

# 16th Annual Private Investment Funds Seminar

## Investing in Registered Funds, Banks and Financial Institutions

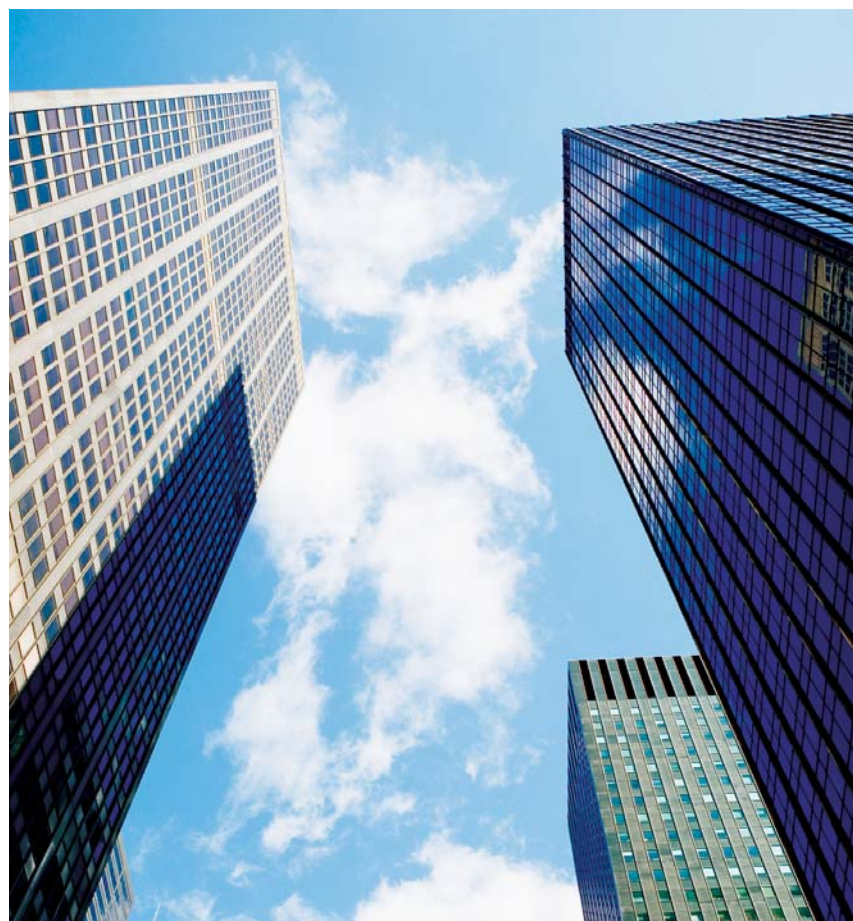
Donald Mosher | George M. Silfen

Thursday, January 18, 2007

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## About the Speakers



## Donald Mosher

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Donald Mosher is a partner in the Investment Management and Regulatory Practice Groups at Schulte Roth & Zabel LLP. His practice focuses on bank regulation, payments and privacy law. He represents leading banks, financial institutions, financial services companies, money transmitters and consumer finance businesses.

Significant transactions include:

- Representation of sellers and bidders in connection with the acquisition and divestiture of payments and consumer finance businesses
- Representation of financial institutions in connection with joint marketing, sponsorship and outsourcing arrangements
- Representation of banks, money transmitters and check sellers in the development of electronic, paper and card based payment products and all aspects of regulatory compliance
- Representation of financial services companies in applications to federal and state banking agencies in connection with the acquisition and organization of financial institution subsidiaries, including credit card banks and industrial loan companies
- Representation of foreign and domestic banks, bank holding companies and their subsidiaries in applications to the federal and state banking agencies to obtain approval for acquisitions, for the establishment of new subsidiaries and for expansion into new business

Don is a 1991 *cum laude* graduate of the St. John's University School of Law, where he was the notes and comments editor of the *St. John's Law Review*. He is a 1987 graduate of the State University of New York at Stony Brook. He serves as a member of the board of directors of First Financial Bank.

## George M. Silfen

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George M. Silfen is a partner in the Investment Management Practice Group of Schulte Roth & Zabel LLP. He represents investment companies and their boards of directors, investment advisers and broker/dealers in connection with the organization and operation of investment products and services, including mutual funds, closed-end investment companies, business development companies, registered hedge funds, wrap accounts, and 401(k) and IRA products. He also advises clients on regulatory and compliance matters associated with investment company, investment advisory, brokerage, securities custody and transfer agent services.

George is a 1994 *cum laude* graduate of Brooklyn Law School where he was the articles editor of the *Brooklyn Law Review*, and has an M.B.A. degree from Baruch College. He graduated *summa cum laude* and Phi Beta Kappa from Brooklyn College in 1990, where he majored in economics. Prior to joining Schulte Roth, he worked for Morgan Stanley Investment Management.

# Outlines



## Investing in Banks and Financial Institutions

Donald J. Mosher

January 18, 2007

### 1) Banks and Other Financial Institutions

- a) Depository Institutions
  - i) National Banks
  - ii) State-Chartered Banks
  - iii) Federal Savings Associations
  - iv) State-Chartered Savings Associations
  
- b) Other Financial Institutions
  - i) Insurance Companies
  - ii) Securities Firms
  - iii) Broker-Dealers
  - iv) Mortgage Bankers
  - v) Sales Finance Companies
  - vi) Licensed Lenders
  - vii) Money Remitters
  - viii) Other

### 2) What Are the Securities You Are Looking To Purchase: Voting vs. Nonvoting

- a) Are they "voting securities"?
  - i) Yes, if they:
    - (1) Entitle you to vote for or select directors;
    - (2) Entitle you to vote on or direct operations or significant policies; OR
    - (3) Are convertible to voting securities at the option of the holder.
  - ii) No, if:
    - (1) Any voting rights are limited solely to the type customarily provided by statute with regard to matters that would significantly and adversely affect the rights and preferences of the interest;
    - (2) The interests represent an essentially passive investment or financing device and do not otherwise provide control; AND
    - (3) The interests do not entitle you, by statute, charter or in any manner, to select or to vote for the selection of directors.

### 3) Regulatory Definition of "Control"

- a) Banks - If you directly or indirectly:
  - (1) Own, control or have the power to vote 25% or more of any class of voting securities (BHCA);
    - (a) Voting shares of an issuer are deemed to be the same class of voting shares (regardless of differences in liquidation preferences or dividend rights) if the shares are voted together as a single class on all matters for which the shares have voting rights other than matters that would significantly and adversely affect the rights or preferences of the security.
    - (b) If multiple commonly controlled funds invest in the same institution, their interests will be aggregated.
    - (c) If A controls B which in turn controls C, A will be deemed to control C.

- (2) Are able to select a majority of directors (BHCA);
- (3) Own 25% or more of total equity (FRB admin. rulings); OR
- (4) Have a "controlling influence" (BHCA).
  - (a) Presumption of no control for less than 5% of any class of voting securities.
  - (b) Between 5% and 25% of any class of voting securities (case-by-case basis; rebuttable presumptions of control may apply between 10% and 24.9%, or if there is a management agreement).
  - (c) Consider veto rights, board membership and special contract provisions that allow investor to influence the business.
- b) Other Financial Institutions - Varies by state
  - (1) Typically 25% of voting stock (in some cases class of voting securities)
  - (2) In some states as low as 10%
  - (3) In some states direct or indirect

#### 4) Regulatory Consequence of a Controlling Investment

- a) Banks
  - i) Application
  - ii) Supervision and Examination
  - iii) Reporting
  - iv) Capital Requirements
  - v) Activity Restrictions
- b) Other Financial Institutions
  - i) Application/Notice
  - ii) Reporting
  - iii) Commitments

#### 5) Structuring the Investment to Remain Passive

- a) Will you own or have the power to vote more than 5% of any class of "voting securities" or own 25% of total equity?
- b) What are the control thresholds of each chartering or licensing jurisdiction?
  - i) If the institution is a bank and you are over 9.9% of any class of voting securities, expect to provide passivity commitments

#### 6) Acquisition of Control Procedures

- a) Diligence Process
  - i) Information Request
  - ii) Document Review
  - iii) Management Interviews
- b) Acquisition Agreement
  - i) Compliance-with-Law Representation and Warranty
  - ii) Regulatory Conditions
  - iii) Regulatory Covenants
  - iv) Indemnities
- c) Application Process
  - i) Summary of the Transaction
  - ii) Target Closing Date
  - iii) Information about Control Party
  - iv) Personal and Financial Information for Officers/Directors/Principal Shareholders
  - v) Background Checks and Fingerprints
  - vi) Other (*i.e.*, for banks, competitive effect, convenience and needs of community, availability of information)

- d) Closing
  - i) Approvals/Confirms from Every Licensed Jurisdiction
  - ii) Consummation Letters
  - iii) Post-Closing Regulatory Requirements

## Investing in Registered Funds

George M. Silfen

January 18, 2007

### 1) *Introduction*

The Irony: Even Hedge Funds are Regulated by the 1940 Act

### 2) *Rules to Worry About*

#### a) The 3% Rule: The 1940 Act Restriction on Owning More than 3% of a Registered Fund:

Section 12(d)(1)(A)(i) effectively prohibits a 3(c)(1) or 3(c)(7) fund, and any entity controlled by the fund, from acquiring, in the aggregate, more than 3% of the outstanding voting stock of a registered fund.

##### i) How to Calculate 3% Compliance when Dealing with Affiliated Hedge Funds?

See *meVC Draper Fisher Jurvetson Fund I, Inc. v. Millenium Partners, L.P.*, 260 F. Supp. 2d 616 (S.D.N.Y. 2003)

##### ii) Use of Derivatives and the 3% Rule

##### iii) Disregarding Increases in the Value of Existing Holdings

##### iv) Exceptions to the Rule:

###### (1) Money Market Funds

(a) New Rule 12d1-1 under the 1940 Act

###### (2) Certain ETFs

(a) BLDRS and Similar Exemptive Orders (*e.g.*, ICA Release No. 27511)

###### (3) Master Feeder Arrangements -- Section 12(d)(1)(E)

###### (4) 3% Rule is Not Applicable to Non-3(c)(7) or Non-3(c)(1) Investment Funds

###### (5) Last Resort -- Exemptive Relief Pursuant to Section 12(d)(1)(J)

In short, Section 12(d)(1)(J) provides that, upon application, the SEC may grant an order exempting any entity from any provision of Section 12(d)(1), including the 3% Rule, if and to the extent that such exemption is consistent with the public interest and the protection of investors.

#### b) The 1940 Act Affiliated Transaction Rule

##### i) The Web of Section 17 Restrictions

(1) Section 17(a) generally prohibits a hedge fund that is affiliated with a registered fund from entering into a principal transaction with the registered fund.

- (a) Exception: Buying or redeeming shares of the registered fund
  - (2) Section 17(d) and Rule 17d-1 thereunder effectively prohibit a hedge fund that is affiliated with a registered fund from engaging in a "joint transaction" with the registered fund.
  - (3) 5% ownership of a registered fund creates affiliation and implicates Section 17 restrictions.
    - (a) Section 2(a)(3) Definition of Affiliates:
      - (i) Section 2(a)(3) Defines an "Affiliated Person of Another Person" to Include, Among Other Things:
        - 1. any person directly or indirectly owning, controlling, or holding with power to vote, 5 per centum or more of the outstanding voting securities of such other person
        - 2. any person 5 per centum or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by such other person
    - c) Public Disclosure Rules
      - i) Section 16 & 13 Reporting Obligations  
Closed-end fund ownership is subject to 1934 Act reporting.
      - ii) Registered Fund Reporting Obligations -- SAI Disclosure of 5% Investors
- 3) *The Red Flag Rule: Registered Fund Transactions with Hedge Funds Could Be Subject to SEC Inspection*

# Presentation



**SchulteRoth&Zabel**

**2007 Private Investment Funds Seminar**



**Investing in Registered Funds,  
Banks and Financial Institutions**

**Donald J. Mosher**

**George M. Silfen**

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**Banks and Other Financial Institutions**

- **Depository**
  - **National vs. State**
  - **Banks and Thrifts**
- **Other**
  - **Insurance Companies**
  - **Securities Firms**
  - **Licensed Financial Services**



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## Purpose for and Type of Investment

- Passive vs. Active
- Voting vs. Non-Voting Securities



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## You Control an Institution if You:

- Own, control or have power to vote 25% of any class of voting securities
- Own or control 25% or more of the total equity
- Have the ability to elect majority of board
- Have a controlling influence

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## Presumptions of Control

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## Remaining Passive

5%

25%

10%

Applicable  
Regulatory  
Control  
Thresholds

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## Control Procedures

**Diligence**

**Agreement**

**Application**

**Closing**

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## Registered Funds

### Rule #1: The 3% Rule



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## Registered Funds

### Rule #1: The 3% Rule

- What happens if:
  - You have multiple funds
  - You use derivatives
- What happens if:
  - Your holdings appreciate

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## Registered Funds



## Exceptions to the Rule

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## Registered Funds

### Exceptions to the Rule

- Money Market Funds
- ETFs
- Master Feeders
- Non Typical Hedge Funds
- Exemptive Relief

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**Registered Funds**

**Rule #2:  
The Affiliated Transaction Rule**

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**Registered Funds**

**Rule #3:  
The Public Disclosure Rule**

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**Rule #4:  
The Red Flag Rule**

