House Proposal Could Regulate Private Fund Compensation

On Tuesday, July 28th, the House Financial Services Committee approved legislation principally authored by Chairman Barney Frank that is designed to address public company and financial institution compensation issues. Media coverage of H.R. 3269, "The Corporate and Financial Institution Compensation Fairness Act," has focused on provisions granting shareholders of public companies a "say on pay" for top executives by granting these shareholders a nonbinding, advisory vote on compensation practices, as well as provisions strengthening the independence of public company compensation committees.

However, the proposed legislation would also grant federal regulators (*e.g.*, the SEC and the Federal Reserve) the authority to substantively regulate the incentive compensation arrangements of "covered financial institutions," which are defined to include banks, credit unions, registered broker-dealers, and investment advisers with assets of at least $1 billion. By including investment advisers in its definition, the legislation would apply to private equity, venture capital, hedge fund, and other private investment fund firms with assets of at least $1 billion (whether or not they are required to be registered). As drafted, the exemption of institutions with less than $1 billion of assets refers to the assets of the institution. In the case of investment advisers, given the apparently intended broad reach of the legislation, it is not clear whether the intention was to refer to assets under management, rather than the assets of the investment adviser.

Covered financial institutions would be required to disclose to federal regulators (in the case of investment advisers, disclosure would likely be to the SEC) the structures of all incentive-based compensation arrangements. The disclosure would be intended to allow the regulators to determine whether the incentive compensation structure is "aligned with sound risk management," "structured to account for the time horizon of risks," and meets other criteria determined appropriate to reduce "unreasonable incentives" for employees to take undue risks. Disclosure of the actual compensation of particular individuals would not be required.

Federal regulators would also be granted rule-making authority to prohibit covered financial institutions from using incentive compensation structures that could "threaten the safety and soundness of covered financial institutions or could have serious adverse effects on economic conditions or financial stability."

Management fees, transaction fees and carried interest would all appear to fall within the incentive compensation subject to disclosure and potentially substantive regulation. However, the private fund investor community has not heretofore thought that any of these compensation mechanisms provided incentives for firms to take undue risks. Nor has it been thought that private investment funds generally pose the risks of "serious adverse effects on economic conditions or financial stability," although, of course, the potential market impact of large hedge funds has been noted. Finally, the SEC already routinely asserts authority to review compensation of registered investment advisers. For these reasons, even if legislation were enacted in the form proposed, there appears to be little sound basis for federally mandated changes to the economic terms of private investment funds.

The legislation is scheduled to come before the full House of Representatives for a vote later this week, and it may change considerably as it proceeds through the legislative process in the House and later in the Senate. Senate action is not expected until after the Congressional recess. Ropes & Gray will continue to monitor developments relating to this legislation and potential impacts on private investment funds and their sponsors.

For more information, please contact your usual Ropes & Gray attorney.