

# The President Proposes Broad Reform of The Financial Regulatory System

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On June 17, 2009, President Barack Obama released a series of proposed initiatives entitled [Financial Regulatory Reform: A New Foundation](#) (the "White Paper") [.pdf], which, if implemented, would effect sweeping reforms to the U.S. financial regulatory system. Certain individual proposals of particular importance to investment advisers and the alternative investment community are summarized below.

## Registration of Investment Advisers and Private Pools of Capital

The White Paper calls for adoption of new rules which, if implemented, would require all advisers to hedge funds and other private pools of capital (including private equity funds and venture capital funds) whose assets under management exceed a certain threshold (yet to be determined) to register with the Securities and Exchange Commission ("SEC") under the Investment Advisers Act of 1940, as amended. Advisers would be required to report, on a confidential basis, certain information on the funds for purposes of allowing regulators to assess potential threats to financial stability. The Obama administration (the "Administration") contends that such data would inform the SEC whether any funds have become so large, leveraged or interconnected that they require regulation for financial stability purposes.

The White Paper further calls for imposition on all investment funds advised by an SEC-registered investment adviser certain recordkeeping requirements; requirements with respect to disclosures to investors, creditors, and counterparties; and regulatory reporting requirements. The regulatory reporting requirements for such funds would require reporting on a confidential basis on the amount of assets under management, borrowings, off-balance sheet exposures and other information necessary to assess whether the fund or fund family is so large, highly leveraged, or interconnected that it poses a threat to financial stability. Furthermore, the SEC would be instructed to conduct regular, periodic examinations of such funds to monitor compliance with these requirements. Mention is made that the requirements may vary among the various type of private pools, although no further detail is provided regarding the extent of any such variance.

Under the proposals set forth in the White Paper, the SEC would share the reports that it receives from the investment advisers regarding the funds they manage with the Board of Governors of the Federal Reserve System (the "Federal Reserve"). Any financial firm that is determined to meet Tier 1 FHC criteria (defined as a financial firm whose failure could pose a threat to financial stability due to their combination of size, leverage and interconnectedness), would then be regulated and supervised by the Federal Reserve.

## **Regulation of the OTC derivatives market**

The White Paper calls for the creation of comprehensive regulation of all OTC derivatives, including credit default swaps (“CDS”). In order to contain systemic risks, the Commodities Exchange Act (CEA) and the securities laws would be amended to require clearing of all standardized OTC derivatives through regulated central counterparties (“CCPs”), which would impose robust margin requirements as well as other necessary risk controls. Further, regulators would be tasked with ensuring that customized OTC derivatives not be used solely as a means to avoid using a CCP. For example, if an OTC derivative is accepted for clearing by one or more fully regulated CCPs, it would be expected to create a presumption that it is a standardized contract and thus required to be cleared.

Other specifics of the White Paper call for all OTC derivatives dealers, and all other firms whose activities in the derivatives markets create large exposures to counterparties, to be subject to regulation, aimed at least in part to address counterparty risks associated with customized bilateral OTC derivatives transactions that would not be accepted by a CCP, including conservative capital requirements (more conservative than the existing bank regulatory capital requirements for OTC derivatives), business conduct standards, reporting requirements and conservative requirements relating to initial margins on counterparty credit exposures.

In addition, the Commodity Futures Trading Commission (the “CFTC”) and the SEC would be authorized to impose recordkeeping and reporting requirements (including an audit trail) on all OTC derivatives. CCPs and trade repositories would be required to, among other things, make aggregate data on open positions and trading volumes available to the public, and make data on any individual counterparty’s trades and positions available on a confidential basis to the CFTC, SEC and the institution’s primary regulators. Furthermore, the CFTC would have authority to set position limits on OTC derivatives that perform or affect a significant price discovery function with respect to regulated markets.

## **Financial Services Oversight Council and Expanded Role of Federal Reserve**

The White Paper proposes the creation of a new Financial Services Oversight Council (the “Council”), which would be composed of the heads of various regulatory agencies, and whose roles would include facilitating communication among regulatory agencies, providing a forum for discussion of cross-agency issues and identification of gaps in legislation, market trends and potential threats to the financial stability (including advising the Federal Reserve with respect to the regulation of Tier 1 FHCs). The Council would replace the President’s Working Group on Financial Markets.