Investment Management Regulatory Reform Update: March 2009

Proposed Hedge Fund Reform—Round Up the Usual Suspects

Congress wants to regulate hedge funds and other private funds—six recently introduced bills call for new disclosure and registration requirements or studies of hedge fund industry practices. But if the goal is to "fix" hedge fund regulation to avoid the perceived excesses of the past decade that contributed to the current financial crisis, it's not clear that any of these will do the trick.

Three of the bills focus exclusively on increasing investor protection through disclosure and/or registration. The Hedge Fund Adviser Registration Act of 2009 would remove the private adviser exemption from Investment Advisers Act registration. The Hedge Fund Transparency Act proposes to remove the private fund exemption from the definition of investment company and would require funds with at least $50 million in assets to register with the SEC and comply with certain disclosure requirements. Indirectly, it would also require advisers of such funds to register under the Advisers Act. The Pension Security Act of 2009 would require defined benefit plans to disclose private fund investments in their annual reports.

Of these, the Hedge Fund Transparency Act has captured the most attention. Sen. Carl Levin (D-Mich.) touted the bill as necessary due to hedge funds' ability to endanger the financial system and other market participants.

But registration and prospectus-like disclosure won't do much to avoid any systemic risk hedge funds might be seen to create. For example, hedge funds are thought to create risk to the financial system by virtue of the almost unlimited leverage they can use through derivatives and other strategies. Congress and regulators might mitigate that risk by requiring ongoing reporting of derivatives positions and margin levels, imposing position limits, and requiring exchange trading of many derivatives to create an ownership trail—regulation of trading in commodity futures is a good example of such a system that works. But burdening the capital formation process with registration and disclosure requirements of dubious value—even Bernie Madoff's firm was registered with the SEC—may be the wrong approach at a time when free, investable capital is sorely lacking.

The Hedge Fund Study Act, the Financial Crisis Investigation Act of 2009, and the Financial Oversight Commission Act of 2009 show some promise. All of the bills would, to varying degrees, authorize investigations to study the role of hedge funds in the economy. Specifically, the Hedge Fund Study Act would require the President's Working Group on Financial Markets to analyze whether hedge funds' use of leverage might be limited, and to consider the systemic risks posed by hedge funds to the financial markets and other investors. But even that still falls short, calling for a report proposing new *disclosure* requirements for hedge funds, development of industry best practices, and general oversight by the President's Working Group, and does not call for substantive proposals to identify and regulate the use of leverage and other primary causes of systematic risk.

Our guess is that any bill that comes out of Congress in the next few months will require registration and enhanced disclosure. There are many in Congress who have wanted to see this type of regulation for many years, and this is pretty clearly their time to strike. But we may end up with the worst of all worlds—new headwinds to capital formation and no new tools to allow financial regulators like the Fed and the Treasury to detect the build-up of large off-balance sheet risks to the financial system.

Money Market Mutual Funds—Do They Squawk Like a Bank?

Paul Volcker, head of the President's Economic Recovery Advisory Board and venerable ex-Fed chairman, said about money market mutual funds, "If they are going to talk like a bank and squawk like a bank, they ought to be regulated like a bank."

That sentiment is reflected in the recent report by The Working Group on Financial Reform, a steering committee of the Group of 30 (an international non-profit body composed of representatives of the private and public sectors and academia), chaired by Mr. Volcker, recommending radical changes to the regulation of money market funds. The report would have regulators recognize two types of money market products, distinguishing between "those services that are most appropriately housed in regulated and supervised banks," on the one hand, and "those that can reasonably be provided by mutual funds focused on short-term fixed-rate credit instruments," on the other. Money market funds offering bank-like services such as transaction account services and withdrawals on demand at par, would be required to reorganize as "special-purpose banks, with appropriate prudential regulation and supervision, government insurance, and access to central bank lender-of-last-resort facilities." By contrast, institutions wishing to remain "money market mutual funds" would "only offer a conservative investment option with modest upside potential at relatively low risk." These money market funds would not be allowed to use amortized cost pricing to maintain a stable net asset value of $1.00 per share and would instead have fluctuating NAVs.

The mutual fund industry strongly opposes the proposal. The Investment Company Institute's president Paul Schott Stevens stated that, "[i]f the recommendations are implemented, there will be no more money market funds, period." Money market fund sponsors argue that money market funds keep banks honest through healthy competition, which would be destroyed by implementation of the Group of 30's proposals. Other observers see the recommendations as regulatory overkill in reaction to the recent high-profile Reserve Primary Fund's "breaking the buck" and overly protective of the banking industry. Banks, on the other hand, see money market funds as enjoying an unfair advantage—offering a higher-yielding bank-account substitute with few of the regulatory trappings—especially now that many, if not most, money market funds are insured against loss, at least to some extent, by the Treasury. Bank objections were a principal reason the Treasury's insurance program only insures accounts in existence on September 19, and then only up to the amounts in those accounts at that time.

And so now the Treasury is in a tough position. It has extended the money market insurance program through April, making bankers unhappy. But what if the Treasury ends the program in April, or when formal authorization for the program runs out in September? Many fear a run on money market funds when the program ends, leading those funds to dump commercial paper in huge volumes, destabilizing credit markets and causing every money market fund to break the buck. But banks won't stand for an indefinite unequal playing field, and the confusion in the regulatory schemes calls out for a resolution.

Maybe the problem with money market funds is not in their structure but in the expectations the funds and regulators, specifically the SEC, have created over time as to the funds' safety. For years, fund sponsors have touted the safety of money market funds, and the SEC has long helped to create an aura of invincibility around these funds, informally at least telegraphing an expectation that fund sponsors should take whatever steps are necessary, including cash injections, to avoid breaking the buck. And the rush to avoid breaking the buck itself created huge financial stress among banks and other large mutual fund sponsors last summer as credit markets froze.

If a mutual fund sponsor wants to convey to its customers that its money market fund enjoys a level of safety equivalent to a bank deposit, perhaps it should submit to bank-like regulation. A solution for the rest of the industry may be first to recognize that an occasional or rare capital loss in a money market fund is not only likely unavoidable, but also perhaps not the worst thing in the world. It would take some pretty large capital losses to wipe out the spread over time between even a relatively conservative money market fund and its bank alternative. Money market funds should be able to continue to use amortized cost pricing. In the rare case where a fund can't sustain it, the fund might effect a forward or reverse stock split, get back to the dollar, and tell shareholders that the fund took a loss; in most cases, shareholders will likely still be well ahead of the game over the medium to long term. These funds might go by a slightly different name—"cash management" funds?—to signify their slightly greater risk profiles than bank-like funds.

A more realistic acceptance of the limitations and advantages of money market funds by fund sponsors, investors, and regulators might be a simpler and better approach than death of the industry by regulation.

Reforming the Financial Regulatory System—Super-Regulator to the Rescue?

The regulatory breakdowns that have contributed to the current financial crisis have led many legislators, economists, investors, and taxpayers to conclude that the regulatory system is in need of a major overhaul.

Since early February, both the Senate and the House have held hearings to address what an overhaul should look like, and we've seen proposals and suggestions from the Group of 30, the Government Accountability Office, the Financial Services Roundtable, and the Investment Company Institute, among others. On February 25, President Obama articulated seven key principles for regulatory reform: oversight of financial institutions that pose systemic risks; a regulatory system that can withstand both system-wide stress and the failure of one or more large institutions; rebuilding of trust; strong and uniform supervision of financial products marketed to investors and consumers; strict accountability; a regulatory system that covers appropriate institutions and markets and that is comprehensive and free of gaps; and global action. These principles are incorporated, in one form or another, into many of the current proposals for reform. Although each proposal differs in its specifics, the common theme that has emerged is a call for a systemic risk regulator (SRR) working in coordination with "first line of defense" regulator(s) that would handle sector-specific regulation. House Financial Services Committee Chairman Barney Frank (D-Mass.) has said that defining an SRR is the "biggest" reform issue, and that the reshuffling of financial regulators would be a secondary issue.

Under most proposals, the SRR would serve as a sort of super-regulator, charged with overseeing the financial markets as a whole, analyzing changing conditions, and evaluating and mitigating risks in conjunction with other responsible regulators. What entity would serve as the SRR is somewhat less clear, although there seems to be growing support for the Federal Reserve stepping into this position. (As we went to press on March 16, the Treasury announced a number of general principles to enhance market oversight, including a brand new role for the Fed to monitor and address broad economic risks.)

Rep. Frank thinks that the Federal Reserve would be the appropriate institution to serve as SRR, with broad powers to avoid regulatory arbitrage, and Fed Chairman Ben Bernanke has said that the Fed would welcome the opportunity, given clear expectations. This model mirrors the proposal made by the Treasury Department in its 2008 Blueprint for a Modernized Financial Regulatory Structure, which called for a market stability regulator and recommended that the Federal Reserve fill the role. A recent GAO report also cited this possibility, but cautioned that providing the agency with such broad responsibility for overseeing non-bank entities could imply a government guarantee of such activities, which could, in turn, encourage greater risk-taking by financial institutions and investors. The point has also been made that in the lead-up to the present crisis, the Fed encouraged loose standards; permitted financial holding companies over which it was the primary regulator to take on excessive leverage; allowed the shadow financial system to grow without oversight; and turned a blind eye to excesses in mortgage-backed securities markets.

Some have characterized allowing the Fed to become the new SRR as "failing upward." Sen. Christopher Dodd (D-Conn.), chairman of the Senate Committee on Banking, Housing, and Urban Affairs, has remained cool to the idea of the Federal Reserve as SRR, and other proposals suggest a new entity be created for the role, or a pool of regulators be tapped to fill it together. Other critics have questioned whether the SRR would be adding another layer of costly bureaucracy without attendant benefits.

Even less consensus exists with respect to the second part of the proposed regulatory reform—the sector-specific regulators. The Investment Company Institute has proposed a Capital Markets Regulator, which would encompass a combined SEC and CFTC, to be complemented by an advisory committee with representatives from the private sector. The ICI further recommends a consolidation of the regulatory structure for banking and the authorization of an optional federal charter for insurance companies. For now, however, sector-specific regulation seems to be lower down on the priority list, and debate really hasn't yet begun over a combined SEC-CFTC and the mechanics of that combination.

Rep. Frank has said that a "general outline" for financial regulatory system reform can be expected in time for the G-20 meeting in April, but that legislation on the matter will likely be longer in coming. Administration officials have indicated, however, that only very broad principles with little detail may be all that is ready for the G-20 meeting. President Obama has said that he expects legislation "in the coming weeks and months." For now, focus will be on congressional hearings, primarily before the Senate Committee on Banking, Housing, and Urban Affairs and the House Financial Services Committee, working together with the new economic team of the Obama administration.

Then there is the problem of unrealistic expectations and political reality. Any SRR will only be successful in the context of a broad regulatory overhaul of the financial markets. A system for reporting and evaluating risk across markets—and across borders (which fortunately appears to be a current priority for the Obama administration)—will be absolutely necessary to avoid future systemic meltdowns. This will require increased transparency and governmental access to information—and a necessary loss of privacy that many may oppose. And, then, if this Congress or future Congresses are unwilling to provide adequate funding to the SRR and all of the sector-specific regulators, and to otherwise support them as necessary governmental incursions into the private sector, even the most competent regulatory body will fail. So, perhaps the key question will turn out to be not who the SRR will be, but whether the country is really ready for one.

Contact Information

For further information, please contact the Ropes & Gray attorney who normally advises you.

Links to relevant resources:

Statement of Sen. Carl Levin

Hedge Fund Adviser Registration Act

Hedge Fund Transparency Act

Pension Security Act

Hedge Fund Study Act

Financial Crisis Investigation Act

Financial Oversight Commission Act

Group of 30 Report on Financial Reform

American Bankers Association's Reaction to Treasury Guarantee Program

GAO Report

Financial Services Roundtable testimony

President Obama's Remarks on February 25

ICI White Paper on Regulatory Reform

Rep. Barney Frank's press conference

Ben Bernanke's Speech on Systemic Risk

Treasury Blueprint