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Treasury's Latest Proposals May Herald Important Changes for Private Fund Managers

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Introduction

On June 17, 2009, the U.S. Department of the Treasury issued a press release and posted a white paper to its website regarding President Obama's proposed comprehensive regulatory reform. The white paper, titled "A New Foundation: Rebuilding Financial Supervision and Regulation" and available at http://www.financialstability.gov/docs/regs/FinalReport_web.pdf, sets out a number of sweeping legislative and regulatory proposals that the Obama Administration believes are necessary to protect the U.S. financial system from systemic risks. The proposal set forth in the white paper (the "Proposal") is far-reaching and includes suggested policy changes ranging from a re-engineering of the administrative framework for the regulation of banks and bank holding companies, the creation of a new Consumer Financial Protection Agency, and the imposition of new political controls on the Federal Reserve's lending authority, to passage of the often-proposed "say on pay" legislation.

Included in the Proposal's laundry list of reforms are a number of legislative and regulatory changes that, if enacted, may substantially increase the regulation of managers of private investment funds. Relevant changes discussed in the Proposal include the requirement that most private fund managers register as investment advisers under the Investment Advisers Act of 1940 (the "Advisers Act"), the requirement that registered investment advisers provide more information to the Securities and Exchange Commission (the "SEC"), and regulation by the Federal Reserve of investment advisers who manage funds whose insolvency could trigger a financial collapse. Also included in the Proposal is the possibility of additional substantive regulation of the relationship between fund managers and their investors, including possible regulation of fund manager compensation.

In addition to the Proposal, the Treasury Department has released a number of proposed statutes meant to implement the Proposal's policy recommendations, including two that are of direct concern to fund managers (the "Proposed Legislation"). The first of these proposed statutes, the "Investor Protection Act of 2009" (the "Protection Act"),

would give the SEC broader powers with respect to the regulation of registered investment advisers, including the authority to review and ban certain compensation agreements entered into by investment advisers and their clients. The second provision, which is titled the "Private Fund Investment Advisers Registration Act" (the "Registration Act"), would remove the exception to the Advisers Act's registration requirement that is relied on by most private fund managers and would require additional reporting by registered fund managers. The texts of these proposed statutes are available on the Treasury's website, at http://www.ustreas.gov/press/releases/tg205.htm and http://www.treas.gov/press/releases/tg214.htm, respectively.

In the event the Proposed Legislation and the other Obama Administration policy ideas set forth in the Proposal are ultimately enacted into law, they would result in important changes in the way that the managers of private investment funds are regulated. These changes are discussed in more detail below.

Fund Manager Registration with the SEC

Currently, the Advisers Act requires the registration of "investment advisers" – generally all persons who are engaged in the business of providing advice regarding securities for compensation – with the SEC, and subjects them to certain ongoing regulations. The registration requirements of the Advisers Act, however, are subject to some important exceptions. The most important of these is the "private adviser" exception in Section 203(b) of the Advisers Act for investment advisers with fewer than 15 clients that do not hold themselves out to the public as investment advisers or act as investment advisers to entities required to register as investment companies under the Investment Company Act of 1940 (the "Investment Company Act"). Most managers of private investment funds are able to take advantage of this exception because the funds they manage, rather than the investors in those funds, are generally considered to be their "clients" for purposes of the 15 client limitation and because those funds are usually structured to take advantage of one of two popular exceptions to the definition of "investment company" under the Investment Company Act. These Investment Company Act exceptions are the "3c-1 exception" for investment companies with fewer than 100 investors and the "3c-7 exception" for investment companies all of whose investors are "qualified purchasers".

The Obama Administration believes that the exceptions to the Advisers Act contributed to the financial crisis. The Proposal states that although "de-leveraging by hedge funds contributed to the strain on financial markets" during the 2008 financial crisis, the government was unable to gather reliable data on those hedge funds' activities and the risk they posed to the financial system because hedge fund managers are generally not registered with the SEC. The Proposal also cites, but does not discuss, a "compelling investor protection rationale" for requiring generally all investment advisers to register with the SEC.

If enacted into law, the Registration Act will remove the private adviser exception altogether so that the only exceptions from the Advisers Act registration requirement potentially applicable to most fund managers will be a new exception for "foreign private advisers" and the exception currently set forth in Rule 203A-1 under the Advisers Act for certain investment advisers with less than $30 million of assets under management. The new "foreign private advisers" exception would apply only to fund managers with no place of business in the U.S., with fewer than 15 clients in the U.S., and with less than $25 million in assets under management in the U.S., and only if those fund managers do not hold themselves out to the public in the U.S. as investment advisers or act as investment advisers to registered investment companies. The existing exception in Rule 203A-1 applies only to managers that have their principal office and place of business in a state with its own investment adviser statute, that have less than $30 million of assets under management, and that do not advise any registered investment company. The assets under

management thresholds in these exceptions are low enough that the enactment of the Registration Act as proposed by the Obama Administration would require the registration of nearly all private fund managers with the SEC.

Registration Process and Reporting by Registered Fund Managers

In order to register with the SEC, a fund manager is required to file a Form ADV with the SEC, establish an account with the Investment Advisers Registration Depository, and pay certain setup and annual fees. The Form ADV requires information regarding the adviser's business, including information regarding its clients and ownership, and information regarding the adviser's fees, the services it offers, and any conflicts of interest applicable to the adviser. The information provided is made publicly-available on an SEC website. Neither the Proposal nor the Proposed Legislation indicates that the Obama Administration is considering changes to the registration process.

Once the registration is accepted by the SEC, a registered investment adviser is currently subject to certain record-keeping and reporting requirements, may be inspected from time to time by the SEC, and is required to maintain a code of ethics and policies focused on complying with its fiduciary responsibilities and with insider trading rules. The Administration, however, believes that the information currently provided to the SEC by investment advisers is insufficient to allow the government to collect the data it needs to prevent financial crises, and the Proposal states that registered fund managers should be required to report additional information to the SEC sufficient to allow the government to determine whether the funds they manage pose any systemic risk to the financial system.

If enacted, the Registration Act would require registered fund managers to report certain information regarding the "private funds" that they manage to the SEC, and would give the SEC broad authority to require registered fund managers to report additional information regarding such funds. For purposes of these requirements, "private funds" are all funds that are not required to register under the Investment Company Act because of the 3c-1 or 3c-7 exception and that are either organized in the U.S. or whose securities are 10% or more owned by U.S. persons. The information that private fund managers would be required to disclose to the SEC under this provision of the Registration Act includes the amount of assets under management, use of leverage (including off-balance sheet leverage), counterparty credit risk exposures, trading and investment positions, and trading practices of the private funds they manage, and any other information with respect to such private funds that the SEC determines is necessary to be disclosed "for the protection of investors or for the assessment of systemic risk." The Registration Act also contains a separate broad grant of authority allowing the SEC to require managers of private funds to maintain additional records and submit reports to the SEC as is "necessary or appropriate in the public interest or for the assessment of systemic risk", and to share such information with banking and financial services regulators.

It is unclear how confidential the new information provided by fund managers to the SEC (and by the SEC to other regulators) will be. The Registration Act generally provides that, except with respect to court orders and requests from Congress, federal agencies, and self-regulatory agencies, the SEC will not be required to disclose to any person any of the information disclosed to it pursuant to the new provisions of the Registration Act. The legislation also specifically states that the information provided to the other regulators "shall be kept confidential." There are not, however, any guarantees in the Registration Act as to how such confidentiality will be maintained. In addition, the Registration Act also gives the SEC new authority to require managers of private funds to provide any information to investors, prospective investors, counterparties, and creditors of the private funds they manage that the SEC determines to be "necessary or appropriate in the public interest and for the protection of investors or for the assessment of systemic risk." This grant of authority also raises the possibility that private fund managers will be required to provide information to their investors and others that they currently consider to be confidential.

Additional Substantive Regulation of Fund Managers

In addition to imposing additional reporting and record-keeping requirements on fund managers, the Proposal and the Proposed Legislation would also provide for additional substantive regulation of fund managers, including possibly regulation of the fees charged by fund managers to investors and the compensation paid by them to principals and employees. Currently, the Advisers Act generally prohibits registered investment advisers from entering into advisory contracts providing for compensation based on their clients' capital gains or capital appreciation. This legislative requirement, however, has had little impact on fund managers registered as investment advisers because of an SEC rule providing that the restriction does not apply as long as the investment adviser manages at least $750,000 for a fund that is exempted from the requirements of the Investment Company Act because of the 3c-7 exception. This relatively "hands off" approach to the regulation of fund manager compensation may change, however, if the Protection Act is enacted.

> Under the Protection Act, the SEC would be required to
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> "examine and, where appropriate, promulgate rules prohibiting sales practices, conflicts of interest, and compensation schemes for financial intermediaries (including brokers, dealers, and investment advisers) that it deems necessary to the public interest and the interests of investors."

Although the release accompanying the Protection Act suggests that this provision is aimed at traditional financial advisers who recommend various financial products to retail clients, the language nonetheless appears to give the SEC broad authority over both the internal compensation schemes of fund managers (i.e., how the employees and principals of fund managers are compensated) and the arrangements that fund managers enter into with investors (i.e., the management fees and carry typically charged to investors).

The Protection Act also includes other important changes to the substantive regulation of private fund managers. The legislation would permit the SEC to enact rules to provide that the standard of conduct for investment advisers is to act solely in the interest of the client without regard to the financial interest of the investment adviser. It would also permit the SEC to promulgate rules regarding the "provision of simple and clear disclosures to investors" and allow the SEC to prohibit or put limits on the entering into of arbitration agreements with investors. Again, although the text of the legislation and the accompanying release suggests that this authority is intended to be exercised only with respect to investment advisers providing services to retail clients, the authority delegated to the SEC in the proposed legislation is quite broad.

Possible Regulation by the Federal Reserve

The Registration Act requires that reporting made to the SEC by registered investment advisers be shared with the Federal Reserve and the Financial Services Oversight Council, a new entity whose creation is recommended by the Proposal. This is meant to allow systemic risk regulators to determine whether any private investment fund should be considered a "Tier 1 FHC" – i.e., an entity "whose combination of size, leverage, and interconnectedness could pose a threat to financial stability if it failed." A fund that is considered to be a "Tier 1 FHC" would be subject to additional regulation by the Federal Reserve similar to the regulation currently imposed on bank holding companies, including capital requirements and liquidity and risk management restrictions. This change is unlikely to apply to most funds or fund families, but to the funds to which it would apply, it could result in fundamental changes in fund management and operation.

Conclusions

The Proposal and the Proposed Legislation signal sweeping changes in the federal regulation of investment fund managers. If enacted into law they will result in the federal registration of nearly all private fund managers, new requirements for disclosures to be made by fund managers to their investors and others, additional record-keeping requirements for fund managers, possible regulation of certain fund managers by the Federal Reserve, and possibly even substantive regulation of the fees paid to fund managers by their investors. Substantial additional work remains to be done, however, by the Obama Administration and by Congress (whose appetite for additional change, given the already crowded policy agenda, may be limited), before the proposed reforms actually affect fund managers. In addition to the enactment of the Proposed Legislation, the details of the Administration's reform proposal will need to be set out in additional SEC rule-making. We will continue to monitor existing and future legislative and regulatory proposals and post updates to our website regarding any developments.

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