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Registration

U.S. House of Representatives Holds Hearing on Hedge Fund Adviser Registration

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By Cara Griffith, *Hedge Fund Law Report*

On October 6, 2009, the U.S. House of Representatives, Financial Services Committee held a hearing on three legislative proposals regarding: (1) investor protection; (2) private fund adviser registration; and (3) insurance information. The proposals, introduced by Rep. Paul Kanjorski (D-Pa.), Chairman of the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, are aimed at reforming the regulatory structure of the financial services industry and largely mirror proposals released by the Senate and the Obama administration. See also "House Subcommittee Considers Bill Requiring U.S. Hedge Fund Advisers with Over $30 Million in Assets Under Management to Register with SEC," Hedge Fund Law Report, Vol. 2, No. 41 (Oct. 15, 2009).

At the sparsely-attended hearing, regulators and industry advocates largely expressed support for the proposals. On a positive note for hedge funds, the debate had a moderated tone overall, and participants generally did not seek to blame hedge funds for recent financial crisis. On the contrary, Rep. Spencer Bachus (R-Al.) called private funds, including hedge funds, "a valuable cog in our economy." (Notably, however, the hearings took place before charges against Raj Rajaratnam of the Galleon Group were made public. See "Billionaire Founder of Hedge Fund Manager Galleon Group, Raj Rajaratnam, Charged in Alleged Insider Trading Conspiracy," above, in this issue of the Hedge Fund Law Report. While the charges against Rajaratnam and others have more to do with a group of allegedly bad actors, and less to do with hedge funds per se, press reports already have begun to conflate the hedge fund structure with the alleged insider trading.)

Despite the overall productive tone of the hearing, a major question remains: how quickly will Congress move with the proposed hedge fund adviser registration legislation? From a timing standpoint, even with general support for the legislation, it is unclear how quickly these measures will move. House Majority Leader Steny Hoyer (D-Md.) indicated that the entire package could be put to a House vote as early as next month, but Rep. Kanjorski suggested to reporters after the hearing that such a timeline might be "very optimistic." The bills are scheduled for a "mark-up" session by the Financial Services Committee on October 27, 2009.

Investor Protection Act

The first draft bill discussed was the Investor Protection Act of 2009 (Investor Protection Act) which would strengthen the powers of the Securities and Exchange Commission (SEC) and would require that every financial intermediary, who provides investment advice to a client be held to

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the same fiduciary duty. This would mean that broker-dealers that provide investment advice and investment advisers would be held to the same standard of care. Broker-dealers are currently subject to a less stringent suitability standard, while investment advisers are subject to a higher fiduciary duty standard. See "What Precisely is 'Fiduciary Duty' in the Hedge Fund Context, and To Whom is it Owed?," Hedge Fund Law Report, Vol. 2, No. 29 (Jul. 23, 2009). Rep. Barney Frank (D-Mass.), Chairman of the Financial Services Committee, indicated that the purpose of this portion of the bill is clarification. He noted that "redundancy is preferable to ambiguity" and "we want to make clear what's covered."

Richard Ketchum, Chairman and CEO of the Financial Industry Regulatory Authority (FINRA) said that the standard of care for all intermediaries providing financial advice to clients should be the fiduciary standard. Denise Crawford, president of the North American Securities Administrators Association Inc. and the Texas Securities Commissioner, said that broker-dealers should be subject to the same fiduciary standard that is applied to investment advisers. Crawford warned, however, that Congress should be wary of efforts by industry groups to water down the "pro-investor fiduciary duty that has permeated investment adviser regulation for over four decades."

In addition to imposing a fiduciary duty on broker-dealers, the Investor Protection Act would also authorize the SEC to define the "client" to whom a fiduciary duty is owed. In so doing, the SEC could provide by rule that a hedge fund manager owes a fiduciary duty to each investor in a hedge fund, and not just to the hedge fund itself. In its prepared statement, the MFA expressed "concerns with imposing fiduciary obligations on an adviser with respect to investors in pooled investment funds managed by that adviser." The MFA continued that an "adviser to a pooled investment fund likely would not have the information about the underlying investors in the fund necessary to be able to determine whether an individual investment made for a fund's portfolio would also be appropriate for an individual investor. Further, applying fiduciary obligations to the investor and the fund can create potential conflicts between an adviser's obligation to the fund and obligations to investors." See "For Hedge Fund Managers, How Would a Statutory Definition of 'Fiduciary Duty' Affect the Scope of the Duty and the Standard for Breach?," Hedge Fund Law Report, Vol. 2, No. 34 (Aug. 27, 2009).

The bill would also give the SEC the authority to eliminate mandatory arbitration provisions in contracts investors sign with brokers. This would permit investors to take disputes to court. Crawford, a state regulator, said that Congress "should prohibit the mandatory nature of securities arbitration." Ketchum, while not objecting to the proposal, said that "FINRA has long maintained that a determination about whether mandatory arbitration agreements should be allowable is a decision best made by Congress and the SEC." Although mandatory arbitration has allegedly limited the ability of defrauded investors to seek redress in court, the cost of litigation is a very real concern. Bachus noted that eliminating mandatory arbitration provisions "could substantially increase dispute-resolution costs for investors and compliance costs for firms."

Private Fund Investment Adviser Registration Act

The second draft bill, the Private Fund Investment Adviser Registration Act of 2009, would require most hedge fund managers and other advisers of private pools of capital to register with the SEC and would require registered hedge fund advisers to make certain disclosures to investors and creditors. "Transparency has been non-existent in this area for too long, and the financial crisis revealed that our system cannot tolerate such omissions going forward," said Kanjorski in his opening statement. Kanjorski suggested that by mandating registration of hedge fund managers, regulators will gain a better understanding of how private funds operate and

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thereby will be better positioned to determine whether the actions of private funds pose a threat to the financial system as a whole. Bachus, however, expressed concern about imposing new oversight on generally unregulated funds. "We must ensure that any new regulatory powers . . . are appropriate and do not interfere with the comprehensive due diligence that investors already perform."

In general, the industry groups present at the hearing expressed support for some registration requirements. The Managed Funds Association (MFA), in a prepared statement by Richard H. Baker, President and CEO, expressed support for broad-based registration requirements with only "a limited exemption for the smallest investment advisers with a *de minimis* amount of assets under management and an exemption for advisers registered under the Commodity Exchange Act. Additionally, both Douglas Lowenstein, President and CEO of the Private Equity Council, and James Chanos, Chairman of the Coalition of Private Investment Companies (CPIC) and President of Kynikos Associates LP, a private investment company, issued support for requiring registration of private fund advisers.

After the hearing, Alexandra Poe, a Partner at Reed Smith LLP, noted to the Hedge Fund Law Report that "it is not accurate to describe hedge funds as 'unregulated' or even 'lightly regulated.'" There are numerous anti-fraud rules, market participant rules and industry practices with which hedge funds must comply. That said, Poe suggested that "adviser registration for private fund advisers will be mostly a good thing, as the compliance disciplines that come with it are generally salutary."

While the hedge fund industry has generally conceded that some registration requirements are acceptable, the venture capital industry has come out strongly against registration requirements for venture capital firms. Terry McGuire, Chairman of the National Venture Capital Association, argued that the purpose of requiring registration really does not apply to venture capital firms. He noted that venture capital firms tend to be small, have little staff, use little or no leverage, and, in general, do not pose the type of systemic risk that would justify imposing the expense and burden of SEC registration on them.

Disclosure Requirements

In addition to supporting the SEC's proposed hedge fund adviser registration requirement, the CPIC also expressed support for the idea that Congress should impose disclosure requirements. According to written testimony delivered by James Chanos: "Lenders and counterparties should be provided with information sufficient to assess the risk of doing business with the private fund, including the company's audited annual financial statements, current private placement memorandum, information as to the fund's valuation methodology, the existence of side-letters and side-arrangements and any material conflicts of interest or financial arrangements." Hedge fund managers employ varying approaches with respect to disclosure of valuation methodology, and it can be difficult for investors to distinguish between and reconcile the varying approaches. For example, providing information on how a fund derives income or losses from FAS 157 Level 1, 2 and 3 assets could give investors a view into how reliable the fund's portfolio is.

The Private Equity Council countered, however, that "[r]equiring open-ended disclosures to [counterparties and creditors] is potentially destructive of normal commercial relationships and could expose proprietary information and trade secrets to those with whom we compete." Stuart Kaswell, General Counsel for the MFA said that while the "MFA supports other smart regulatory reform measures, including enhanced transparency and disclosure among counterparties. . . [the MFA is] concerned with initiatives that would require fund managers to

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disclose proprietary information to their counterparties." The MFA believes such information is more appropriately disclosed to a systemic risk regulator.

Federal Insurance Office Act

The final piece of legislation discussed was the Federal Insurance Office Act of 2009. According to Rep. Kanjorski, the goal of the act is to create a Federal Insurance Office within the Treasury Department that would provide a unified voice on insurance matters and would provide policymakers with access to information and resources to respond in a crisis, mitigate systemic risk, and ensure that the insurance industry is functioning well. Some of those present at the hearing expressed support for the Federal Insurance Office Act, while others expressed opposition.

Timing

As noted above, Rep. Hoyer expressed confidence that the Financial Services Committee would complete its work on the regulatory reform legislation in October, meaning that a debate on the House floor could occur in November. However, many observers doubt that such a timeline is feasible, and Rep. Kanjorski seemed to confirm that suspicion when he indicated that Rep. Hoyer was being optimistic in saying the legislation could be put to a House vote next month. Earlier in the year, it appeared that some form of regulatory reform would be passed by the end of the year, but when President Obama said the legislation would take a back seat to health care, those in the financial services industry began to question the speed with which the legislation would move. Although the hearing boosts the chances that some form of regulatory reform will pass this year, whether and when the legislation will become law remains unclear.

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