April 6, 2009

CLIENT ALERT

G-20 RELEASES PLAN TO REFORM FINANCIAL REGULATION

On April 2, 2009, the leaders of the G-20[1] met in London to consider measures to spur world economic growth and create a more stable global economy. The same day, the G-20 issued a communiqué outlining the principles each member state agreed to follow in this effort, including, among other things, strengthening financial supervision and regulation.

With respect to financial regulation, the G-20 agreed as follows:

- A new Financial Stability Board (FSB) will replace the Financial Stability Forum (FSF). The FSB will have a strengthened mandate to promote international financial stability through information exchange, monitoring activities, surveillance and coordination. FSB members will include the G-20 countries, FSF members, Spain and the European Commission.

- The FSB and the International Monetary Fund (IMF) will monitor and warn of macroeconomic and financial risks and propose and take actions necessary to address such risks. This is a level of responsibility and authority not typically accorded the IMF.

- Each member of the G-20 agreed to reshape its regulatory systems to better identify and take into account "macro-prudential" risks.

- Systemically important financial institutions, instruments and markets will be subject to regulation and oversight. This includes systemically important hedge funds.

- Member states will address pay and compensation, and support sustainable compensation schemes and corporate social responsibility, in part by endorsing and implementing the FSF's new principles on pay and compensation.

- Member states will prohibit excessive leverage on the part of banking institutions and require that cushions be built up in times of growth, in order to improve the quality, quantity and international consistency of capital in the banking system.

[1] The G-20 is an international body comprised of representatives of the 19 leading industrial nations, the European Union and (ex-officio) the IMF and the World Bank.

- Action will be taken against tax havens and jurisdictions not in compliance with the internationally agreed tax standard, which "requires exchange of information on request in all tax matters for the administration and enforcement of domestic tax law without regard to domestic tax interest requirement or bank secrecy for tax purposes.". . ." The Cayman Islands is among those jurisdictions identified by the OECD that have committed to internationally agreed tax standards, but that have not yet substantially implemented them.

- Those who set accounting standards will be asked to take responsibility for improving valuation and provisioning standards, as well as to present a unitary high-quality global accounting standard.

- Member states will regulate credit rating agencies to prevent harmful conflicts of interest and other violations of international standards.

- With rather less fanfare, the G-20 leaders also issued a declaration, "Strengthening the Financial System," whereby some detail was added to the principles set out in the communiqué. Aside from, inter alia, setting out the mandate of the FSB—giving further detail to the call for a clear regulatory framework and maintenance of an enhanced regulatory capital requirement and calling for the end of international tax abuse via the use of non-cooperative jurisdictions and tax havens—the declaration covered the following topics among others:

THE SCOPE OF REGULATION

G-20 agreed that all systemically important financial institutions, markets and instruments should be subject to an appropriate degree of regulation and oversight. In particular, the declaration called for the FSB to work with the Bank for International Settlements and other international standard setters, such as the International Organization of Securities Commissions (IOSCO), to develop the tools necessary to regulate macro-prudential risks across the financial system, including regulated banks, "shadow banks" and private pools of capital (such as hedge funds and private equity funds) to limit the buildup of systemic risk. Further, the leaders declared that they would ensure that national regulators possess the powers for gathering relevant information about all material financial institutions, markets and instruments in order to assess the potential for their failure or severe stress to contribute to systemic risk. Responsibility for actual regulation and oversight of systemically important institutions is to rest with national authorities, but with coordination through IOSCO, the International Association of Insurance Supervisors (IAIS) and the Basel Committee on Banking Supervision (BCBS), and with recommendations from the FSB and the IMF.

Of particular importance was the statement that "hedge funds or their managers will be registered and will be required to disclose appropriate information on an ongoing basis to supervisors or regulators, including on their leverage, necessary for assessment of the systemic risks that they pose individually or collectively. Where appropriate, registration should be subject to a minimum size. They will be subject to oversight to ensure that they have adequate risk management." It is of note that the declaration indicates that responsibility for implementation of this regulation rests with national authorities rather than any supranational body.

The management of risk is a theme that runs through the declaration, which calls for "institutions which have hedge funds as their counterparties [to] have effective risk management. This should include mechanisms to monitor the funds' leverage and set limits for single counterparty exposures."

The declaration also calls for the standardization and "resilience" of the credit derivatives markets, in particular through the establishment of central clearing counterparties subject to effective regulation and supervision. The industry is requested to develop an action plan on standardization by the fall of 2009.

COMPENSATION

The declaration endorses the principles on pay and compensation in significant financial institutions developed by the FSF (see above) to ensure compensation structures are consistent with firms' long-term goals and prudent risk taking.

The leaders agreed that national regulators should ensure significant progress in the implementation of these principles in 2009. In addition, the BCBS is required to integrate these principles into its risk management guidance by the fall of 2009. The principles require—

- firms' boards of directors to play an active role in the design, operation and evaluation of compensation schemes
- compensation arrangements, including bonuses, to properly reflect risk, and the timing and composition of payments to be sensitive to the time horizon of risks; payments should not be finalized over short periods where risks are realized over long periods
- firms to publicly disclose clear, comprehensive and timely information about compensation.

The declaration also states that national regulators should be required to assess firms' compensation policies as part of their overall assessment of soundness. Where necessary, regulators are instructed to intervene with responses that can include increased capital requirements.

NEXT STEPS

In relation to financial regulation, the communiqué and the declaration contained little in the way of surprise. Much of the proposed regulatory framework had been aired by the FSF and IOSCO in the lead-up to the summit and certain jurisdictions, notably the United States, UK and the EU, had already begun to consider and even take preliminary steps to implement regulatory change on a similar basis.

In the United States, Treasury Secretary Timothy Geithner testified before Congress on March 26, 2009, regarding the United States' proposed plan for financial regulation reform, including a specific proposal that that all advisers to hedge funds (and private equity and venture capital funds) with assets over a certain threshold register with the Securities and Exchange Commission. The administration's proposal also indicated that all such funds advised by an SEC-registered adviser should be subject to certain disclosure and reporting requirements. Hedge funds considered to pose systemic threats could be subjected to prudential standards, which could include liquidity, counterparty and credit risk management. Further, Secretary Geithner's plan provided for a mechanism whereby the need for government intervention would be assessed, and a variety of options the U.S. government could employ to provide the appropriate financial assistance necessary to stabilize the institution in question or to take over and ensure an orderly liquidation of the institution.

In the United Kingdom, on March 18, 2009, the Financial Services Authority (FSA) published the Turner Review, a regulatory response to the global banking crisis, together with a separate discussion paper that sets out more detail on the proposed changes to policy. The report noted that UK-domiciled hedge fund managers are already regulated more extensively than in some other jurisdictions; however, hedge funds are not subject to prudential regulations. While the report acknowledged that hedge funds are not in general "bank-like in their activities," the report suggested they could become so. The report recommended that regulators and central banks need to gather and analyze much more extensive information on hedge fund activities in order to recognize any such evolution. It also recommended that regulators need the power to apply appropriate prudential regulation to hedge funds if they judge that such funds have become bank-like or systemic in importance.

On December 18, 2008, the European Commission launched a public consultation about the activities of hedge funds, their impact on financial markets and their interactions with investors and other market participants (see press release). This consultation paper is part of a wide-ranging review by the European Commission of the regulatory and supervisory framework for all financial market participants in the European Union, and questions whether current approaches to the regulation and supervision of hedge funds should be reassessed in light of the financial crisis. The consultation process ended on January 30, 2009. Contributions to this consultation can be reviewed on the Commission's Web site.

The Commission intends to publish a draft directive on April 21, 2009, under which hedge funds and private equity groups would be regulated. Given the context in which the European Commission was instructed to prepare the draft directive, it may be assumed that the intention is to impose a level of regulation directly onto the funds themselves, rather than on just the manager or the prime broker. It is worth noting, however, that the legislation is a 'Directive' and, therefore, will need to be approved by all of the EU member states and the European Parliament prior to it being transposed into the national law of the member states. This means that significant political barriers need be overcome prior to it entering the statute books.

The G-20 will meet again in the fall of 2009 in order to review the implementation of the London summit's measures and take further action if needed.

CONTACT INFORMATION

Akin Gump Strauss Hauer & Feld LLP, a leader in alternative investment funds, regulation and public law and policy, will continue to monitor and report on regulatory developments as they affect our clients and contacts.

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