S. 180 (Dec. 9, 1963)

[6] See Advisers Act Section 206(3). A principal transaction is one in which an adviser acts as principal for its own account and sells or purchases securities from a client. An agency cross transaction is one where the adviser advises a client on one side of a transaction and acts as a broker on the other side.

[7] See Advisers Act Rule 206(4)-8 and Advisers Act Section 206.

cover business continuity of the adviser. Investment advisers also have a duty to supervise their employees and agents to prevent violations of applicable securities laws.[8]

To register with the SEC, an adviser must complete a Form ADV, which consists of two parts. Part I is filed online with the SEC and is aimed at providing information to clients and to regulators for use in examinations. The SEC has 45 days to approve the registration application. Upon approval by the SEC, registration is effective. Part II of Form ADV is for delivery to clients and describes various aspects of the adviser's business such as services, fees, types of clients and investments, and other business activities and practices. The Part I is publicly available and must typically be updated annually and when amendments are required. Part II of the Form ADV must be kept updated and current at all times and must be offered to clients on an annual basis.

Investment advisers that are registered with the SEC must fully comply with the Advisers Act including all of the rules thereunder, as well as undergo periodic inspections and examinations by the SEC's Office of Compliance, Inspections and Examinations ("OCIE"). The rules of the Advisers Act include, but are not limited to, restrictions on the terms of advisory contracts, certain trading practices, advertising, performance fees, solicitation arrangements[9], as well as books and records requirements[10] and custody requirements. Registered investment advisers are also required to designate a Chief Compliance Officer to maintain and implement a

8 See In the Matter of Robert Littell and Wilfred Meckel, Advisers Act Release 2203 (Dec. 15, 2003).

9 It should be noted that, in the context of private investment funds, the SEC Staff has provided interpretive guidance concerning the applicability of Advisers Act Rule 206(4)-3. Mayer Brown LLP. SEC No-Action Letter (July 28, 2008)..

10 Advisers Act Rule 204-2

compliance manual,[11] conduct annual reviews of compliance programs and maintain a Code of Ethics.[12]

Many investment advisers to private investment funds are also subject to other forms of regulation, including, but not limited to, regulation under the CEA, ERISA, the Bank Secrecy Act and state law. They may also be subject to reporting requirements under the Securities Exchange Act of 1934, Regulation D and state law. Many hedge funds are also subject to indirect regulation through their dealings with other securities market participants, including broker-dealers, banks and market exchanges.

B. Investment Company Act of 1940.

The Investment Company Act of 1940, as amended (the "1940 Act") provides that all "investment companies" need to register with the SEC. There are two primary exclusions from the definition of an "investment company" that are typically relied upon by private investment funds (such as hedge funds and private equity funds) to avoid 1940 Act registration. Section

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[11] Such compliance manual should include or address, at a minimum: (i) a privacy policy; (ii) the processes for portfolio management; (iii) a policy on the proprietary trading of the adviser as well as the trading activities of supervised persons of the adviser; (iv) insider trading procedures; (v) proxy voting guidelines; (vi) trading practices; (vii) the accuracy of disclosures made to investors, clients and regulators; (viii) the process for safeguarding client assets from conversion or inappropriate use by personnel; (ix) the process for accurate recordkeeping and maintenance; (x) marketing guidelines; (xi) processes to value client holdings and assess fees based on those valuations; (xii) safeguards for privacy protection of client records and information; (xiii) a business continuity plan; and (xiv) anti-money laundering policies. The Chief Compliance Officer is required to develop the appropriate policies and procedures. Such policies and procedures must undergo annual review to ensure their adequacy and effectiveness. See *Compliance Programs of Investment Companies and Investment Advisers*, Advisers Act Release 2204 (February 5, 2004) and *Put The Compliance Rule To Work: IA Compliance Best Practices Summit*, Speech by Lori Richards, Director, Office of Compliance Inspections and Examinations, U.S. Securities and Exchange Commission (March 15, 2004).

[12] See Advisers Act Rule 206(4)-7 and Rule 204A-1. The Code of Ethics is meant to reflect the investment adviser's fiduciary obligations and to require compliance with federal securities laws. The Code of Ethics must include provisions reasonably designed to prevent access to material non-public information about the investment adviser's securities recommendations and client securities holdings and transactions. It must also require access persons of the investment adviser to provide personal trading reports and require prompt internal reporting of any violations of the Code of Ethics to the investment adviser's Chief Compliance Officer. Registered investment advisers must provide each supervised person with a copy of the Code of Ethics and any amendments, and require each supervised person to acknowledge, in writing, his or her receipt of those copies. Investment advisers are also required to maintain and enforce the provisions of their Codes of Ethics.

3(c)(1) of the 1940 Act excludes from the definition of an "investment company" any issuer: (i) whose outstanding securities (other than short-term paper) are beneficially owned by 100 or fewer persons; and (ii) which is not making and does not presently propose to make a public offering (the "100 Person Exclusion"). Whether an offering is considered public for purposes of Section 3(c)(1) depends on a facts and circumstances analysis, but generally, if an offering is public for the purposes of the Securities Act of 1933, it is public for purposes of the 1940 Act.

The second exclusion is found is Section 3(c)(7) of the 1940 Act. Section 3(c)(7) provides that any issuer: (i) whose outstanding securities are beneficially owned exclusively by persons, who at the time of acquisition of such securities, are "Qualified Purchasers"[13] and (ii) which is not making and does not presently propose to make a public offering, is excluded from the 1940 Act's definition of an "investment company" and thus does not need to register with the SEC pursuant to the 1940 Act (the "Qualified Purchaser Exclusion").[14]

II. Proposals for the Harmonization of the SEC and CFTC

What follows is a listing of some steps that the SEC and CFTC may want to consider in connection with their mutual attempt towards the harmonization of regulation. Of course, some may be determined, upon consideration, to not be practical, but many may be found to be useful.

While the area of focus of my law practice is not on the futures world (I focus primarily on private funds and the Advisers Act and the 1940 Act), my understanding, based upon what

[13] The term "qualified purchasers" is defined in Section 2(a)(51) of the 1940 Act. In general, "qualified purchasers" are individuals having $5 million in investments or entities having $25 million in investments.

[14] There is a significant number of SEC Staff "no-action letters" through which the industry has taken interpretive guidance relating to the 100 Person Exclusion (*e.g.*, as to how the 100 count is conducted in the case of investors formed for the purpose of investing in a 100 Person Fund, how married couples investing jointly are counted, and whether the count is combined for 100 Person funds that have similar portfolio, risk and return characteristics) and the Qualified Purchase Exclusion (*e.g.*, as to how determinations of Qualified Purchaser status are made in the context of investors formed for the purpose of investing in a Qualified Purchaser fund and who constitutes a family member for purposes of the category of Qualified Purchaser relating to family offices.

others have said, is that, when the CFTC was first created many years ago, there were clear and logical reasons for the distinctions in regulation that existed at that time primarily due to the differences between the securities and the futures markets. However, over time, sentiment seems to be gathering that in some cases the reasons for different types of regulation has disappeared due to an alignment of securities and futures trading practices.[15]

If there is any overall theme to my suggestions, it is that for any harmonization of regulation to be successful, there must be a significant focus on what might appear to be esoteric concepts, but in reality, may drive the success or failure of any harmonization attempt. For example, consideration needs to be given to whether there should be an alignment of the registration forms, inspection processes, rules that address similar topics, interpretations of similar rules, and regulatory examination focus areas. These sorts of things could, I believe, get the two regulators thinking along the same path, and facilitate regulatory harmonization.

A. <u>Regulatory Approach</u>.

As has been mentioned by others,[16] the SEC takes a "rules based" approach to regulation, while the CFTC takes a "principles based" approach. While I understand the distinction in concepts on a superficial level, it is not clear to me in practice how the distinction actually manifests itself in approach as between the SEC and the CFTC. In order to have any real chance at substantial "harmonization," one first needs to begin with an analysis of the two seemingly diametrically opposed approaches of the two agencies to determine if, in practice, they result in

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15 U.S. Department of the Treasury, White Paper on Financial Regulatory Reform-A New Foundation: Rebuilding Financial Supervision and Regulation (June 17, 2009)

16 *E.g.*, U.S. Department of the Treasury, White Paper on Financial Regulatory Reform-A New Foundation: Rebuilding Financial Supervision and Regulation (June 17, 2009)

real distinctions in regulation, and, if so, whether they can be reconciled, or whether there is some middle ground where the two can live together.

B. Similar Standards of Care.

Consideration should be given to whether the standard of care applicable to those subject to SEC and CFTC jurisdiction (*e.g.*, investment advisers, commodity trading advisors and commodity pool operators) should be rationalized in some respect.

C. Common Registration Form

Consideration should be given to whether there is any real need for completely different registration processes and forms for investment advisers, commodity trading advisors and commodity pool operators. If one accepts the premise that each of the SEC and CFTC would benefit from the same sorts of information about those who they regulate, a common registration form may be useful. With a common registration form, an investment adviser applying to register with the SEC would use the same form as someone applying to register with the CFTC as a commodity trading advisor. They would simply check a box to indicate which registration(s) are being applied for. A common form would naturally aid in harmonization by promoting the common usage of language and eliminating differences in regulation caused by unnecessary differences in language or jargon.[17]

D. Position Reporting.

Consideration should be given to whether there should be a common approach to securities and futures position reporting.

[17] Including resolving the differences between the spelling of “adviser” (SEC) and “advisor” (CFTC).

E. Joint Examinations and Alignment of Protocols.

Consideration should be given to whether there should be an alignment of regulatory examination protocols. For example, should the methodologies for regulatory exams be aligned and should the potential uses of information collected in examinations be aligned?

F. Consistent Books and Records.

Consideration should be given to whether the types and extent of the books and records required to be maintained should be aligned.

G. Common Rules and Interpretations.

To the extent that regulatory oversight provided by the SEC and CFTC address the same topics, consideration should be given to whether it makes sense to have rules that either are identical or vary only where necessary. In this regard, I think it important that the actual wording of the aligned rules either be the same or key words be defined to mean the same things. Just as important, following the adoption of a rule, the meanings of the aligned rules, as both formally and informally interpreted by the lawyers and examination staffs of each agency, would need to remain consistent. Divergence of rule interpretation by the staffs at either agency post rule adoption could constitute a true risk to harmonization.

H. Clear and Concise Guidance.

It would significantly further the harmonization effort if the SEC and CFTC would consider jointly issuing interpretive releases on a broad array of topics that clearly and concisely set out minimum standards or activities that are permissible. If one labors under the presumption (as I do) that most people want to comply with the laws, and would do so if they know what the law is, such interpretive releases would facilitate legal compliance by industry participants who may be operating under misperceptions (or a lack of knowledge) of legal standards.

One example of a particularly noteworthy release from the SEC was the interpretive release relating to soft dollars that was issued in 2006.[18] While the release necessarily left some issues unresolved, for the most part, the release was extremely valuable in that it included specific information as to the types of products and services that constitute research and brokerage for purposes of Section 28(e) under the Securities and Exchange Act of 1934.

Concise clear interpretive guidance of the sort described above could help to reduce the burden on the examination and enforcement staffs somewhat and reduce the number of unanswered and open questions that tend to plague the industry.

I. Common Major Exam Focus Areas.

As a sort of supplement to the concept of joint common interpretive guidance described above, consideration should be given to whether it would be helpful if the SEC and CFTC periodically, through releases, describe the regulatory examination priorities of the agencies. In some instances, the examination priorities may be similar and where that is the case, in order to address those shared regulatory concerns consideration should be given to whether topics such as performance reporting, allocations of trades, market manipulation, and disclosure standards, present possibilities for the two agencies to provide clear guidance as to permissible standards of conduct.

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I would be happy to answer any questions. I appreciate the opportunity to share these suggestions.

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[18] Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934, Rel No. 34-54165 (July 18, 2006)