



Private Equity Alert

Developments in private equity law

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Financial industry reform proposals would affect private equity funds and venture capital funds

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The Obama Administration's proposal for comprehensive restructuring of the federal government's supervision and regulation of the financial industry, announced by Secretary of the Treasury Timothy Geithner on June 18, 2009, includes several proposals that, if adopted, would affect private pools of capital, including private equity funds, venture capital funds, and funds of funds.

The proposals are included in an 88-page white paper entitled "Financial Regulatory Reform: A New Foundation: Rebuilding Financial Supervision and Regulation." The white paper sets forth a number of specific proposals intended to achieve five key objectives:

1. Promote robust supervision and regulation of financial firms;
2. Establish comprehensive supervision of financial markets;
3. Protect consumers and investors from financial abuse;
4. Provide the government with the tools it needs to manage financial crises; and
5. Raise international regulatory standards and improve international cooperation.

Addressing the issue of private investment funds, the white paper asserts that, at various points in the financial crisis that we have faced over the past two years, de-leveraging by hedge funds contributed to the strain on financial markets. It notes that, since hedge funds were not required to register with government regulators, the government lacked reliable, comprehensive data with which to assess this sort of market activity. Furthermore, the white paper argues that there is a compelling investor protection rationale to fill the gaps in the regulation of investment advisers and the funds they manage.

Without acknowledging the distinction between hedge funds and other private investment pools, such as private equity funds and venture capital funds, the white paper proposes that "*all* [emphasis added] advisers to hedge funds (and other private pools of capital, including private equity funds and venture capital funds) whose assets under management exceed some modest threshold should be

required to register with the Securities Exchange Commission under the Investment Advisers Act.” Requiring registration of fund managers, the white paper argues, will allow the SEC to collect data that would permit an informed assessment of whether such funds have become so large, leveraged, or interconnected as to require regulation of private investment funds themselves for financial stability purposes.

The white paper also proposes that any investment fund advised by an SEC-registered adviser (which, under the Administration’s proposal, would include most private equity funds and venture capital funds) be subject to:

1. Recordkeeping requirements;
2. Requirements with respect to disclosures to investors, creditors, and counterparties; and
3. Regulatory reporting requirements.

Although some of the reporting requirements may vary depending on the type of investment fund, the white paper asserts that all funds should be required to report to the SEC, on a confidential basis, (a) the amount of assets under management, (b) borrowings, (c) off-balance sheet exposures, and (d) other information necessary to assess whether the fund or fund family is so large, highly leveraged, or interconnected that it poses a threat to financial stability. The white paper also proposes that the SEC should share the reports it receives from funds with the Federal Reserve, which would have the authority to designate a fund or a family of funds as a “Tier 1 Financial Holding Company” (i.e., a firm whose combination of size, leverage, and interconnectedness could pose a threat to financial stability if it failed) and to subject such fund or family of funds to robust supervision and regulation. Under the proposal, funds would be subject to regular, periodic regulatory examinations by the SEC to monitor their compliance with the reporting and recordkeeping requirements.

The white paper also proposes that federal regulators should establish standards on compensation for “financial firms” that will be fully integrated into the supervisory process in order to align compensation incentives better with the interests of investors and the need to ensure safety and soundness in the financial sector. In this regard, the white paper sets forth five principles:

1. Compensation plans should properly measure and reward performance;
2. Compensation should be structured to account for the time horizon of risks;
3. Compensation practices should be aligned with sound risk management guidelines;
4. Compensation packages (including “golden parachutes”) should be reexamined to determine whether they align the interests of executives and investors; and
5. Transparency and accountability should be promoted in the process of setting compensation.

Although the proposals with respect to compensation appear to be directed primarily at the executives of banks and investment banks, the broad sweep of the term “financial firms” suggests that, when details are forthcoming, the compensation standards may extend to hedge fund managers

and the general partners of private equity funds, venture capital funds, and other private investment pools.

Although broad in its scope, the Administration's proposal contains few specifics about implementation. Implementation will require comprehensive legislation and the subsequent adoption of a broad range of regulations by the Federal Reserve, the SEC, and other financial regulatory agencies. The white paper's proposals with respect to hedge funds, private equity funds, venture capital funds, and other private investment funds are generally consistent with legislation introduced in Congress earlier this year, including the Hedge Fund Transparency Act (S. 334, introduced by Senators Grassley and Levin) and the Hedge Fund Adviser Registration Act (H.R. 771, introduced by Representatives Castle and Capuano). Representative Barney Frank (D-MA), chair of the House Financial Services Committee, has announced that he intends to bring comprehensive financial services reform legislation to a vote in the House of Representatives before year-end. No doubt, the legislation that emerges from Frank's committee will be strongly influenced by the Administration's white paper and, in addressing the regulation of hedge funds and their managers, will likely impose on private equity funds, venture capital funds, and funds of funds and their general partners registration, reporting, and record-keeping obligations consistent with those recommended in the white paper.

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