financial reform matters

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Preparing for Financial Reform: Investment Companies and Investment Advisers

On May 20, 2010, the Senate approved the *Restoring American Financial Stability Act of 2010* (the "Senate Bill"). Similar to the *Wall Street Reform and Consumer Protection Act of 2009* (the "House Bill"), which was passed by the House of Representatives in December 2009, the Senate Bill proposes to restructure the U.S. financial regulatory system by providing for more extensive regulation of banks and other financial institutions, over-the-counter derivative markets, consumer financial products and services, certain investment advisers, credit rating agencies, and mortgage lending. Neither the Senate Bill nor the House Bill is particularly intended to restructure the regulatory scheme applicable to investment companies and investment advisers; however, a number of its provisions, if they become law, would have a significant effect on investment companies, private investment funds such as hedge funds, and registered and unregistered investment advisers. A summary of the provisions of the Senate Bill compared to those of the House Bill appears below. For a more detailed analysis of the House Bill see *Potential Effects on Funds and Investment Advisers of The Wall Street Reform and Consumer Protection Act of 2009* (dated January 11, 2010).

Provisions Intended to Maintain Financial Stability

The Senate Bill, similar to the House Bill, would provide additional oversight of financial companies. The House Bill defines "financial companies" as those engaged in "financial activities." The Senate Bill divides "financial companies" into bank holding companies and nonbank financial companies (including foreign nonbank financial companies) and defines "nonbank financial companies" as those companies "predominately engaged" in financial activities.[1] In both bills, financial companies could include investment companies, business development companies (BDCs), hedge funds, and investment advisers, although it is not entirely clear that all of these entities were intended to be covered by the bills.

Similar to the House Bill's establishment of a Financial Services Oversight Council, the Senate Bill would create a Financial Stability Oversight Council. Both Councils would identify financial companies that pose a threat to the financial stability of the United States based upon factors such as the amount and nature of the company's financial assets, liabilities, leverage, off-balance sheet exposures and transactions, and relationships with other financial companies; the extent to which financial assets are simply managed and not owned by the financial company, and the extent to which ownership of assets under management is diffuse; and any other factors that the Council deems appropriate. Similar to the House Bill, under the Senate Bill, if the Council determines that a financial company poses a threat to the financial stability of the United States, the Senate Bill allows the Federal Reserve Board (the "Board") to impose "prudential standards," meaning enhanced supervision and regulatory standards, on the entity.[2] Both bills require other regulatory agencies overseeing the applicable institutions to enforce such standards. Prudential standards would include risk-based capital

[1] A company is "predominately engaged" in financial activities if annual gross revenues from activities (or consolidated assets related to activities) that are financial in nature (as defined in section 4(k) of the Bank Holding Company Act of 1956) and, if applicable from owning/controlling one or more insured depository institutions, represents 85% or more of consolidated annual gross revenues (or consolidated assets).

[2] The Council may also recommend to a regulatory agency that financial activities and practices be subject to prudential standards.

requirements and leverage limits,[3] liquidity requirements, resolution plan and credit exposure requirements[4] (*e.g.*, credit exposure to an unaffiliated company may not exceed 25% of capital stock and surplus of the financial company), and concentration limits. Prudential standards may also include a contingent capital requirement (*e.g.*, require a nonbank financial company to maintain a minimum amount of long-term hybrid debt that is convertible to equity in times of financial stress); enhanced public disclosures (*e.g.*, to support market evaluation of the risk profile, capital adequacy, and risk management capabilities of a company); and overall risk management requirements. The Senate Bill also requires the Board to mandate that publicly traded nonbank financial companies that are subject to the new prudential standards establish a risk committee.[5]

Similar to the House Bill, the Senate Bill would create an orderly liquidation fund to facilitate the liquidation of covered financial companies. Unlike the House Bill, however, the orderly liquidation fund established under the Senate Bill would not be pre-funded. Instead, the Federal Deposit Insurance Corporation (FDIC), when necessary, would borrow from the U.S. Treasury, which borrowings would be repaid through repayments from financial companies that received amounts from the orderly liquidation fund and by imposing risk-based assessments on bank holding companies with at least $50 billion in assets, any nonbank financial companies supervised by the Board, and any other financial companies with at least $50 billion in assets.

The Senate Bill also provides for the recoupment of compensation from senior executives and directors "substantially responsible" for the failed condition of a covered financial company (which could include a nonbank financial company under the supervision of the Board) of any compensation received during the two-year period before the FDIC was appointed as the receiver of the financial company.

Registration and Reporting Requirements Under the Advisers Act

Both the House Bill and the Senate Bill include provisions that would substantially alter the registration and reporting schemes under the Investment Advisers Act of 1940 (the "Advisers Act") by requiring investment advisers to certain private funds to register with the Securities and Exchange Commission (SEC). Please read *Preparing for Financial Reform: Investment Adviser Registration* for further information on these new requirements.

Regulation of Over-the-Counter Derivatives Markets

Both the House Bill and the Senate Bill impose new requirements on swap participants and authorize the Commodity Futures Trading Commission and the SEC to regulate certain swap participants. In addition, both

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[3] Unlike the House Bill, the Senate Bill does not create a carve-out from risk-based capital requirements and leverage limits if the Board determines that such requirements are not appropriate for a financial holding company subject to stricter standards because of such company's activities (such as investment company activities or assets under management) or structure. In addition, the Senate Bill mandates minimum leverage and risk-based capital requirements for companies subject to prudential standards. The Senate Bill provides that Federal banking agencies would develop capital requirements applicable to nonbank financial companies supervised by the Board that address risks arising from significant volumes of activity in derivatives, securitized products, financial guarantees, securities borrowing, and lending and repurchase and reverse repurchase agreements; from concentrations in assets for which values in financial reports are based on models rather than historical costs or prices deriving from deep and liquid two-way markets; and from concentrations in market share for activities that would substantially disrupt financial markets if the entity ceases the activity.

[4] These include reports regarding the financial company's plan for rapid and orderly resolution in the event of material financial distress or failure and its credit exposure to significant financial companies and the credit exposure that other significant financial companies have to that company.

[5] The Investment Company Institute has been seeking to clarify that investment companies will be excluded from these standards, but it is not clear whether they will be successful.

the House Bill and the Senate Bill impose additional regulations on many derivative transactions. Please read *Preparing for Financial Reform: Derivatives* for further information on these new requirements.

Credit Risk Retention

Similar to the House Bill, the Senate Bill would require the adoption of regulations that would require any securitizer[6] of an asset-backed security to retain at least 5% of the credit risk on any asset-backed security transferred, sold, or conveyed. The portion of credit risk may be lower if certain underwriting standards are met by the originator[7] of the assets. The credit risk may be shared between the securitizer and the originator. The Senate Bill includes an exemption for asset-backed securities collateralized only by residential mortgages that satisfy underwriting standards to be determined by regulation. Depending on actual adopted regulations, investment companies, BDCs, and hedge funds that make or invest in loans (or could be considered originators of asset-based securities) could be affected by the House Bill provision.

Short Sale Regulation

Unlike the House Bill, which seeks to further regulate short sales of securities through reporting and notice requirements and the outlawing of manipulative short sales, the Senate Bill calls for a study on short selling on national securities exchanges and in over-the-counter markets. The study, to be conducted by the SEC's Division of Risk, Strategy, and Financial Innovation, would pay particular attention to the impact of the SEC's recent rule changes and the incidence of (1) the failure to deliver shares sold short; or (2) the delivery of shares on the fourth day following the short sale transaction. The report, along with any recommendations for market improvements, is due to the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee of Financial Services within two years after the bill becomes law.

Effects of FDIC Receivership

Both bills include provisions that could impact recovery in the event of an insolvency of derivatives or other trading counterparties when certain financial companies are placed in FDIC receivership. As receiver, the FDIC would have many of the powers currently held by the FDIC in a bank receivership, such as the power to transfer the assets or liabilities of the insolvent company, including certain financial contracts, such as securities lending agreements and derivatives agreements. An investment company, BDC, hedge fund, or investment adviser that is a party to such a contract could not object to such transfer or terminate the agreement because of the appointment of a receiver or the insolvency or financial condition of the financial company until 5 p.m. ET the business day (House Bill) or the third business day (Senate Bill) following the appointment of the receiver or after notice that the contract has been transferred. However, the Senate Bill, unlike the House Bill, would not limit the claims of secured creditors of financial institutions subject to an FDIC receivership.

Adoption of Fiduciary Standards for Brokers and Dealers

Unlike the House Bill, which would require the SEC to promulgate rules creating fiduciary standards for broker-dealers, the Senate Bill requires the SEC to study the effectiveness of legal/regulatory standards of care

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[6] A "securitizer" is either an issuer of an asset-backed security or a person who organizes and initiates an asset-backed securities transaction by selling or transferring assets to the issuer.

[7] An "originator" is a person who through the extension of credit creates a financial asset that collateralizes an asset-backed security and who sells the financial asset to a securitizer.

for broker-dealers to determine whether there are legal/regulatory gaps in the protection of retail customers. Although the Senate Bill does not establish a general fiduciary standard for broker-dealers, it holds swap dealers and security-based swap dealers to a fiduciary standard in certain derivatives transactions. Please read *Preparing for Financial Reform: Derivatives* for further information on these new requirements.

Corporate Governance

The Senate Bill would require that directors be elected by a majority of votes cast in an uncontested election for issuers registered under the Securities Exchange Act of 1934 (the "Securities Exchange Act"). If a director receives less than a majority vote in an uncontested election, the director would be required to submit his or her resignation. The board could accept the resignation of the director or, with unanimous vote, reject the resignation and publicly disclose the specific reasons that the board chose not to accept the resignation and that the decision was in the best interests of the issuer and shareholders. In a contested election, if the number of director nominees exceeds the number of directors to be elected, directors would be elected by a plurality vote of shares represented at the meeting and entitled to vote.

The Senate Bill also amends the Securities Exchange Act to require national securities exchanges to adopt rules to prohibit brokers from voting shares without shareholder instructions with respect to director elections, executive compensation, or any other significant matter (as determined by the SEC, by rule).[8] Please read *Preparing for Financial Reform: Banking, Corporate Governance and Executive Compensation* for further information on these requirements and other requirements relating to executive compensation.

Miscellaneous Provisions

- *Establishment of Risk Management Standards*. The Senate Bill would consider investment companies, broker-dealers, and investment advisers "financial institutions" under the *Payment, Clearing and Settlement Supervision Act of 2010*, which would require the Board, in consultation with the Council, to prescribe risk management standards governing payment, clearing, and settlement activities of designated financial market utilities and the conduct of systemically important activities by financial institutions.
- *Fees*. The Senate Bill would permit the Board to assess fees on nonbank financial companies supervised by the Board, as discussed above under *Provisions Intended to Maintain Financial Stability*. Fees would also be assessed on such companies to fund the Financial Research Fund (under the Office of Financial Research).
- *Limits Proprietary Trading and Sponsorships and Investments in Hedge Funds/Private Equity Funds*. The Senate Bill would prohibit insured depository institutions, their control companies, bank holding companies, and any subsidiaries ("banking organizations") from proprietary trading (investments in obligations of the United States, certain government-sponsored enterprises, or any state are excepted) and certain sponsorships and investments in a hedge fund or private equity fund. Further, banking organizations that serve (directly or indirectly) as investment manager/adviser to a hedge fund or private equity fund would be prohibited from entering into "covered transactions" (as defined in Section 23A of the Federal Reserve Act, which would include, for example, a loan or extension of credit to an affiliate or a purchase of or an investment in securities issued by an affiliate) with such a fund. Additional capital

[8] New York Stock Exchange Rule 452 was recently amended to similarly limit broker discretionary voting in director elections.

requirements and quantitative limits would be placed on financial companies supervised by the Board (as noted above under *Provisions Intended to Maintain Financial Stability*) that engage in proprietary trading or sponsor and invest in hedge funds and private equity funds.

- *Removal of Credit Ratings References*. The Senate Bill would remove statutory references to credit ratings (similar to the House Bill) by amending Federal statutes, including the Investment Company Act of 1940 (the "Investment Company Act") and the Securities Exchange Act. References to investment grade ratings in these and other Acts by nationally recognized statistical ratings organizations (NRSROs) would be eliminated and replaced with standards of credit-worthiness as determined by the SEC (or other comparable regulatory agencies). Although the Senate Bill would remove statutory references, unlike the House Bill, it would not also require applicable Federal agencies to remove references to credit ratings in their regulations, although the agencies could do so on their own accord.
- *Regulation of NRSROs*. The Senate Bill would create a new Office of Credit Ratings within the SEC, which would regulate NRSROs. NRSROs would be required to have a board of directors that meets certain independence requirements, create internal controls and publicly disclose information on initial, and subsequent changes to, credit ratings.
- *Establishment of Credit Rating Agency to Provide Initial Credit Ratings for Structured Finance Products*. The Senate Bill would create a self-regulatory organization, the Credit Rating Agency Board (the "Credit Rating Board"). Issuers would no longer be able to request initial credit ratings for structured financial products directly from NRSROs.[9] Instead, all issuer requests for an initial credit rating for a structured finance product would be made to the Credit Rating Board, and the Credit Rating Board would select a qualified NRSRO (from a group of NRSROs that submits applications to the Credit Rating Board) to provide the initial credit rating to the issuer. The Credit Rating Board would be initially composed of an odd number of members selected from the industry (including at least one member who is an issuer industry representative and one representative of the credit rating agency industry) who would be appointed for an initial four-year term.
- *Study on Mutual Fund Advertising*. The Senate Bill would require a study on mutual fund advertising by the Comptroller General to identify existing and proposed regulatory requirements for open-end mutual fund advertisements, current marketing practices for sales of open-end mutual fund shares, and impacts of such advertising on consumers. The study would be required to identify recommendations intended to improve investor protections. A report detailing the results of the study would be due to the Senate Committee on Banking, Housing, and Urban Affairs and to the House Committee on Financial Services within one year after the bill becomes law.
- *Broker-Dealer Disclosure to Retail Investors Prior to Purchase*. Similar to the House Bill, the Senate Bill would amend the Securities Exchange Act to permit the SEC to issue rules designating documents or information that a broker or dealer would be required to provide to a retail investor prior to the purchase of an investment product (including investment company shares) or service. Any documents or information required would be in a summary form and contain information about investment objectives, strategies, costs and risks, and any compensation or other financial incentive received by a broker or dealer in connection with the purchase of retail investment products.

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[9] Under the Senate Bill, structured finance products include any asset-backed security and any structured product based on an asset-backed security, and the SEC would further define and expand this definition by rule as necessary.

- *Adviser Safeguards of Client Assets*. The Senate Bill would permit the SEC to promulgate rules that require an investment adviser to safeguard client assets, including verification of such assets by an independent accountant. The House Bill would require the SEC to promulgate rules making it unlawful for a registered investment adviser to have custody of client funds in excess of $10 million, unless a qualified custodian that is not involved directly or indirectly in providing investment advice with respect to those accounts holds such funds.
- *Limits on Securities Lending*. Both bills amend Section 10 of the Securities Exchange Act to make it illegal to engage in securities lending in contravention of SEC rules and allow for promulgation of regulations restricting the lending and borrowing of securities. The Senate Bill also requires the SEC to promulgate rules intended to increase the transparency of information available to brokers, dealers, and investors relating to securities lending and borrowing.
- *No Expansion on Authority to Pursue Aiders and Abettors.* Unlike the House Bill, the Senate Bill does not expand the SEC's authority to pursue aiders and abettors by allowing the standard of knowledge to be satisfied by recklessness, and does not grant the SEC the authority to prosecute for aiding and abetting under the Securities Act of 1933, Investment Company Act, or Advisers Act (it currently has this authority under the Securities Exchange Act).
- *Accredited Investor Status*. The Senate Bill also directs the SEC to amend the net worth threshold for "accredited investor" status under the Securities Act of 1933 for natural persons. Please read *Preparing for Financial Reform: Investment Adviser Registration* for further information.
- *State Powers*. Both the Senate Bill and House Bill contain provisions preserving the enforcement powers of states. However, unlike the House Bill, the Senate Bill restricts the ability of state attorneys general to bring civil actions against national banks or Federal savings associations. Both bills also contain provisions relating to federal preemption for national banks and certain subsidiaries.

We expect that the Senate and House will soon meet in conference to resolve the differences between their respective bills. A compromise bill would have to be approved by the House and Senate before the bill is presented to President Obama, which early reports suggest may happen before July 4. Although it is impossible to predict which provisions will survive to become law, we will continue to monitor developments.

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