

FINANCIAL REGULATORY REFORM: IMPLICATIONS FOR HEDGE FUNDS AND ALTERNATIVE INVESTMENTS

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To Our Clients and Friends:

On Wednesday, the Obama Administration unveiled its proposals for financial regulatory reform, and the Department of Treasury published a White Paper entitled “Financial Regulatory Reform, a New Foundation: Rebuilding Financial Supervision and Regulation.” The White Paper sets forth the Administration’s key objectives for the reforms, which include: (i) robust supervision and regulation of financial firms, (ii) comprehensive supervision of financial markets, and (iii) providing the government with the tools it needs to manage financial crises.

The recommendations designed to achieve these objectives have significant implications for hedge funds and other private funds as well as the regulation of futures and other derivatives.

SUPERVISION AND REGULATION OF FINANCIAL FIRMS

Financial Services Oversight Council. The Administration’s proposal contemplates the creation of a “Financial Services Oversight Council” chaired by the Secretary of the Treasury, whose members would include the chairs of various regulatory agencies (including the chairs of the SEC and CFTC) as well as a number of new regulatory agencies that would be created under the proposal.

The White Paper contemplates that private funds of substantial size would come under the jurisdiction of the Financial Services Oversight Council. Presumably, any such fund would face increased disclosure (although likely to be confidential) and also increased substantive restrictions (particularly related to leverage and risk management).

Adviser Registration and Regulation. As part of its plan to implement a robust and comprehensive supervision of financial firms, the Administration’s proposal contemplates that advisers to hedge funds and other private pools of capital whose assets under management exceed a “modest” threshold would register as investment advisers. (On June 16, 2009, Senator Jack Reed (D-RI) introduced a bill that appears to have anticipated the Administration’s proposal. The threshold for registration in the Reed bill would be \$30 million.)

The Administration's proposal also contemplates that private funds advised by SEC-registered investment advisers would be subject to recordkeeping requirements, requirements with respect to disclosure to investors, creditors and counterparties, and regulatory reporting requirements. The regulatory reporting requirements would require reporting on a confidential basis of the amount of assets under management, borrowings and other data necessary to assess "whether the fund . . . is so large, highly leveraged, or interconnected that it poses a threat to financial stability." This information would be reported to the SEC but shared with the Federal Reserve for purposes of identifying which, if any, funds should be subject to the oversight of the Financial Services Oversight Council. It does not appear that private funds would be subject to the oversight of a new Consumer Financial Protection Agency. It is unclear at this point whether this legislation would open the door for greater substantive regulation of private funds.

COMPREHENSIVE REGULATION OF FINANCIAL MARKETS

Comprehensive Regulation of All OTC Derivatives. The proposed regulatory reforms are designed to achieve the following objectives: (1) preventing activities in the OTC derivatives markets from posing risk to the financial system, (2) promoting the efficiency and transparency of the OTC derivatives markets, (3) preventing market manipulation, fraud and other market abuses, and (4) ensuring that OTC derivatives are not marketed inappropriately to unsophisticated parties.

The Administration's proposal would require all standardized OTC derivatives to be cleared through regulated central counterparties (CCPs). Regulators would also require the CCPs to adhere to more robust margin requirements and other risk control measures. New regulations would also seek to encourage the movement of standardized trades to regulated exchanges and electronic trading execution systems and to promote greater use of exchange-traded derivatives.

Further, OTC derivatives dealers and all other firms that create large exposures to counterparties would be subject to a robust regime of supervision and regulation, including conservative capital requirements (more stringent than the existing bank regulatory capital requirements for OTC derivatives), business conduct standards, reporting requirements and conservative requirements for initial margin.

The proposal would also seek to promote market efficiency and price transparency by imposing recordkeeping and reporting requirements on all OTC derivatives and requiring the clearing of standardized contracts through CCPs.

Harmonize Futures and Securities Regulations. The Administration intends to make the necessary amendments to the Commodities Exchange Act (CEA) and the federal securities laws to give clear and unimpeded authority to the CFTC and the SEC to regulate and police the OTC derivatives markets. Noting that the current regulatory structure creates many instances of jurisdictional and regulatory overlap between the CFTC and the SEC, the Administration proposes to harmonize the CEA and the federal securities laws and promote coordination between the two agencies. With this in mind, the Administration recommends that the CFTC and the SEC complete a report to Congress by the end of September “that identifies all existing conflicts in statutes and regulations with respect to similar types of financial instruments and either explains why those differences are essential to achieve underlying policy objectives with respect to investor protection, market integrity, and price transparency or makes recommendations for changes to statutes and regulations that would eliminate the differences.” If the two agencies cannot reach agreement on this report by the end of September, their differences will be referred to the newly created Financial Services Oversight Council that is then required to address such differences and make recommendations to Congress within six months of its formation.

The White Paper only outlines the broad framework of the proposed regulatory reforms, and it remains to be seen what shape the proposed legislation will take in Congress in the weeks and months ahead.

We plan to monitor future developments in this area and will report on any important developments.

Please feel free to contact us with any questions.

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