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U.S. Financial Regulatory Reform – Investment Advisory Proposals

On June 17, 2009, the U.S. Department of the Treasury released the Obama Administration's proposals for U.S. financial services regulatory reform ("Plan").[1] The Plan makes recommendations for significantly overhauling the oversight of the U.S. financial services industry. The Plan's stated goals are to close perceived gaps, weaknesses, and overlaps in the current U.S. financial services regulatory system, promote robust and comprehensive governmental supervision and regulation over virtually all financial services providers, ensure robust oversight over sources of systemic risks, and strengthen investor protections.

The Plan's recommendations include:

- registration for certain private investment fund advisers with the U.S. Securities and Exchange Commission ("SEC");
- disclosure, reporting, and other information requirements for certain private investment funds themselves; and
- new and enhanced investor protections.

The Plan also calls on other nations to require registration and regulation for certain private investment fund managers and/or such funds themselves.[2]

Investment Advisers

The Plan recommends that advisers to hedge funds and other private pools of capital (including private equity and venture capital funds) whose assets under management exceed some "modest threshold"[3] be subject to the investment adviser registration and regulation requirements under the U.S. Investment Advisers Act of 1940 as amended ("Advisers Act").[4] Under the Advisers Act, an investment adviser is "any person who, for compensation, engages in the business of advising others . . . as to the value of securities or as to the advisability of investing in, purchasing, or selling securities . . . .",

[1] The Plan is available at http://www.financialstability.gov/docs/regs/FinalReport_web.pdf.

[2] The European Commission's proposed Directive on Alternative Investment Fund Managers, released in April 2009, is discussed in our earlier Client Alert (dated May 5, 2009), available at http://www.shearman.com/fia-050509-updated-new-european-proposals-for-the-regulation-of-alternative-investment-fund-managers/.

[3] Such threshold may refer to the existing SEC rule threshold of $30 million for required SEC investment adviser registration, although that threshold may be modified as details emerge.

[4] In January 2009, the "Group of 30"—an international committee of current and former senior regulators and bankers—endorsed a similar idea: that managers of private pools of capital employing substantial leverage be required to register with a national regulator. However, the Group of 30 proposal differs from the Plan in that it exempted from registration managers of venture capital funds, presumably due in part to their lesser reliance on leverage. The Group of 30 proposal is discussed in our earlier Client Alert (dated January 30, 2009), available at http://www.shearman.com/am_013009/.

subject to certain exclusions not generally applicable in the context of private investment funds. The Plan cites as justification the government's need for more information in order to assess the financial stability and potential systemic implications of private investment funds, as well as investor protection rationales.

The Plan does *not* define hedge funds, private pools of capital, or other private investment funds, but presumably would include private commingled investment vehicles that customarily rely on exceptions from the definition of investment company pursuant to Sections 3(c)(1) and 3(c)(7) of the U.S. Investment Company Act of 1940 as amended ("Investment Company Act"). Those private investment companies would include all or some hedge funds, private equity funds, buyout funds, venture capital funds, certain real estate funds, funds of funds, and certain CDO and other securitization vehicles. Likewise, the Plan does *not* distinguish between investment advisers to different types of private investment funds. Presumably, investment advisers to all such vehicles would be subject to investment adviser registration.

Registration under the Advisers Act would subject presently unregistered investment advisers to the full panoply of the requirements of the Advisers Act and regulations thereunder, including:

- advisory contracts;
- advisory fees;
- fiduciary duties and standards of care to clients;
- disclosure to clients and regulators;
- custody and possession of client assets;[5]
- recordkeeping;
- advertising;
- trading and investment practices;
- supervision, compliance, and code of ethics practices, policies, and procedures;
- solicitors and placement agents; and
- SEC inspections, discipline, and disqualification.

For private investment fund advisers having mature organizations but not previously subject to SEC registration and regulation, the Advisers Act requirements that will have the most impact on their business will be those relating to SEC firm inspections (including review of proprietary and personal trading and related conflicts of interest, investment valuation policies and practices, and compliance programs and infrastructure generally), as well as compliance with certain requirements relating to advertising, custody of client assets, mandated public disclosure on Form ADV, privacy policies, and annual audits.

Private Investment Funds

Contrary to press reports, the Plan does *not* recommend that private investment funds themselves be subject to direct registration or regulation under the Investment Company Act. Instead as discussed above, the Plan recommends registration for the investment advisers to such funds.

However, the Plan employs its SEC investment adviser registration requirement as a means to impose certain requirements on private investment funds advised by such advisers. The Plan recommends that all private investment funds advised by SEC-registered investment advisers be subject to:

- recordkeeping requirements;
- requirements with respect to disclosures to investors, creditors, and counterparties; and
- other regulatory reporting requirements.

The Plan recommends that the SEC conduct regular, periodic examinations of such funds to monitor compliance with those requirements. Moreover, the Plan recommends that such funds be subject to confidential

[5] In May 2009, the SEC proposed changes to the investment adviser custody rules. The changes are discussed in our earlier Client Alert (dated June 8, 2009), available at http://www.shearman.com/sec-proposes-changes-to-investment-adviser-custody-rules/.

reporting requirements for certain information, such as assets under management, borrowing, off-balance sheet exposures, and other information necessary to assess whether such funds or fund families are so large, highly leveraged, or interconnected that such funds or fund families pose a threat to financial stability or otherwise should be subject to direct regulation (as described in the next section below). Only once additional details emerge will it be clear how extensive these disclosure, reporting, and information requirements will be. Whether there is governmental infrastructure to make effective use of this information is also unclear.

Financial Holding Companies

The Plan assigns to the Board of Governors of the U.S. Federal Reserve System ("Federal Reserve") the task of being the U.S. systemic risk regulator. The Plan creates the category of a "Tier 1 Financial Holding Company" ("Tier 1 FHC"), which designation would be imposed on any financial firm (including a private investment fund or fund family) with a combination of size, leverage, and interconnectedness that would make its failure a risk to financial system stability. As a financial holding company, a Tier 1 FHC would be subject to the jurisdiction and consolidated supervision of the Federal Reserve. The Plan recommends that the SEC share with the Federal Reserve the reports it receives from private investment funds and fund families, and that the Federal Reserve determine whether such funds or fund families meet the Tier 1 FHC criteria and should be supervised and regulated as such.

The Plan recommends that the Federal Reserve impose on any Tier 1 FHC "prudential standards", including more robust capital requirements and standards for risk management, liquidity, and prompt corrective action than those imposed on bank holding companies. In addition, Tier 1 FHCs would be subject to certain non-banking activity restrictions under the U.S. Bank Holding Company Act of 1956 as amended. A Tier 1 FHC would also be subject to the recommended Federal Reserve "resolution authority" to deal with non-bank financial institutions whose failure could have serious adverse effects on the financial system or the economy, which authority would include the winding down of such firms and emergency lending to them.

Although private investment funds or fund families of sufficient size could be designated Tier 1 FHCs, the Federal Reserve might be more likely to impose such designation and related supervision and regulation on more highly leveraged entities, such as systemically important insurers or financing companies. The Plan notes that forthcoming legislation will propose criteria that the Federal Reserve must consider in identifying Tier 1 FHCs. Private investment funds and their investment advisers will likely go to great lengths to avoid Tier 1 FHC designation and the resulting restrictions, supervision, and regulation. A Client Alert about the Plan's implications for banking institutions also discusses the Tier 1 FHC designation.[6]

SEC and CFTC Harmonization

In the past, the SEC and the U.S. Commodity Futures Trading Commission ("CFTC") have been subject to criticism on the basis of overlapping, complex, and sometimes inconsistent and uncoordinated regulation. Although the products and services regulated by the SEC and CFTC often overlap, it is noteworthy that the purposes of the SEC (investor protection) and CFTC (market integrity) and underlying regulatory principles differ. Notwithstanding these historical differences, the Plan instructs the SEC and the CFTC to begin to resolve the various jurisdictional disputes between them and to achieve greater coordination, harmonization, and appropriate regulation of products, services, and participants. The Plan notes that operators of funds trading in the exchange-traded futures markets (including many hedge funds) must already register and be supervised and regulated (or qualify for an exemption

[6] This Client Alert (dated June 23, 2009) is available at http://www.shearman.com/fia-062309-us-financial-regulatory-reform-implications-for-banking-institutions/.

from such requirements) as commodity pool operators ("CPOs"). Such registration, supervision, and regulation is implemented by the CFTC and the self-regulatory authority, the U.S. National Futures Association ("NFA"). The Plan does not mention the commodity trading advisors ("CTAs") to such funds, who must already register and be supervised and regulated (or qualify for an exemption from such requirements) as CTAs by the CFTC and NFA. The Plan stresses the importance of the CFTC's continued enforcement authority over registrants.

Presumably, the SEC and CFTC will seek to rationalize and harmonize the various requirements that will be imposed on persons dually registered as investment advisers with the SEC and CPOs and/or CTAs with the CFTC and their personnel.[7]

Money Market Mutual Funds

The Plan makes recommendations relating to the U.S. money market fund industry that are intended "to strengthen the regulatory framework around money market funds to reduce the credit and liquidity risk profile of individual money market funds and to make the money market fund industry as a whole less susceptible to runs".

As discussed in an earlier Client Alert,[8] the collapse in September 2008 of two large U.S. money market funds sharply focused the attention of fund industry leaders and policymakers on the risks to the industry and the broader markets of a sudden run of shareholder redemptions. The fund industry's main trade group, the Investment Company Institute ("ICI"), responded in March 2009 with a package of reform proposals. The SEC is expected to announce its own proposals shortly.

Largely tracking key elements of the ICI proposals, the Plan calls for SEC rulemaking that would:

- require money funds to maintain "substantial liquidity buffers" (presumably in which some percentage of fund assets would be maintained in extremely high quality and liquid investments);
- reduce the maximum weighted average maturity of money fund assets;
- tighten the credit concentration limits applicable to money funds;
- improve the credit risk analysis and management of money funds; and
- empower money fund boards of directors to suspend redemptions in extraordinary circumstances to protect the interest of fund shareholders.

The Plan also goes beyond the ICI proposals in a call for a special report to assess "whether more fundamental changes are necessary" to reduce further the money fund industry's susceptibility to runs of shareholder redemptions, such as eliminating a money fund's ability to use a stable net asset value or requiring money funds to obtain access to emergency liquidity facilities from private sources. These liquidity facilities should be "reliable, scalable, and designed in such a way that drawing on the facilities to meet redemptions would not disadvantage remaining [money fund] shareholders" – certainly an ambitious policy order. The Plan calls for the report to be prepared by September 15, 2009 by the existing President's Working Group on Financial Markets. That date coincides with the September 18, 2009 date on which the Treasury Department's temporary money market fund guarantee program expires.

Broker-Dealers

The Plan recommends that the SEC hold broker-dealers to a fiduciary duty standard when they provide investment advice to retail investors. Broker-dealers are already subject to registration, supervision, and regulation by the SEC pursuant to the U.S. Securities Exchange Act of 1934 as amended ("Exchange Act") and

7 A Client Alert (dated June 22, 2009) about the Plan's implications for derivatives, among other things, treats SEC/CFTC harmonization in greater depth, and is available at http://www.shearman.com/us-financial-regulatory-reform-implications-for-derivatives/.

8 This Client Alert (dated April 17, 2009) is available at http://www.shearman.com/us-money-market-fund-reform-initiatives/.

by the self-regulatory authority, the U.S. Financial Industry Regulatory Authority. Currently, investment advisers are held to a fiduciary standard (meaning that the adviser must place client interests ahead of its own interests), whereas broker-dealers are subject to regulation of their advisory services principally on the basis of the suitability and professional standards of that advice. In making this recommendation, the Plan reiterates the often cited point that clients place an identical degree of trust in the advice of an investment adviser or broker-dealer.

The Plan recommends that standards of care for all broker-dealers providing investment advice (whether incidental or primary) about securities to retail investors be raised to the fiduciary standard to align the legal framework with investment advisers. Additionally, the Plan recommends that the SEC be empowered to examine and ban forms of compensation that encourage intermediaries (ostensibly including investment advisers and broker-dealers) to put investors into financial products that are profitable to the intermediary but that are not in the investors' best interests.

In addition, the Plan recommends legislation that would:

- require broker-dealers to provide simple and clear disclosure to investors regarding the scope of the terms of their relationships with investment professionals;
- prohibit certain conflicts of interest and sales practices that are contrary to the interests of investors; and
- empower the SEC to prohibit mandatory arbitration clauses in both broker-dealer and investment advisory accounts with retail customers.

The Plan does not specify details as to how the proposed fiduciary standard is to be implemented and under what laws (whether the Advisers Act, Exchange Act, or other laws). If these changes in legal duties become law, there will be significant changes in the manner in which investments are marketed and sold by broker-dealers and in the contractual and practical relationships between broker-dealers and their clients, especially in the different scenarios of when a broker-dealer is providing investment advice as compared to acting as a sales agent.

SEC Investor Advisory Committee

On June 3, 2009, SEC Chairman Schapiro announced the formation of an Investor Advisory Committee, comprised of a diverse group of prominent investors, to advise the SEC on its regulatory priorities and investor concerns, including issues concerning new products, trading strategies, fee structures, and disclosure. The Plan recommends a permanent role for the committee.

Going Forward

The Plan does not provide specific time frames for the recommendations to be implemented and effective. As details of the Plan and the resulting legislation and regulation get debated, incorporate compromises, and become finalized, the Plan's recommendations are likely to undergo significant modifications, especially in view of expected lobbying and commentary by certain constituencies, such as advocates for the various affected industries. Nonetheless, the Plan represents the Obama Administration's considered proposals to the U.S. Congress and governmental agencies.

Private investment fund advisers are well advised to begin to prepare for likely increased government oversight, including becoming familiar with, and adapting their structures, practices, policies and procedures to, the substantive requirements of the Advisers Act. We will continue to monitor and report on these and related proposals and counterproposals as the legislation and regulations evolve.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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