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White House Proposal Calls for Increased Regulation of Private Investment Funds in Broad Attempt to Restore Confidence in Integrity of Financial System

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Overview

On June 17, the Department of the Treasury released a report titled, “Financial Regulatory Reform: A New Foundation” (the “White Paper”), which provides a general outline of a plan to increase federal oversight of private investment funds and their advisers. The proposals contained in the White Paper are subject to change as draft legislation and regulations are proposed.

Registration Requirement for Private Investment Fund Advisers

In order to “promote robust supervision and regulation of financial firms,” the White Paper suggests that all investment advisers to private pools of capital (including hedge funds, private equity funds and venture capital funds) with assets under management in excess of a “modest threshold” should be required to register with the SEC under the Investment Advisers Act of 1940 (the “Advisers Act”). Under the current private investment adviser exemption, an investment adviser is generally exempt from the federal registration requirement if it does not hold itself out to the public as an investment adviser and has fewer than 15 clients (counting each fund as one client) during the preceding 12 months.

The White Paper observes that in the recent financial crisis, “the government lacked reliable, comprehensive data” which inhibited its ability to assess the “de-leveraging by hedge funds” that contributed to the strain on the financial markets. Requiring SEC

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registration of private fund advisers would allow the SEC to collect data which would permit the federal government to make “an informed assessment of how such funds are changing over time and whether and such funds have become so large, leveraged, or interconnected that they require regulation for financial stability purposes.”

Reporting Requirements for Private Investment Funds

In addition, the White Paper states that all investment funds advised by an SEC-registered investment adviser should be subject to recordkeeping requirements, requirements with respect to disclosures to investors, creditors and counterparties, periodic SEC examinations, and, on a confidential basis, SEC reporting requirements of assets under management, borrowings, off-balance sheet exposures and “other information necessary to assess whether the fund or fund family ... poses a threat to financial stability.” This information would be shared with the Federal Reserve to determine if any investment fund should be treated as a Tier 1 Financial Holding Company (*i.e.*, a firm whose failure could pose a threat to financial stability due to its combination of size, leverage, and interconnectedness (“Tier 1 FHC”)). Tier 1 FHCs would be subject to capital requirements, liquidity standards, overall risk management, restrictions on non-financial activities, rapid resolution plans, and a prompt corrective action regime similar to the existing regime for insured depository institutions under the Federal Deposit Insurance Corporation Improvement Act.

Global Regulation of Hedge Funds

A subsequent section of the White Paper, which aims to “raise international regulatory standards and improve international cooperation,” calls for hedge funds to be subjected to increased global regulation. It notes that G-20 leaders have called for hedge funds to be registered or for their managers to be subject to threshold limits and for hedge funds to disclose “appropriate information” to allow regulators to determine the systemic risks posed both by individual funds and by the hedge fund industry. Although the White Paper makes no specific U.S. regulatory recommendations concerning global regulation, it does expand upon recommendations of the G-20 to subject other private pools of capital to regulation.

Broker-Dealers to Become Fiduciaries

To protect “consumers and investors from financial abuse,” the White Paper also calls for a study of broker-dealer contracts that require customers to agree in advance to arbitration. While the White Paper does not call for such contract terms to be prohibited, it asks “whether investors are harmed by being unable to obtain effective redress of legitimate grievances” and “whether changes to arbitration [clauses] are appropriate.” The White Paper also notes that, since retail consumers view investment advisers and brokers in a similar fashion, brokers should be held to the same fiduciary standards as investment advisers.

Private Fund Transparency Act of 2009

In related news this week, Sen. Jack Reed (D-RI) introduced the Private Fund Transparency Act of 2009 (the “Bill”) which seeks to amend the Advisers Act and increase the SEC’s power to regulate and require disclosure from investment advisers. This Bill would revoke the private investment adviser exemption and replace it with a new exemption for “foreign investment advisers” that (A) have “no place of business in the

United States,” and (B) during the preceding 12 months have had (1) “fewer than 15 clients in the United States” and (2) assets under management attributable to clients in the United States of less than \$25 million (or a higher amount set by the SEC), and (C) do not hold themselves out to the public in the U.S. as investment advisers.

The Bill expands the recordkeeping and reporting requirements of investment advisers from those established by the SEC to those established “for the supervision of systemic risk” by any Federal department or agency. Such requirements would apply to any private fund for which an investment adviser (or any of its affiliates) acts as a sponsor, underwriter, distributor, placement agent, finder or similar capacity.

The Bill would also remove section 210(c) of the Advisers Act which currently prohibits the SEC from requiring investment advisers to disclose the identity, investments, or affairs of any client except insofar as such disclosure is necessary or appropriate in a particular proceeding or investigation enforcing a provision of the Advisers Act.

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We will continue to track the progress of these proposals and update you regarding any significant developments. If you have questions regarding this Client Alert, please contact a member of the [Private Equity Fund Group](#) at Morrison & Foerster LLP.