April 2011

SEC Proposes Rules Limiting Certain Investment Adviser Incentive Compensation

SEC Implementation of the Dodd-Frank Wall Street Reform Act

On March 2, 2011, the Securities and Exchange Commission ("SEC") proposed new rules under the Investment Advisers Act of 1940, as amended (the "Advisers Act"), as required by Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). If adopted as proposed, the proposed rules would require each investment adviser with assets of at least $1 billion to file reports with the SEC about its incentive-based compensation arrangements and certain incentive-based compensation arrangements would be prohibited for such advisers. A copy of the SEC's proposing release is available here.

Background

Section 956 of Dodd-Frank requires the SEC, the Federal Reserve, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, Federal Housing Finance Agency and the National Credit Union Administration to jointly write rules and guidelines that require "covered financial institutions" to disclose to their appropriate federal regulator the structure of their incentive-based compensation arrangements so the regulator can determine whether such compensation is excessive and prohibit any type of incentive-based compensation that the regulators determine encourages inappropriate risks. The SEC-regulated financial institutions affected by the rulemaking include broker-dealers and investment advisers with $1 billion or more in assets.

The proposed rules are the first step in the process for implementing the related Dodd-Frank requirements and, following a comment period, the SEC will adopt final rules, which may differ from the proposed rules in significant respects. For additional information on the implementation of Section 956, see our related memo.

What entities are subject to the proposed rules?

The proposed rules would apply to "covered financial institutions," including among other financial institutions, brokers, dealers and investment advisers with assets of at least $1 billion. Under Section 956 of Dodd-Frank, any entity that satisfies the definition of investment adviser under the Advisers Act would be included, regardless of whether the firm is registered or exempt from registration as an investment adviser. For investment advisers, asset size would be determined by the adviser's total assets shown on the balance sheet for the adviser's most recent fiscal year-end.

While this calculation is proposed to be based on the adviser's balance sheet rather than its assets under management, private investment fund sponsors may be more likely to be subject to the proposed rules if they carry the assets of their funds on their balance sheets. The SEC solicited comment on the calculation of assets for hedge fund or private equity fund advisers.

The proposed rules would further apply to "covered persons" of the covered financial institutions, including executive officers, employees, directors or principal shareholders.

© 2011 Hunton & Williams LLP

What do the proposed rules require of these investment advisers?

The proposed rules include three basic requirements:

1) Required Reports to the SEC About Incentive-Based Compensation

Under the proposed rules, a covered financial institution must file a report annually with the SEC describing the firm's incentive-based compensation arrangements for covered persons, including:

- A clear narrative description of the components of the institution's incentive-based compensation arrangements.
- A succinct description of the institution's policies and procedures governing its incentive-based compensation arrangements.
- The reasons why the firm believes the structure of its incentive-based compensation arrangement does not encourage inappropriate risks by the firm by providing covered persons with excessive compensation or incentive-based compensation that could lead to a material financial loss to the firm.

2) Prohibitions on Excessive Compensation and Material Financial Loss

Under the proposed rules, a covered financial institution must not establish or maintain an incentive-based compensation arrangement (or any feature of any such arrangement) that encourages inappropriate risks by providing covered persons with excessive compensation, or that could lead to material financial loss.

An incentive-based compensation arrangement provides excessive compensation when amounts paid are unreasonable or disproportionate to the services performed by a covered person, after taking into consideration a number of factors, including the combined value of all cash and noncash benefits provided to the covered person, the compensation history of the covered person and other individuals with comparable expertise at the firm, the financial condition of the firm, comparable compensation practices at comparable covered financial institutions, the projected total cost and benefit to the firm of postemployment benefits, any connection between the individual and any fraudulent act or omission and any other factors the SEC determines to be relevant.

The proposal states that a covered financial institution must not establish or maintain any type of incentive-based compensation arrangement that encourages inappropriate risks by providing incentive-based compensation to covered persons, either individually or as part of a group of persons subject to similar arrangements, that could lead to a material financial loss to the covered financial institution. An incentive-based compensation arrangement does not comply unless it balances risk and financial rewards, is compatible with effective controls and risk management and is supported by strong corporate governance, including active and effective oversight by the institution's board of directors. The proposed rule lays out more specific requirements for executive officers and certain other designated individuals at financial institutions with $50 billion or more in total consolidated assets.

In addition, a covered financial institution is prohibited from doing indirectly or through or by any other person any act or thing that it would be unlawful for it to do directly under the proposed rules.

3) Required Policies and Procedures

Under the proposed rules, an incentive-based compensation arrangement must be adopted pursuant to policies and procedures developed and maintained by the institution and approved by its board of directors, reasonably designed to ensure and monitor compliance and commensurate with the size and complexity of the organization and the nature of its use of incentive-based compensation.

© 2011 Hunton & Williams LLP

Timetable

Each agency must individually review and approve the proposed rule for public comment before jointly publishing the proposal in the *Federal Register*. The SEC's deadline for submitting comments on the proposals is May 31, 2011.

Conclusion

Based on the proposals, these rules may not apply to many private investment fund sponsors because the $1 billion asset threshold is proposed to be measured at the investment adviser level (rather than based on assets under management). However, the SEC requested comments on the application of the proposed rules to hedge fund and private equity fund sponsors and it is possible that the final rules may differ in material respects from the proposals. We can assist in evaluating these issues, preparing to address the new rules and drafting proposed comments to the SEC regarding the proposals.

Further Information

The Hunton & Williams Private Investment Funds practice group regularly represents funds, sponsors and a variety of investors in all types of private investment fund matters, including structuring, formation, offerings and compliance. We will continue to monitor the progress of the SEC's rulemaking to implement Dodd-Frank's requirements relating to investment advisers as well as relevant trends in private investment fund regulation.

For additional information on financial industry recovery proposals, see our related memoranda, available on www.huntonfinancialindustryresourcecenter.com. For additional information on recent legislation and regulations relating to regulation of private investment funds and their advisers, see our prior memoranda available on our website at www.hunton.com.

Contacts

Cyane B. Crump
ccrump@hunton.com

James S. Seevers, Jr.
jseevers@hunton.com

© 2011 Hunton & Williams LLP. Attorney advertising materials. These materials have been prepared for informational purposes only and are not legal advice. This information is not intended to create an attorney-client or similar relationship. Please do not send us confidential information. Past successes cannot be an assurance of future success. Whether you need legal services and which lawyer you select are important decisions that should not be based solely upon these materials.