Possible Effects on Investment Companies and Investment Advisers of the Administration's Financial System Regulatory Proposals

On June 17, 2009, the Obama administration released a white paper[1] which proposes to significantly restructure the U.S. financial regulatory system. With the exception of proposals to change the regulatory structure governing money market funds and requiring the registration of advisers to private investment funds, the proposals do not appear to have as their primary goal an overhaul of the regulatory regime governing registered investment companies and registered investment advisers. However, a number of the administration's proposals have the potential to change the regulatory landscape applicable to both registered and private funds and their advisers, although it is not clear that they were necessarily intended to do so or that those effects had been carefully considered in formulating the proposals.

Regulations Applicable to "Tier 1 Financial Holding Companies"

The administration plan proposes a new regulatory regime for financial firms whose combination of size, leverage and interconnectedness could pose a threat to financial stability if they failed. These firms, referred to as "Tier 1 Financial Holding Companies" (Tier 1 FHCs), would be subject to a full range of "prudential regulation" and consolidated supervision and examination by the Federal Reserve, regardless of whether they own an insured depository institution. These regulations would include higher capital requirements and liquidity and risk management standards that are stricter and more conservative than those applicable to other financial firms. Tier 1 FHCs would also be required to comply with the non-financial activity restrictions of the Bank Holding Company Act—described in the white paper as the "wall between banking and commerce." Please see our June 18 Alert for more information about the selection and regulation of Tier 1 FHCs.

Although large banking institutions are the obvious candidates for designation as Tier 1 FHCs, the white paper states that hedge funds and "fund families" may also be Tier 1 FHCs, although it does not indicate how, if at all, the definition and regulations would be applied to sponsors of registered investment companies or firms which sponsor both registered funds and private investment funds.[2] The proposals also have the potential to affect fund complexes that are sponsored by large financial institutions, as they include the ability to impose and enforce more stringent capital and other requirements on "regulated subsidiaries" (defined in the white paper to include investment advisers, investment companies and entities regulated by the CFTC) of Tier 1 FHCs. Funds and advisers subject to Tier 1 FHC regulatory requirements would continue to be regulated functionally by the SEC.

Money Market Funds

The white paper encourages the SEC to consider imposing a number of additional requirements on money market funds (MMFs). These include (i) requiring MMFs to maintain substantial liquidity buffers, (ii) reducing the maximum weighted

[1] *Financial Regulatory Reform—A New Foundation: Rebuilding Financial Supervision and Regulation* (Department of the Treasury).

[2] At a news briefing on June 17, Treasury Secretary Timothy Geithner initially expressed doubt that a hedge fund could be classified as a Tier 1 FHC, but later agreed with the statement by National Economic Director Larry Summers that the government does not yet have enough information to make that determination.

average maturity of MMF assets, (iii) tightening the credit concentration limits applicable to MMFs, (iv) improving the credit risk analysis and management of MMFs and (v) empowering MMF boards of directors to suspend redemptions in extraordinary circumstances to protect the interests of fund shareholders. In the main, these proposals have already been embraced as part of the Investment Company Institute's recommendations on reforming the regulation of MMFs, and a number of fund groups have announced that they will be implementing some or all of the ICI's recommendations.[3] The white paper goes on to suggest, however, that these proposals, while helpful, are not sufficient, and proposes that the President's Working Group on Financial Markets consider more fundamental changes to address systemic risk, such as moving away from the use of stable net asset values by MMFs or requiring MMFs to obtain reliable and scalable emergency liquidity facilities from private sources.

In addition to these specific proposals, the white paper also includes proposals of more general applicability with the potential to significantly impact the operation of MMFs and their sponsors. For example, the white paper states that regulators should reduce their use of credit ratings in regulations and supervisory practices wherever possible (credit ratings are integral to the current regulatory scheme for MMFs) and proposes that all banks have stricter capital requirements for implicit exposures to off balance sheet vehicles, including MMFs.

Registration of Advisers to Hedge Funds and Other Private Funds; Enhanced Regulation of Derivatives

As discussed in more detail in our June 18 Alert, the administration's proposals would require all advisers to private funds (including hedge funds, private equity funds and venture capital funds) whose assets under management exceed some "modest threshold" to register with the SEC under the Investment Advisers Act of 1940. The proposals would also impose on the private funds themselves a number of recordkeeping, disclosure and reporting requirements. The proposals leave a number of questions unanswered, such as how the rules would apply to commodity pools regulated by the CFTC (which will continue to have regulatory jurisdiction with respect to commodity pools), and how the registration and other requirements would apply to non-U.S. advisers and/or non-U.S. private funds.

Our June 18 Alert also discusses a number of proposed changes to the derivatives market relevant to fund complexes. For example, derivatives dealers and all other financial firms whose activities create large exposures to counterparties should be subject to a "robust and appropriate scheme of prudent supervision and regulations" (such as conservative capital and margin requirements and reporting requirements), although it does not indicate whether an advisory firm's client and proprietary accounts would be aggregated for these purposes. Regulated firms would also be "encouraged" to make use of exchange-traded, as opposed to over-the counter, derivatives.

Investor Protection Initiatives

The white paper proposes the creation of a new federal agency, the Consumer Financial Protection Agency (CFPA), dedicated to protecting consumers in the financial products and services markets. Although the CFPA's authority is not intended to apply to "investment products and services already regulated by the SEC or CFTC," it remains to be seen whether the CFPA's proposed mandate to "reduce gaps" in federal supervision, improve coordination among the states, set higher standards for and impose higher duties on "financial intermediaries," and promote consistent regulation of "similar products" would give it the ability, even if indirect, to affect the operation or distribution of investment products targeted at "retail" investors, such as MMFs, other registered investment companies and some private funds.

[3] The SEC has scheduled a public meeting for June 24 to consider whether to propose amendments governing the operation of MMFs.

The proposals would also grant additional authority to the SEC. Specifically, the new regulatory regime would empower the SEC to authorize that certain disclosures (including mutual fund summary prospectuses) be provided to investors at or before the point of sale and to examine and ban forms of compensation that encourage intermediaries to put investors into products that are profitable to the intermediary but are not in the investors' best interests. The white paper also calls for legislation prohibiting certain (but as of yet unspecified) conflicts of interests and sales practices that are "contrary to the interests of investors." The proposals would also establish a fiduciary duty for broker-dealers offering investment advice to retail investors and harmonize the regulation of investment advisers and broker-dealers. Depending on how they are implemented, these proposals have the potential to significantly impact the distribution of investment products such as mutual funds by limiting "revenue sharing" or similar payments, requiring enhanced "point of sale" disclosures or making it more difficult for financial intermediaries to recommend proprietary or affiliated funds and other products. Because the proposals do not mention the specific practices that would be limited or banned, it is possible that any legislation would simply grant the SEC additional authority to define and regulate sales and other practices considered to be contrary to the interests of investors. The white paper also proposes granting the SEC the authority to establish a fund to pay whistleblowers for information that leads to enforcement actions resulting in significant financial awards.

The administration's proposals would also enhance the power of state regulators. For example, the white paper proposes that the states should have the ability to adopt and enforce laws regulating financial institutions that are stricter (but not weaker) than federal laws. It is unclear whether this enhanced authority would apply to investment products and services regulated by the SEC or CFTC, or merely to products and services under the jurisdiction of the CFPA (assuming such a line can be drawn). If the former, the proposals have the potential for greatly upsetting the jurisdictional balance between state and federal authority that has been in place for registered investment companies and many privately placed securities since the enactment of the National Securities Markets Improvement Act of 1996 (NSMIA), possibly imposing significant new regulatory burdens on funds and their advisers.

Executive Compensation

The white paper also provides that regulators should issue "standards and guidelines" to better align compensation practices of financial firms with long term shareholder value and prevent compensation practices from providing incentives that could threaten the safety and soundness of supervised institutions. These standards and guidelines would not be limited to public companies, and therefore could impact the compensation practices (presumably including incentive compensation) of investment advisers and sponsors of private investment funds.[4]

Contact Information

If you have any questions about the administration's proposals, please contact the Ropes & Gray attorney who normally advises you.

[4] See Ropes & Gray's June 19 Alert for more information about the various executive compensation proposals proposed by the Obama administration.