CADWALADER

Cadwalader, Wickersham & Taft LLP
New York London Charlotte Washington Beijing

One World Financial Center, New York, NY 10281
Tel 212 504 6000 Fax 212 504 6666
www.cadwalader.com

Clients&FriendsMemo

House Regulatory Reform Bill May Impose Further Burdens On Large Funds

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H.R. 4173, the "Wall Street Reform and Consumer Protection Act of 2009" (the "bill"), passed the House of Representatives on December 11, 2009 and garnered substantial publicity as to its requirements for the registration of fund advisers and the further regulation of derivatives.[1] Little has been written, however, as to how the bill's **systemic regulation provisions could affect private funds.** The bill offers at least two ways in which funds could be affected: the first perhaps unlikely, but very significant; the second less significant, but more likely. Each of these two concerns is summarized below.

I. Prudential Safeguards

Title I of the bill imposes "prudential safeguards" on firms that (i) are deemed to engage, directly or indirectly, in "financial activities" (an undefined term) (ii) if regulators[2] determine that either (a) material financial distress at the firm could pose a threat to financial stability or the economy or (b) the nature, scope, size, scale, concentration, and interconnectedness or mix of the firm's activities pose such a threat (we will call (a) and (b) the "economic threat" determination).[3]

1 See H.R. 4173 (the "bill").

2 Under the bill, the Financial Services Oversight Council ("FSOC") is tasked with making "economic threat" determinations. The FSOC would be comprised of the Chairpersons of the federal banking, securities, and commodities agencies, as well as the Secretary of the Treasury. Although the FSOC makes these determination, the Federal Reserve Board acts as "agent" of the FSOC in the implementation of such determinations. See Section 1100 of the bill. Note, as well, the "tie-breaking" function that the FSOC would offer in the event of regulatory disputes between the federal financial agencies. See Section 1002 of the bill.

3 Section 1103(a) of the bill. One of the factors the regulators are to consider is "[t]he extent to which assets are simply managed and not owned by the financial company and the extent to which ownership of assets under management is diffuse", which would appear to reflect legislative awareness that a fund could be an FHCSSS. Other criteria the regulators are to apply in determining whether a financial firm poses systemic risk include leverage, off-balance sheet exposures, interconnectedness with other financial firms, the firm's importance as a source of credit and liquidity (including the impact of failure on availability of credit to low-income, minority, and underserved communities), activities, degree of existing regulation of the firm, size, and reliance on short-term funding.

There would seem little doubt that hedge funds are, and private equity funds very likely are, engaged in "financial activities," so the primary inquiry for the regulators would be whether such funds pose an "economic threat." The bill refers to firms as to which an "economic threat" determination has been made as "**financial holding companies subject to stricter supervision**" ("FHCSSS").[4] A company may be an FHCSSS without regard to whether it owns a bank or qualifies as a "financial holding company" under the Bank Holding Company Act. Thus, essentially all private funds risk designation as an FHCSSS by federal regulators under the bill.[5]

Of course, the obvious intent of the bill is that the firms designated to be an FHCSSSs would be the largest systemically significant firms, such as Citi, BofA, JP Morgan Chase, Morgan, and Goldman. However, there is no provision in the legislation precluding regulators from designating smaller firms an FHCSSS, indeed much smaller firms. Obviously, regulators have a natural conservative inclination to regulate where they have power to do so (and where they might be criticized for failing to do so), and it is not at all inconceivable that, in this case, they would strive to avoid blame for future crises by being generous in awarding FHCSSS status. Unintentionally illustrating this concern, Senator Charles Schumer at a hearing of the Senate Banking Committee two days ago suggested that 50 small but highly correlated hedge funds might combine to create systemic risk.

A determination that a fund is an FHCSSS would trigger severe negative consequences for the fund as generally summarized below.

- The fund could be subjected to bank-like capital standards and would be subjected to liquidity standards. Bank capital requirements simply are requirements that banks maintain a certain minimum ratio of capital to assets; thus, a fund subjected to capital standards would have to hold a certain amount of capital to support a certain amount of fund assets; in essence, this restricts the amount of leverage that a fund could use. FHCSSS capital standards would be risk-based; *i.e.* lower capital would be required against less risky assets such as cash and U.S. Government securities, but higher capital would be required against assets with higher credit risk, and the capital standards would include non-risk-based leverage limits. The bill does permit the Federal Reserve Board to determine that risk-based

4 All of the new draft legislation has made it virtually impossible for potentially newly regulated entities to obtain a desirable acronym, *e.g.*, one with four letters or less that includes a centrally-placed vowel. It is currently projected that by 2016, all new regulatory acronyms will require a 3-digit "area code" to distinguish them.

5 A firm designated an FHCSSS would have a right to appeal the designation to a federal court of appeals. However, it is not likely that a federal court would substitute its judgment as to systemic risk for the judgment of the regulators. Thus, the right of appeal appears ineffectual.

capital requirements and leverage limits may not be appropriate because an FHCSSS's activities are investment company activities or assets under management.[6]

- The fund's nonbank activities would be limited such that its investments in voting securities of nonfinancial firms would be capped at 5% of any class of such voting securities because FHCSSSs automatically become subject to Section 4 of the Bank Holding Company Act restricting such investments.[7] Thus, a fund that is designated an FHCSSS would have to limit the amounts of its portfolio holdings of individual nonfinancial firms, which could substantially interfere with a fund's investment strategy.
- A statutory 15-to-1 debt-to-equity ratio also would be imposed.[8]
- Concentration prohibitions limiting credit exposure to any one nonaffiliated firm to 25% of the fund's capital and surplus would be imposed.[9] This would make it virtually impossible for a fund to obtain a significant amount of its financing from a single dealer or even any mid-sized group of dealers. That would cover not only obvious extensions of credit, such as loans, deposits, and lines of credit, but also repos and reverse repos, securities borrowings and lendings that create credit exposure, and derivatives. The effect on securities borrowing and lending by a hedge fund could be very significant as there may not be a large enough pool of counterparties from which to borrow securities and to which to lend securities in order to comply with the 25% of capital concentration cap; if a hedge fund is highly leveraged or enters into significant hedging activities, especially short sales, it may not be able to have enough counterparties to keep each below 25% of its capital and surplus at all times; this could have significant adverse effects on a large hedge fund's prime brokerage activity. The bill also has an attribution rule so that any of these transactions with one firm will be attributed to a second firm if the proceeds are transferred to the second firm or used for the benefit of the second firm.
- FHCSSSs also could be subject to a limit on short-term debt the regulators are authorized to impose. As most financing by funds is "short-term," this would effectively empower regulators to put a fund out of business.
- Funds would be subject to a prompt corrective action regime under which increasingly punitive actions are required to be taken by regulators as capital drops below required levels.

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[6] Section 1104(a)(2)(A)(i) of the bill. Again, this reflects conscious consideration by the drafters that a fund can be an FHCSSS.

[7] Section 1103(f)(1)(A) of the bill.

[8] Section 1103(f)(3) of the bill.

[9] Section 1104(c)(2) of the bill.

- FHCSSSs must also file “living wills” (rapid resolution plans) with regulators explaining how the firm would be liquidated if it failed.
- FHCSSSs would be required to undergo quarterly stress tests.

Obviously, the consequences of a fund being deemed an FHCSSS are very serious and very adverse to the ongoing functioning of its business, and, while the risk of such designation for most funds may not be high, it is there nonetheless.

II. Mandatory Stress Testing for Large Financial Companies

A more certain, albeit less significant, burden the House-passed bill would impose on large funds and other financial companies is semi-annual stress testing.

Specifically, the bill passed requires that any financial company (even those not designated a FHCSSS) that has more than $10 billion in total assets and is in part or in whole engaged directly or indirectly in financial activities must conduct semiannual stress tests under “baseline,” “adverse,” and “severely adverse” conditions, and must report the results to its primary federal regulator and the Federal Reserve Board.[10]

The bill further provides that, if the effect of the financial company’s stress test shows that it is significantly or critically undercapitalized (possibly less than 2% tangible equity to total assets, which is the test for an FHCSSS to be deemed critically undercapitalized) under baseline or adverse conditions, it must file a “living will” (rapid resolution plan) with the Federal Reserve Board.[11]

Thus, even if a large fund were to escape FHCSSS designation, it would have to undergo and pay for semi-annual stress tests and report the results and, if such tests suggest a sufficient decline in capital levels, it would be required to prepare and file with the Federal Reserve Board a “living will” that describes its plans for liquidation and dissolution.

Of course, these new government powers are based on the version of the bill that has passed the House, and no bill as of this writing has been introduced yet in the Senate.

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[10] Section 1115(b) of the bill.

[11] Section 1104(f)(3)(B) of the bill.

Please feel free to contact any of the following if you have any questions about this memorandum:

Steven Lofchie	+1 212 504 6700	steven.lofchie@cwt.com
Stuart Goldstein	+1 704 348 5258	stuart.goldstein@cwt.com
Gregg Jubin	+1 202 862 2485	gregg.jubin@cwt.com
Richard Schetman	+1 212 504 6906	richard.schetman@cwt.com
Jonathan Wainwright	+1 212 504 6122	jonathan.wainwright@cwt.com
Julius Loeser	+1 212 504 6768	julius.loeser@cwt.com
Bryan Shipp	+1 212 504 5615	bryan.shipp@cwt.com