

# President Obama Proposes New Financial Regulations, including Hedge Fund Registration

On June 17, 2009, the Obama administration released its plan for a new financial regulatory regime in the United States. If adopted, the proposals would require registration of virtually all U.S. hedge fund advisers and would have other significant impacts on the hedge fund industry. While bills have already been introduced in Congress that would accomplish certain of the plan's objectives, comprehensive legislation to adopt the president's proposals has not been introduced and the timetable for such legislation is unknown.

A summary of a portion of the administration's proposals, focusing on those provisions of greatest significance to hedge funds, appears below.

## Registration of Hedge Funds and Other Private Funds

Under the proposals, all advisers to private funds (including hedge funds, private equity funds, and venture capital funds) whose assets under management exceed some modest threshold would be required to register with the Securities and Exchange Commission (SEC) under the Investment Advisers Act of 1940 (Advisers Act). Newly registered advisers would be subject to all existing laws and regulations applicable to registered investment advisers under the Advisers Act and would be subject to regular examination by the SEC. In addition, all private investment funds managed by registered advisers would be subject to recordkeeping requirements, requirements with respect to disclosures to investors, creditors and counterparties, and confidential regulatory reporting of assets under management, borrowings, off-balance sheet exposures and other information. The specific reporting requirements may vary across different types of private funds. Reporting by fund managers would, among other things, be used by the Federal Reserve to determine whether individual funds or fund families should be subject to special regulation as Tier 1 Financial Holding Companies (see below for details).

## Heightened Regulation of All Large, Interconnected Financial Firms

The administration's plan includes the proposed creation of a new category of large financial firms whose combination of size, leverage and interconnectedness could pose a threat to financial stability if any such firm were to fail (Tier 1 Financial Holding Companies). Under the proposal, the Federal Reserve Board would be granted new authority to supervise and regulate Tier 1 Financial Holding Companies. Tier 1 Financial Holding Companies could potentially include hedge funds to the extent a hedge fund or hedge fund family is so large, highly leveraged or interconnected that, in the view of the Federal Reserve, it poses a threat to financial stability.

Tier 1 Financial Holding Companies would be subjected to stricter and more conservative prudential standards than those that apply currently to bank holding companies – including higher standards on capital, liquidity and risk management. Tier 1 Financial Holding Companies would be required to implement processes for monitoring and controlling the full range of their liquidity risks including regular stress tests across a variety of liquidity stress scenarios. In addition, the administration's proposal includes the creation of a resolution regime, modeled on the existing resolution regime for insured depository institutions under the Federal Deposit Insurance Act, to avoid the disorderly resolution of failing Tier 1 Financial Holding Companies, if a disorderly resolution would have serious adverse effects on the financial system or the economy.

The Federal Reserve Board, in consultation with Treasury, would determine which firms should be regulated as Tier 1 Financial Holding Companies. Factors include (a) the impact the firm's failure would have on the financial system and the economy, (b) the firm's combination of size, leverage (including off-balance sheet exposures), and degree of reliance on short-term funding and (c) the firm's criticality as a source of credit for households, businesses and state and local governments and as a source of liquidity for the financial system. The Federal Reserve Board would also be allowed to consider other relevant factors and exercise discretion in applying the specified factors to individual financial firms. The Federal Reserve Board would have the authority to examine any U.S. financial firm that meets certain minimum size thresholds if the Federal Reserve is unable to determine whether the firm's financial activities pose a threat to financial stability based on regulatory reports, discussions with management and publicly available information.

## Derivatives and Other Financial Market Regulation

The proposals also include three major changes relevant to the derivatives market. First, the proposals would amend the Commodity Exchange Act and applicable securities laws so that standardized derivatives are cleared through centralized counterparties, and OTC dealers and other firms whose activities in the OTC derivatives markets create large counterparty exposures would become subject to more burdensome regulation and margin rules. Various recordkeeping and reporting requirements would also be imposed on OTC market participants, including a requirement that customized OTC transactions be reported to a regulated trade repository. Centralized counterparties and trade repositories would be required to make aggregate data on open positions and trading volumes available to the public, and to make information on any individual counterparty's trades and positions available on a confidential basis to the Commodity Futures Trading Commission (CFTC) and the SEC. Second, the proposals would harmonize the statutory and regulatory regimes relating to securities and futures by requiring the SEC and the CFTC to propose uniform rules and procedures. Finally, the proposals would give the U.S. government additional powers in the event of the failure or potential failure of certain financial firms, which failure the Treasury Department determines would have serious adverse effects on the financial system or the economy. These additional powers include the ability of the receiver or conservator of the financial firm (the FDIC or the SEC) to transfer the derivatives contracts of the failing firm to a bridge institution or other entity and thereby avoid termination of such contracts by the failing firm's counterparties, notwithstanding the counterparties' contractual right to terminate.

The administration's plan would also seek to strengthen oversight and functioning of financial settlement systems. The Federal Reserve would be granted authority to oversee systemically important payment, clearance and settlement systems and to provide such systems access to Reserve Bank accounts, financial services, and the discount window.

## Strengthened Investor Protection

The administration's proposals also include several major changes intended to strengthen investor protection. First, the proposals aim to give the SEC expanded authority to promote increased transparency in disclosures to investors. However, it is unclear exactly what disclosures to hedge fund investors would be required. Second, the proposals seek to establish a fiduciary duty for broker-dealers offering investment advice and to harmonize the regulation of investment advisers and broker-dealers. Finally, the proposals would grant the SEC authority to establish a fund to pay whistleblowers for information that leads to enforcement actions resulting in significant financial awards.



## Other Proposals

In addition to the topics described above, the administration's proposals include:

- Creation of a new Financial Services Oversight Council to identify emerging systemic risks and improve interagency cooperation;
- Changes to banking regulations, including a reassessment of regulatory capital requirements, creation of a new National Bank Supervisor, and the elimination of existing loopholes that allowed some depository institutions to avoid regulation as a bank holding company;
- Increased regulation of securitization markets, including a proposal that originators or sponsors be required to retain 5 percent of the credit risk of securitized exposures;
- Proposals to protect consumers of financial products from abuse, including the creation of a new Consumer Financial Protection Agency;
- Revisions to the Federal Reserve Board's emergency lending authority;
- A review of accounting standards and fair value accounting rules;
- An overhaul of money market mutual funds regulation;
- Coordination of efforts by Federal regulators to issue standards for executive compensation;
- Creation of a new Office of National Insurance within Treasury to promote national coordination in the insurance sector;
- Enhanced oversight of credit rating agencies by the SEC and other agencies; and
- International regulatory reforms to support many of the other proposals, including implementing by the end of this year an existing commitment of G-20 leaders to require hedge funds or their managers in each G-20 country to register and disclose appropriate information necessary to assess the systemic risk they pose individually or collectively.

If you have any questions about the administration's proposals, please contact the Ropes & Gray attorney who normally advises you.

*This alert should not be construed as legal advice or a legal opinion on any specific facts or circumstances.  
This alert is not intended to create, and receipt of it does not constitute, a lawyer-client relationship.  
The contents are intended for general informational purposes only, and you are urged to consult your own  
lawyer concerning your own situation and any specific legal questions you may have.*