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The Obama Administration Outlines Major Financial Rules Overhaul, Announces Greater Scrutiny for Hedge Funds and Derivatives

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On June 17, 2009, the Obama administration released its proposed "rules of the road" for the nation's regulation of the financial industry. The proposal aims to restore confidence in the nation's financial system after last year's collapses of The Bear Stearns Cos. and Lehman Brothers Holdings Inc., which caused a credit-market seizure, froze bank lending and paralyzed consumer spending. The proposal generally tightens regulations on many existing institutions already subject to government scrutiny, and brings many products and companies that had operated outside of the banking system under federal control. The proposed reforms target almost every facet of the financial system, including hedge funds and derivatives.

The administration's proposal focuses on five areas:

1. Promoting the robust supervision and regulation of financial firms by:
    a. Expanding the power of the Federal Reserve to regulate all financial firms which pose a threat to the financial stability of the economy based on their size, leverage and interconnectedness to the financial system, and
    b. creating a council of regulators to consult with the Federal Reserve, including the Secretary of the Treasury, and the heads of the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC);
2. Establishing comprehensive regulation and supervision of financial markets, including securitization markets, over-the-counter derivatives, investment advisors to hedge funds and other private pools of capital;
3. Enhancing consumer and investor protection through stronger regulations and the creation of a new Consumer and Financial Protection Agency, empowered to enact new rules related to mortgages, credit cards and other consumer products;
4. Providing the government with tools to manage future financial crises by creating a regime to resolve systemically important nonbank financial institution failures and revising the Federal Reserve's emergency lending authority; and
5. Raising international regulatory standards and improving international cooperation by international reforms, including:
    a. Strengthening the capital framework,

b. Improving oversight of global financial markets,

c. Coordinating supervision of internationally active firms, and

d. Enhancing crisis management tools.

This article focuses on those proposals that will, if enacted, most directly impact hedge funds, fund advisers and the derivatives market.

I. Robust Supervision and Regulation of All Financial Firms

In the years leading up to the current financial crisis, the nation's largest financial firms became increasingly dependent on unstable sources of short-term funding. When asset prices began to fall and market liquidity froze, those firms pulled back from lending, limiting credit for households and businesses. The government was not equipped to handle the resulting crisis. Several federal agencies had split responsibility for supervising these financial firms. Capital and liquidity requirements were too low and regulators had failed to account for the harm that large, interconnected and highly leverage institutions could inflict on the financial system if they failed. And, many hedge funds and other private pools of capital operated completely outside of the regulatory framework.

The administration proposes a solution to these concerns by creating a new foundation for the regulation of all financial institutions, based on more robust and consistent regulatory standards for financial institutions, with no loopholes or opportunities for arbitrage. The plan would accomplish this feat by creating a financial service oversight council which would identify emerging risks and advise the Federal Reserve on potential problem firms.

A. Financial Services Oversight Council

The Financial Services Oversight Council would replace the President's Working Group on Financial markets and would have a permanent, full-time staff at the Treasury Department. The council would:

- Possess broad authority to gather information from any financial firm to identify emerging risks to financial stability;
- Identify gaps in regulation and prepare an annual report to Congress on market developments and potential emerging risks;
- Recommend firms for identification as Tier 1 Financial Holding Companies (FHCs) (i.e., those whose failure could pose a threat to financial stability due to their combination of size, leverage and interconnectedness);
- Provide consultation on material prudential standards for Tier 1 FHCs and systemically important payment, clearing and settlement systems;
- Establish a forum for discussion of cross-cutting issues among the principal federal financial regulatory agencies; and
- Facilitate information sharing and coordination among the principal federal financial regulatory agencies regarding policy development, rulemaking, examinations and reporting requirements.

B. Registration of Hedge Funds and Other Private Pools of Capital

Significantly, the proposal calls for registration with the SEC of advisers to hedge funds and other private pools of capital, including private equity funds and venture capital funds, whose assets under management exceed modest thresholds. The advisers would have to report sufficient information on funds they manage to permit the government to assess whether any fund poses a threat to financial stability.

The white paper explains how the lack of hedge fund regulation has contributed to the stress on financial markets. Since funds had not registered with regulators, the government lacked reliable, comprehensive data with which to assess their activity. The proposal aims to allow for the collection of data that would permit an informed assessment of how these funds change over time, and whether any funds have become so large, leveraged, or interconnected that they require regulation for financial stability purposes. The plan also recommends subjecting all investment funds advised by an SEC-registered investment adviser to recordkeeping requirements; requirements with respect to disclosures to investors, creditors and counterparties; and regulatory reporting requirements. It suggests that the SEC should conduct regular, periodic examinations of these funds to monitor compliance with those recordkeeping requirements. While the requirements may vary across the different types of private pools, the white paper proposes certain uniform regulatory reporting requirements, including reporting on a confidential basis of 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. If implemented, the SEC would share the reports it receives with the Federal Reserve.

C. Other Goals

The President's plan laid out several other important steps in order to create a more robust and consolidated supervision of financial firms.

1. Tier 1 Financial Holding Companies

The proposal calls for more robust consolidated supervision and regulation for any financial firm whose size, leverage and interconnectedness poses a threat to financial stability if it failed (a so-called Tier 1 FHC). It applies to firms regardless of whether they own an insured depository institution. The proposal gives the Federal Reserve powers to oversee the entire financial system, including the regulation of Tier 1 FHCs. The plan also outlines criteria that the Federal Reserve must consider in identifying Tier 1 FHCs: (1) the impact the firm's failure would have on the financial system and the economy; (2) the firm's combination of size, leverage and degree of reliance on short-term funding; and (3) 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. In proposing this plan, the Obama administration endeavors to provide the central bank with the powers necessary to prevent the problems that overwhelmed the financial system last year.

2. Capital and Other Prudential Standards for Banks and Bank Holding Companies

The white paper states that the Treasury Department, in consultation with federal financial regulatory agencies and external experts, will conduct a fundamental reassessment of existing capital requirements for banks and bank holding companies (BHCs), by December 31, 2009. Thereafter, thousands of financial institutions will have to increase capital reserves to protect against unexpected losses, and certain companies will have to keep part of the credit risk for loans they packaged into securities.

3. Creation of a National Bank Supervisor

The white paper proposes the creation of a new federal governmental agency, the National Bank Supervisor, to replace the Office of the Comptroller of the Currency and the Office of Thrift Supervision. The new agency would conduct prudential supervision and regulation of all federal chartered depository institutions and all federal branches and agencies of foreign banks. President Obama added that investment banking firms that seek consolidated supervision by a United States regulator would also be subject to the Federal Reserve's supervision and regulation. The SEC would not be a consolidated supervisor.

4. SEC Plans to Strengthen Money Market Funds

The white paper states that the SEC will proceed with plans to strengthen the regulatory framework around money market funds. By September 15, 2009, the President's Working Group on Financial Markets plans to prepare an assessment of potential fundamental changes to directly address systemic risk.

II. Strengthening Comprehensive Regulation of Core Financial Markets and Market Infrastructure

President Obama also pledged to bring more transparency to the murky market for derivatives (including contracts whose values are tied to assets including stocks, bonds, commodities and currencies, or to events such as changes in interest rates or the weather), which he called a system of "enormous risk." He said, "We are going to make sure that they have to register, that they are regulated, that you have clearinghouses." He also promises further regulation of mortgage-backed securities, which fueled the housing bubble and ignited the recent credit crisis. If implemented, the markets for all over-the-counter (OTC) derivatives and asset-backed securities will fall under one coherent and coordinated regulatory framework.

Comprehensive Regulation for Over-The-Counter Derivatives, Including Credit Default Swaps

The white paper recommends subjecting all OTC derivatives markets, include credit default swaps (CDS) markets, to comprehensive regulation that addresses relevant public policy objectives. The objectives include: preventing activities in those markets from posing risks to the financial system; promoting the efficiency and transparency of those markets; preventing market manipulation, fraud and other market abuses; and ensuring that OTC derivatives are not inappropriately marketed to unsophisticated parties.

To achieve these goals, the proposal offers four key recommendations.

A. Clearance of Standardized OTC Derivatives through Central Counterparties

The proposal recommends amendment of the Commodities Exchange Act (CEA) and federal securities laws to require clearance of all standardized OTC derivatives through central counterparties (CCPs), which impose robust margin requirements and other risk controls. Counterparty risks associated with customized bilateral OTC derivatives transactions not accepted by a CCP would also need to be addressed by this regime.

B. OTC Derivatives Dealers Subject to Prudential Supervision

The proposal recommends subjecting all OTC derivative dealers to prudential supervision. Such supervision includes four elements: (a) capital requirements; (b) conduct of business standards; (c) requirements of initial margins on counterparty credit exposure; and (d) reporting requirements. Capital requirements have to be more conservative than the existing bank regulatory capital requirements for OTC derivatives in order to contain systemic risk.

C. Recordkeeping and Reporting Requirements

The proposal also recommends that the CFTC and the SEC impose recordkeeping and reporting requirements on all OTC derivatives. Pursuant to this proposal, CCPs and trade repositories will have to make public aggregate data on open positions and trading volumes. Standard derivative contracts would be cleared on regulated exchanges and electronic trading platforms. And, regulated financial institutions would be encouraged to use exchange-traded derivatives.

D. Market Protection Authority

The proposal also recommends giving the CFTC and the SEC unimpeded authority to police market abuses involving OTC derivatives, and providing the CFTC with authority to set position limits on OTC derivatives. The administration plans to amend current law by stringently limiting the types of counterparties that can participate, or by limiting disclosure requirements or standards of care with respect to marketing.

III. The Future of the Proposals

Under the administration's proposals, the government would possess authority to take over and unwind a large financial company, a power the government lacked last year when the financial crisis began. The Federal Reserve would have increased powers over payments and settlements systems in American financial markets to prevent a destabilization of the economy. Finally, the Treasury Department could seize any large, interconnected company at any time, if certain exigent conditions are met. All proposals would give the central bank unprecedented new powers to conduct comprehensive examinations of almost any American financial company, as well as any foreign affiliates of those companies.

Most of the proposals require passage by Congress, and the plan may not pass in its present form. Some legislators who believe that the Obama administration has exceeded its legal authority have already dissected the proposals, and many banks resist the creation of a new consumer protection agency. Some critics of the proposals contend that the system is presently broken beyond repair, and that this overhaul does not go far enough. For instance, a retired hedge fund manager, Shah Gilani, reported that the administration's proposals may not be comprehensive enough to fix the deeply entrenched problems plaguing the financial system. Treasury Secretary Timothy Geithner, when testifying as to the administration's proposals, expressed doubt that they would "prevent all regulatory failures in the future," but still acknowledged that they were the best set of reforms under the circumstances.

Please click here for a copy of the white paper.

Please click here for a copy for the fact sheet entitled, "Requiring Strong Supervision and Regulation of All Financial Firms."

Please click here for a copy for the fact sheet entitled, "Strengthening Regulation of Core Markets and Market Infrastructure."

Please click here for a copy for the fact sheet entitled, "Strengthening Consumer Protection."

Please click here for a copy for the fact sheet entitled, "Providing the Government With Tools to Effectively Manage Financial Crises."

Please click here for a copy for the fact sheet entitled, "Improving International Regulatory Standards and Cooperation."