

## Shadow Markets

We applaud the Administration's efforts to address the shadow financial markets, however, certain key elements remain unaddressed. There is also some uncertainty about how important proposals, particularly the regulation of OTC derivatives, will be implemented and whether regulation will be sufficiently vigorous to bring the shadow markets into the light.

- **Private pools of capital (private equity and hedge funds).** We have heard repeatedly that under the Administration's proposal private pools of capital will be regulated. This is a mischaracterization that must be corrected.
  - The Administration's proposal would require all *advisers* to hedge funds and other private pools of capital to register with the SEC.
  - The SEC has stated the following of the Investment Adviser regulations: "Unlike the laws of many other countries, the U.S. federal securities laws do not prescribe minimum experience or qualification requirements for persons providing investment advice. They do not establish maximum fees that advisers may charge. Nor do they preclude advisers from having substantial conflicts of interest that might adversely affect the objectivity of the advice they provide. Rather, investors have the responsibility, based on disclosure they receive, for selecting their own advisers, negotiating their own fee arrangements, and evaluating their advisers' conflicts."<sup>1</sup>
  - Adviser registration is very different from fund registration. Adviser registration simply requires investment advisers to disclose basic information to the SEC and to adhere to internal compliance policies and codes of ethics. In addition, registered advisers may be subject to periodic examinations.
  - Fund registration would likely be drawn from mutual fund regulation and would require comprehensive disclosures, safety and soundness regulation, prohibitions on conflicts of interest and other regulations generally designed to prevent fraud, theft, self-dealing and breach of fiduciary duties to investors.
  - While the Administration does propose some fund-level of disclosure to investors, creditors, and counterparties, the proposal does not provide sufficient details to ascertain how comprehensive such disclosures would be. In addition, the advisers would be required to report information on the funds they manage to enable regulators to determine whether they may pose a systemic threat.
  - We believe it is very important, not only that disclosures to investors, creditors and counterparties are comprehensive, but also that they are publicly available to ensure that all investors have access to sufficient information to perform appropriate due diligence.
  - SEC Chairman Mary Schapiro has stated that the SEC is still considering whether hedge funds, themselves, should register.<sup>2</sup> SEC Commissioner Luis Aguilar has suggested applying some provisions of the mutual fund regulations to hedge funds.<sup>3</sup>

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<sup>1</sup> Amendments to Form ADV; Proposed Rule, 17 CFR Parts 275 and 279, available at <http://sec.gov/rules/proposed/2008/ia-2711fr.pdf>.

<sup>2</sup> Regulatory Reform: Despite Obama Plan, Schapiro Maintains Idea of Hedge Fund and Adviser Registration, *BNA* (Jun. 22, 2009).

Spokespersons for Rep. Barney Frank and Rep. Paul Kanjorski have also expressed support for hedge fund registration.<sup>4</sup>

- **Asset-backed securities.** Depending on how broadly one defines “asset-backed securities”, this portion of the proposal could be very effective or relatively meaningless. Asset-backed securities are a discrete class of securitizations that are regulated by the SEC. According to testimony by Andrew Donohue, the former Director of the SEC’s Division of Investment Management, at the end of 2007 there were \$2.5 trillion worth of asset-backed securities outstanding.<sup>5</sup> This is a small fraction of the securitization market. Financial regulation must ensure that all securitizations are subject to comprehensive regulation that includes plain-English public disclosure requirements.
  - We applaud the Administration’s proposal that the SEC be given authority to require comprehensive ongoing disclosure by issuers and that such disclosures should provide the “information necessary to assess the credit quality of the assets underlying a securitization transaction at inception and over the life of the transaction, as well as the information necessary to assess the credit, market, liquidity, and other risks of ABS.”
  - We also support the proposal that securitization standards should include clear rules that allow mortgage servicers to modify mortgages under appropriate circumstances.
  - We hope that Congress will greatly expand the scope of securitizations that fall within the SEC’s jurisdiction so that all issuances are subject to regulation.
  - Finally, Congress must ensure that borrowers that have been victims of predatory lending practices always have recourse.
- **Derivatives regulation.** We support the general direction of the Administration's proposal with respect to its treatment of OTC derivatives. The ultimate effectiveness of any proposal, however, will depend on the how vigorously the CFTC works to ensure that nearly all derivatives are traded on regulated exchanged. This will require the CFTC to apply a high standard when determining whether derivatives contracts should be exempt from trading on regulated exchanges.
  - While we support the Administration’s proposal to harmonize SEC and CFTC regulations and the proposal’s support for regulations that are sufficiently specific to allow enforcement, we are concerned by the Administration’s suggestion that the regulations should be “principles-based.”
    - Principles-based regulation is often a euphemism for “light-touch” regulation or regulation without enforcement. The Administration’s support for principle’s based regulation with strong enforcement is somewhat incongruous. It is important to make clear that light touch regulation, without sufficient enforcement, has been an important contributing factor to the financial crisis that we cannot allow to continue.

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<sup>3</sup> Joseph A. Giannone, SEC's Aguilar urges tougher hedge fund rules, *Reuters* (Jun. 19, 2009), available at <http://www.reuters.com/article/hedgeFundsTechMediaTelco/idUSLNE55I02X20090619?pageNumber=2&virtualBrandChannel=11569>.

<sup>4</sup> Regulatory Reform: Despite Obama Plan, Schapiro Maintains Idea of Hedge Fund and Adviser Registration, *BNA* (Jun. 22, 2009).

<sup>5</sup> <http://sec.gov/news/testimony/2009/ts020409-joint.htm>

- Many people who support principles-based over rules-based regulation cite the UK's Financial Services Authority as an example of a jurisdiction that used principles-based regulation. Unfortunately, financial services regulation in the UK has proven to be wholly inadequate and the UK financial services sector is currently suffering far more than the US.