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July 16, 2010

Congress Approves Financial Regulatory Reform Legislation; President's Approval Expected This Week

[24431]

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VARIABLE INSURANCE PRODUCTS ADVISORY COMMITTEE No. 5-10 RE: CONGRESS APPROVES FINANCIAL REGULATORY REFORM LEGISLATION; PRESIDENT'S APPROVAL EXPECTED THIS WEEK

On July 15, the U.S. Senate gave final approval to the "Wall Street Reform and Consumer Protection Act of 2010" by a vote of 60-39. [1] This sweeping legislation, which was approved by the U.S. House of Representatives on June 30, is expected to be signed into law this week by President Obama.

ICI will host a webinar on the new regulatory reform legislation on Thursday, July 22nd from 2:00 p.m. to 4:00 p.m. ET.The webinar will focus on those aspects of the legislation most relevant to registered investment companies (funds) and their advisers. [2]

The legislation addresses a broad range of topics including, among others:

- heightened regulation of financial companies and activities for financial stability purposes
- orderly liquidation of failing non-depository institution financial companies
- establishment of an independent bureau within the Federal Reserve Board to protect consumers of certain financial products
- regulation of over-the-counter derivatives
- investor protection and strengthening of the Securities and Exchange Commission
- consolidated supervision of securities holding companies
- requirements relating to corporate governance and executive compensation
- registration of private fund advisers
- enhanced regulation relating to credit rating agencies and municipal securities

This memorandum highlights provisions that may be of particular interest to ICI members.

Financial Stability

- The bill creates a Financial Stability Oversight Council (Council) whose voting members include the heads of various federal financial regulatory agencies and the new Bureau of Consumer Financial Protection (CFPB) (discussed further below). The Secretary of the Treasury will chair the Council, which, among other things, will identify risks to financial stability and respond to emerging threats to the U.S. financial system.
- The bill also establishes an Office of Financial Research within Treasury (OFR). OFR will have authority to collect reports, data and information, including financial transaction and position data, and will be required to provide data to the Council and its member agencies to support their work. For the first two years after enactment of the legislation, OFR expenses will be paid by the Federal Reserve. After that time, OFR will be financed through assessments on bank holding companies with total consolidated assets of at least $50 billion and identified nonbank firms (as defined below).
- The Council, in consultation with the appropriate primary financial regulator, is responsible for identifying U.S. nonbank financial companies for heightened supervision and regulation by determining whether material financial distress at the company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the company's activities could pose a threat to U.S. financial stability. Foreign nonbank financial companies likewise may be identified for heightened supervision and regulation. (For purposes of this memo, these U.S. and foreign companies are referred to as "identified nonbank firms.")
- The Council's determinations are to be based on various criteria, including "the importance of the company as a source of credit for households, businesses, and State and local governments and as a source of liquidity for the U.S. financial system." Criteria also include, among others:
    - the extent of leverage of the company

    - the extent to which assets are managed rather than owned by the company, and the extent to which ownership of assets under management is diffuse
    - the degree to which the company is already regulated by one or more primary financial regulatory agencies
    - the amount and nature of the financial assets of the company
    - the amount and types of the liabilities of the company, including the degree of reliance on short-term funding
    - any other risk-related factors that the Council deems appropriate
- The Federal Reserve, on its own or pursuant to recommendations by the Council, must impose "prudential standards" and reporting and disclosure requirements on the identified nonbank firms and on bank holding companies with total consolidated assets of at least $50 billion. These standards must include risk-based capital requirements and leverage limits, unless the Federal Reserve, in consultation with the Council, determines that such requirements are not appropriate for an identified nonbank firm "because of the activities of such company (such as investment company activities or assets under management) or structure, in which case, the [Federal Reserve] shall apply other standards that result in similarly stringent risk controls."

  The Federal Reserve also must impose liquidity requirements, overall risk management requirements, resolution plan and credit exposure report requirements, and concentration limits. Additional standards may include a contingent capital requirement, enhanced public disclosures, short-term debt limits, and such other standards as the Federal Reserve (on its own or pursuant to a Council recommendation) determines are appropriate.
    - In prescribing prudential standards for identified nonbank firms, the Federal Reserve may, on its own or pursuant to a Council recommendation, differentiate among such firms on an individual basis or by category, taking into consideration their capital structure, riskiness, complexity, financial activities, size, and any other risk-related factors that the Federal Reserve deems appropriate.
    - The Federal Reserve is required to "adapt the required standards as appropriate in light of any predominant line of business of such company, including assets under management or other activities for which particular standards may not be appropriate."
- The Council may provide for more stringent regulation of a financial activity by issuing recommendations to one or more primary financial regulatory agencies to apply "new or heightened standards and safeguards" for a financial activity or practice conducted by bank holding companies or nonbank financial companies, if the Council determines that the conduct, scope, nature, size, scale, concentration, or interconnectedness of such activity or practice could create or increase the risk of significant liquidity, credit, or other problems spreading among bank holding companies and nonbank financial companies, the financial markets of the United States, or low-income, minority, or underserved communities. The primary regulator(s) must impose the recommended standards or similar standards acceptable to the Council, or explain in writing why the regulator has determined not to follow the Council's recommendation.
- Pursuant to Section 171 of the bill (frequently referred to as the "Collins amendment"), the federal banking agencies must establish, for insured depository institutions, depository institution holding companies (defined by reference to Section 3 of the Federal Deposit Insurance Act), and identified nonbank firms:
    - Minimum leverage capital and risk-based capital requirements, which cannot be less than "generally applicable leverage capital requirements" and "generally

  applicable risk-based capital requirements," as defined in the legislation
    - Subject to Council recommendations, capital requirements to address systemically risky activities, specifically including (among other things) significant volumes of activity in derivatives, securitized products, financial guarantees, securities borrowing and lending, and repurchase agreements
- The Federal Reserve, in coordination with the appropriate primary regulators and the new Federal Insurance Office, shall conduct annual stress tests of bank holding companies with total consolidated assets of at least $50 billion and identified nonbank firms to determine "whether such companies have the capital, on a total consolidated basis, necessary to absorb losses as a result of adverse economic conditions." Such testing may be extended to other bank holding companies and nonbank financial companies. The Federal Reserve is required to publish a summary of all test results.
- Financial companies themselves will be required to conduct "stress tests" (as defined by the primary regulators). For bank holding companies with total consolidated assets of at least $50 billion and identified nonbank firms, the testing must be done semiannually; annual testing will be required of other financial companies that have total consolidated assets exceeding $10 billion and are regulated by a primary federal financial regulatory agency. All companies subject to these requirements will have to submit reports to the Federal Reserve and their primary regulators; they will also have to publish a summary of their test results.
- If the Federal Reserve determines that a bank holding company with total consolidated assets of at least $50 billion or an identified nonbank firm poses a "grave threat" to U.S. financial stability, the Federal Reserve, upon a two-thirds vote of the Council's voting members, shall: (1) limit the company's ability to merge with, acquire, consolidate with, or otherwise become affiliated with another company; (2) restrict the company's ability to offer one or more financial products; (3) require the company to terminate one or more activities; (4) impose conditions on the manner in which the company conducts one or more activities; or (5) if the Federal Reserve determines that the foregoing actions are inadequate to mitigate a threat to U.S. financial stability, require the company to sell or otherwise transfer assets or off-balance-sheet items to unaffiliated entities.

Orderly Liquidation Authority

- Upon the recommendation of at least two thirds of the members of the Federal Reserve Board and of the board of the FDIC (or two thirds of the SEC in the case of a broker-dealer, or the Director of the Federal Insurance Office in the case of an insurance company), a failing nonbank financial company can be subjected to an "orderly liquidation" process if the Treasury Secretary, in consultation with the President, determines among other things that the company is "in default or in danger of default," that its failure and resolution under otherwise applicable law would have serious adverse effects on U.S. financial stability, and that there is no viable private sector alternative to prevent the company's default. Upon such a determination, the FDIC will be appointed as receiver and must liquidate the "covered financial company." An insurance company that is determined to be a "covered financial company" will be liquidated under state law.
- The bill prescribes mandatory terms and conditions for all orderly liquidation actions taken by the FDIC. In particular, the FDIC must: determine that the action is necessary for U.S. financial stability and not to preserve the covered financial company; ensure that shareholders do not receive payment until after all other claims and the Orderly Liquidation Fund are fully paid; ensure that unsecured creditors bear

losses in accordance with the bill's priority of claims provisions; ensure removal of management and board members responsible for the company's failed condition; and not take an equity interest in or become a shareholder of any covered financial company or "covered subsidiary" of such company.

- No taxpayer funds may be used to prevent the liquidation of a financial company under the orderly liquidation provisions. In addition, any funds expended in the liquidation of a financial company must be recovered from the disposition of the company's assets or through assessments on the financial sector (discussed below).
- The FDIC, in consultation with the Council, is charged with prescribing rules to implement the bill's orderly liquidation provisions, including rules with respect to the rights, interests, and priorities of creditors, counterparties, security entitlement holders, or other persons with respect to a covered financial company or such company's assets or other property. The bill instructs the FDIC, to the extent possible, to seek to harmonize such rules with otherwise applicable insolvency laws.
- The bill establishes an order of priority for different types of unsecured claims, and generally requires that similarly situated creditors be treated in a similar manner. An exception provides that the FDIC may take any action, including making additional payments to some claimants, if: (1) the FDIC determines such action is necessary to maximize the value of the covered financial company's assets, initiate and continue operations essential to implementation of the receivership or any bridge financial company, or maximize the present value return or minimize losses realized from the sale or other disposition of the covered financial company's assets; and (2) all similarly situated creditors receive not less than the amount of the FDIC's maximum liability as set forth in the bill.
- Consistent with the treatment of financial contracts in a resolution by the FDIC of an insured depository institution, the bill allows for a delay of up to one business day in the enforcement of "qualified financial contracts," including repurchase agreements.
- The bill requires the Council to conduct a study on secured creditor haircuts, including an examination of the treatment of secured creditors under various resolution mechanisms and how a haircut "could improve market discipline and protect taxpayers." The Council must report its findings and conclusions to Congress within one year of the bill's enactment.
- To cover the costs of actions taken under the orderly liquidation authority provisions, the FDIC is authorized to issue debt securities to the Treasury Department, up to a specified maximum amount. Borrowings from Treasury are to be repaid through post-liquidation assessments—first, on claimants that received additional payments under the provisions discussed above concerning similarly situated creditors, to recover on a cumulative basis the difference between (1) the amount such claimants received and (2) the amount they were entitled to receive solely from the proceeds of the liquidation.
- If those assessments are insufficient to allow the FDIC to repay Treasury within 60 months, then the FDIC is required to impose assessments on bank holding companies with total consolidated assets of $50 billion or more, identified nonbank firms, and other financial companies with total consolidated assets of $50 billion or more. Such assessments must be graduated, with higher assessments imposed based on a company's larger size and higher risk. Assessments also must be based on a risk matrix established by the FDIC. The Council is required to make a recommendation on the risk matrix to be used, and the FDIC must take any such recommendation into account.
    - Both the Council and the FDIC must take into account various specified criteria in recommending or establishing the risk matrix, including: economic conditions

generally affecting financial companies, to allow assessments to increase during more favorable economic conditions and decrease during less favorable economic conditions; assessments imposed on financial companies or their affiliates that are insured depository institutions, members of the Securities Investor Protection Corporation (SIPC), insured credit unions, or insurance companies; the risks the financial company presents to the financial system and the extent to which the company has benefitted, or likely would benefit, from a financial company's orderly liquidation under the legislation; any risks the financial company presented during the 10-year period preceding the FDIC's appointment as receiver that may have contributed to the covered financial company's failure; and any other risk-related factors the FDIC or the Council determines to be appropriate.

  - In taking into account the risks the financial company presents to the financial system, the Council and the FDIC must consider several specific factors, including: the activities of the company and its affiliates; the extent to which the company is leveraged; the company's importance as a source of credit for households, businesses, and State and local governments and as a source of liquidity for the financial system; and the extent to which assets are simply managed and not owned by the company and the extent to which ownership of assets under management is diffuse.

Consumer Financial Protection Bureau

- The bill establishes the CFPB as an independent bureau within the Federal Reserve, with a Director who is appointed by the President and confirmed by the Senate. The Bureau will have a broad consumer protection mandate and the authority to regulate and enforce substantive standards for persons engaged in offering or selling a "consumer financial product or service."
- Many classes of persons, however, are excluded from the Bureau's jurisdiction. Additionally, the Council has the authority to stay a Bureau regulation temporarily (upon petition from a Council member agency) or to veto a Bureau regulation (upon a two thirds vote of Council member agencies).
- The Bureau has "no authority to exercise any power to enforce" the legislation with respect to SEC-regulated persons. This exclusion specifically applies to registered investment companies, registered investment advisers, registered broker-dealers, and registered transfer agents, among others. It also covers employees/agents/contractors of SEC-regulated entities, to the extent that the individuals are acting in a regulated capacity.
- Also excluded from the Bureau's jurisdiction are 401(k) and other retirement plans, the employers sponsoring those plans, IRAs, education savings arrangements, and state 529 plan sponsors. Services relating to retirement plans, IRAs, and 529 plans may fall under the Bureau's authority if granted jointly by the Secretaries of Labor and Treasury (either in response to the Bureau's request or at the request of Labor and Treasury).

OTC Derivatives

- The bill covers a broad range of issues impacting derivatives including, most significantly, the regulation of new categories of market participants (e.g., "major swap participants" and "major security-based swap participants," discussed below) and the clearing and trading of certain derivatives. The CFTC will primarily regulate "swaps" and the SEC will primarily regulate "security-based swaps," as these terms are defined in the bill.

- "Major swap participants" and "major security-based swap participants" (which would include any registered investment companies meeting the definitions of those terms) will be required to register with the CFTC and SEC, respectively, and comply with reporting, recordkeeping, capital and margin, and other regulatory requirements. Many of the regulatory requirements will have to be clarified under directed rulemaking by the two agencies.
- The bill defines "major swap participant" (which is identical in most respects to the definition of "major security-based swap participant") as any person who is not a swap dealer and:
    - who maintains a "substantial position" in swaps for any of the major swap categories as determined by the CFTC and SEC, excluding both positions (1) held for hedging or mitigating commercial risk and (2) maintained by an employee benefit plan under ERISA for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan;
    - whose outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets; or
    - who is a "financial entity" that maintains a substantial position in outstanding swaps in any major swap category as determined by the CFTC and SEC, is highly leveraged relative to the amount of capital it holds, and is not subject to capital requirements established by an appropriate Federal banking agency.
        - The bill requires the CFTC and SEC to provide a definition of "substantial position" that is "prudent for the effective monitoring, management, and oversight of entities that are systemically important or can significantly impact" the U.S. financial system. The definition must take into account the person's relative position in uncleared as opposed to cleared swaps and may take into consideration the value and quality of collateral held against counterparty exposures.
- The bill imposes a central clearing requirement for all swaps that the CFTC or SEC has determined should be cleared and requires the two agencies, on an ongoing basis, to review swaps to determine if they should be required to be cleared.
- All swaps subject to the clearing requirement must be traded on a board of trade designated as a contract market or a securities exchange or through a swap execution facility, unless no such entity accepts the swap for trading.
- The bill prohibits "federal assistance," including federal deposit insurance and access to the Federal Reserve discount window, for any "swaps entity" with respect to any swap or security-based swap or other activity of the swaps entity. Referred to as the "push-out" requirement, this would effectively require certain derivatives activities to be conducted outside of banks and bank holding companies. The term "swaps entity" would include "major swap participants" and "major security-based swap participants."

Investor Protection and SEC Authority

- *Investment adviser/broker-dealer regulation.* The bill directs the SEC to study the standards of care applicable to broker-dealers and investment advisers giving personalized investment advice to retail customers. The SEC is authorized (after considering the results from the study) to promulgate rules addressing the standards of care for broker-dealers and investment advisers to protect retail customers (and such other customers as the SEC may by rule provide). In addition, the SEC is authorized to promulgate rules to provide that the standard of conduct for all broker-dealers and investment advisers, when providing personalized investment advice about securities to retail customers (and such other customers as the SEC may by rule provide), shall be the same as the standard of conduct applicable to investment advisers under the Investment Advisers Act of 1940. When a broker-dealer sells only proprietary or other limited range of products, the SEC may by rule require that such broker-dealer provide notice to each retail customer and obtain the consent or acknowledgment of the customer.

- *Point of sale disclosure.* The bill clarifies the SEC's authority to require broker-dealers to provide disclosure to retail investors before such investors purchase an investment product or service.
- *Investor Advisory Committee.* The bill establishes—by statute—an Investor Advisory Committee to advise and consult with the SEC on specified topics and provide findings and recommendations.
- *Enhanced SEC enforcement authority.* The bill provides the SEC with authority to impose civil penalties in cease and desist proceedings and to impose penalties for aiding and abetting violations. It clarifies that the standard of knowledge for aiding and abetting violations is recklessness. It also provides for enhanced subpoena power, provides incentives and protections for whistleblowers, and enhances the SEC's ability to ban violators from the securities industry.
- *Studies.* The bill calls for numerous investor protection-related studies, including studies on financial literacy, mutual fund advertising, enhancement of investment adviser examinations, and proprietary trading.
- *SEC operations and funding.* The bill makes operational changes to the SEC, including providing streamlined hiring authority for market specialists, improving the agency's ability to share information with other regulators, and clarifying its authority to conduct investor testing. It creates a staff of compliance examiners within the Divisions of Trading and Markets and Investment Management (but does not specify whether this is in addition to, or in lieu of, an independent Office of Compliance Inspections and Examinations). The bill also requires several reports, on internal supervisory controls, personnel management, Commission organization and reform, and SEC "revolving door," among others. Finally, the bill provides for "match funding" for the SEC, under which the Commission must submit a budget appropriations request to Congress, but the request must be submitted to Congress unaltered by the President.
- *Asset-backed securities.* The bill requires the SEC and the federal banking agencies to develop new rules and regulations relating to the underwriting and issuance of asset-backed securities, including requiring those offering the securities to retain some of the risk associated with the securities, and other requirements designed to encourage improved underwriting, risk assessment, risk management and disclosure practices.
- *Short sales.* The bill includes several new requirements relating to short sales. Specifically, the SEC is required to adopt rules for the public disclosure of the amount of short sales by institutional investment managers subject to Section 13(f) of the Securities Exchange Act. At a minimum, the disclosure will be required monthly. The bill also requires broker-dealers to notify customers that they may elect not to allow their fully paid securities to be loaned to cover short sales, and that the broker- dealer may receive compensation for lending the customer's securities. The SEC also is authorized to adopt rules to address manipulative short selling.

“Volcker Rule” Provisions

- The bill generally prohibits any “banking entity” from engaging in “proprietary trading” and from acquiring or retaining an ownership interest in, or “sponsoring,” a “hedge fund” or “private equity fund.” Identified nonbank firms that engage in proprietary trading or invest in or sponsor hedge funds or private equity funds will be subjected to additional capital requirements and additional quantitative limits with respect to such activities.
  - The term “banking entity” is defined to include any insured depository institution, any company that controls an insured depository institution, any company that is treated as a bank holding company for purposes of Section 8 of the International Banking Act of 1978, and any of their affiliates or subsidiaries. Institutions that function solely in a trust or fiduciary capacity and meet certain other conditions are excluded from the definition of “insured depository institution” for this purpose.
  - The term “proprietary trading” is defined to mean purchasing or selling securities, derivatives, commodity futures, options on any of the foregoing (or other securities or financial instruments as determined by the regulators responsible for implementing these provisions), by a banking entity or an identified nonbank firm for the “trading account” of such entity. “Trading account” means any account used for acquiring or taking positions in the financial instruments listed above “principally for the purpose of selling in the near term (or otherwise with the intent to resell in order to profit from short-term price movements)” and any other accounts as determined by the relevant regulators by rule.
  - The term “sponsor,” when used with respect to a hedge fund or private equity fund, includes: (1) serving as a general partner, managing member or trustee of the fund;
    (2) selecting or controlling a majority of the directors, trustees or management of the fund; and (3) sharing the same name (or a variation of the same name) with the fund for corporate, marketing, promotional or other purposes.
  - The terms “hedge fund” and “private equity fund” are defined as funds exempt from registration under sections 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 or “such similar funds” as the regulators may determine by rule.
- The bill enumerates certain “permitted activities,” including, among others: underwriting and market making-related activities, “to the extent that any such activities . . . are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties;” risk-mitigating hedging activities; and trading securities or other instruments on behalf of customers. A banking entity that provides bona fide trust, fiduciary, or investment advisory services is permitted to organize and offer a private equity or hedge fund in connection with providing such services to its trust, fiduciary, or investment advisory customers, subject to various additional restrictions.
- A banking entity may make a *de minimis* investment in a hedge fund or private equity fund that it organizes and offers, subject to certain limitations and restrictions.
- The bill requires the Council to conduct a study and make recommendations on implementing the Volcker rule provisions to achieve specified goals, such as protecting the safety and soundness of banking entities, protecting taxpayers and consumers, and enhancing financial stability. The Council’s recommendations must in turn be considered by the regulators charged with adopting implementing rules through coordinated rulemaking: the appropriate Federal banking agencies; the

Federal Reserve; the SEC; and the CFTC.
- The specified regulators may designate additional "permitted activities" if they determine by rule that such activities "would promote and protect the safety and soundness of the banking entity" and U.S. financial stability. All "permitted activities" are subject to such restrictions or limitations as the regulators may determine. The regulators are required to issue regulations limiting transactions or activity that would: involve a material conflict of interest between a banking entity and its clients, customers, or counterparties; materially expose the banking entity to high risk assets or strategies; threaten the banking entity's safety and soundness; or threaten U.S. financial stability.

Securities Holding Companies

- The bill provides that if a foreign regulator or foreign law requires a securities holding company to be subject to comprehensive consolidated supervision, such a company may register with the Federal Reserve, which will become the consolidated supervisor for the company. The bill defines "securities holding company" as a company that owns or controls an SEC-registered broker-dealer, but is not an identified nonbank firm, is not subject to comprehensive supervision by a Federal banking agency, and is not already subject to comprehensive consolidated supervision by a foreign regulator.
- The Federal Reserve will prescribe capital adequacy and other risk management standards for these institutions "that are appropriate to protect the safety and soundness of the supervised securities holding companies and address the risks posed to financial stability by supervised securities holding companies." Such standards will take into account differences among types of business activities and other factors. The Federal Reserve is permitted to examine a securities holding company and any affiliate other than a bank, and to impose recordkeeping requirements.

Corporate Governance and Executive Compensation

- The bill prohibits broker discretionary voting in uncontested director elections for all listed companies except for registered investment companies. Discretionary broker voting in uncontested director elections for registered investment companies is permitted, consistent with current NYSE rules.
- The bill gives the SEC authority to adopt proxy access rules, and to exempt any issuer or class of issuers from such rules.
- Shareholders in public operating companies are given two new non-binding advisory votes. Companies will be required to have shareholder votes on executive compensation ("say on pay" votes) at least once every three years and shareholder votes on "golden parachute" packages for executives in connection with a merger or similar transaction. Every institutional investment manager will be required to disclose these advisory votes, unless (as with registered investment companies) they are already required to disclose such votes.
- Federally regulated financial institutions with more than $1 billion in assets will be required to disclose incentive-based compensation arrangements to their federal regulator. The federal financial regulators, jointly, will prohibit any types of incentive-based compensation arrangement that they determine encourages inappropriate risks by covered financial institutions. Broker-dealers and investment advisers with more than $1 billion in assets are covered by these provisions.
- Several other provisions will affect executive compensation practices for public operating companies, including through requirements for compensation committee

independence, new disclosures, and procedures to “claw back” incentive-based compensation paid based on financials that later have to be restated due to an accounting error. These provisions should not affect registered investment companies as issuers.
- Issuers, including registered investment companies, will be required to disclose whether employees or directors may hedge or offset any decrease in the market value of equity securities they hold in the company.
- Issuers, including registered investment companies, will be required to disclose why the issuer has chosen to have a single person, or different individuals, to serve as CEO and Chairman of the board.

Investment Advisers to Private Funds

- The bill eliminates the current “private adviser” exemption in section 203(b)(3) of the Investment Advisers Act. Instead, it requires an investment adviser to any “private fund” (i.e., any company relying on section 3(c)(1) or 3(c)(7) of the Investment Company Act) to register with the SEC. Registration is not required for advisers solely to: (1) venture capital funds (as defined by the SEC); or (2) private funds, but only if the adviser has assets under management in the U.S. of less than $150 million. In each case, however, the SEC must require these advisers to maintain records and provide reports.
- The bill exempts from SEC registration any foreign private fund adviser that, among other things, has fewer than 15 clients and investors in the U.S. in private funds and less than $25 million in assets under management attributable to such clients and investors.
- The bill requires private fund advisers to keep records in several identified areas (e.g., use of leverage and off-balance sheet leverage, valuation policies, counterparty credit risk exposure, trading and investment positions) and such other information as the SEC, in consultation with the Council, determines is “necessary and appropriate in the public interest and for the protection of investors or for the assessment of systemic risk.”
- The bill increases the threshold for SEC (as opposed to state) registration of investment advisers to $100 million in assets under management (or such higher amount as the SEC determines).
- The bill gives the SEC the authority to compel an investment adviser to disclose the identity, investments, or affairs of its private fund or other clients for the purpose of assessing potential systemic risk.
- The bill requires that the net worth component of the accredited investor standard for natural persons be periodically adjusted for inflation.

Credit Rating Agencies

- The bill directs action by the SEC in several areas, including creating an Office of Credit Ratings, conducting an annual examination of each NRSRO, and promulgating rules relating to ratings analyst qualifications, rating agency procedures and methodologies, and the disclosure of information about ratings performance.
- The bill requires Federal agencies to review and modify regulatory references to credit ratings, substituting a standard of creditworthiness as established by the agencies.
- The bill creates a private right of action against rating agencies for knowing or reckless failure to conduct a reasonable investigation of the facts related to a rating or to obtain reasonable verification of such facts from an independent source. It also

eliminates the exemption for rating agencies from (1) Regulation Fair Disclosure and (2) the “expert liability” regime, when ratings are included in a registration statement. The bill changes the word “furnish” to “file” in several places in the Securities Exchange Act of 1934, thereby subjecting rating agencies to liability for material misstatements in certain submissions to the SEC.
- The bill requires each rating agency to have an independent board of directors and establishes requirements for a rating agency’s chief compliance officer. The bill also requires each rating agency to establish internal controls and to report to the SEC annually regarding the rating agency’s compliance with such controls. The bill establishes new requirements for rating agencies to conduct look-back reviews when their employees go to work for a rated entity, underwriter, or obligor, and to include an attestation with each credit rating affirming that the rating was not influenced by any other business activities. It also provides the SEC with authority to penalize individuals associated with rating agencies for specified misconduct.
- Not later than 24 months after the SEC studies the rating process for structured finance products, it must establish a system that prohibits issuers of structured finance products from selecting the rating agency that will provide the initial rating.
- The bill calls for several studies by the SEC or Comptroller General, including on the independence of rating agencies, whether to standardize ratings terminology and/or market stress conditions under which ratings are evaluated, and alternative means for compensating rating agencies.

Municipal Securities

- The bill creates an Office of Municipal Securities within the SEC, and provides a source of funding for the Government Accounting Standards Board.
- The bill imposes a fiduciary duty on “municipal advisers” and requires them to register with the SEC.
- The bill contains several provisions relating to the MSRB’s structure, operations and authority, including among others: (1) a requirement that the MRSB have a majority of “independent” board members; (2) a requirement that the MSRB meet with the SEC and FINRA at least twice a year; and (3) authorization for the MSRB to assist the SEC and FINRA in examinations and enforcement actions regarding MSRB rules.
- The bill calls for several studies by the SEC or the Government Accountability Office (GAO), including on enhanced municipal issuer disclosure/repeal of the Tower Amendment and several aspects of the municipal markets (e.g., improving transparency and liquidity and potential uses of derivatives).

Payment, Clearing and Settlement Supervision

- The bill authorizes the Council to designate financial market utilities and payment, clearing and settlement activities of financial institutions that are, or are likely to become, systemically important. Designated utilities and activities are subject to extensive supervision by the Federal Reserve and the utility/institution’s primary regulator.

Federal Reserve Emergency Lending Authority

- The Federal Reserve must adopt policies and procedures governing emergency lending, which is limited to programs or facilities with broad-based eligibility that will

provide liquidity to the financial system overall. It is prohibited from using its emergency lending authority to assist a single individual, partnership or corporation.
- The GAO will perform a one-time audit of all loans or other emergency assistance provided by the Federal Reserve from December 1, 2007 through the enactment of the legislation.

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Given the bill's breadth, as well as the hundreds of rulemakings and scores of studies the bill calls for, its full import will not be known for many years to come. ICI expects to engage actively with regulators as they move forward with rulemaking to implement new requirements that will or may impact funds and their advisers.

Paul Schott Stevens
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General Counsel

endnotes

[1] The text of the legislation is available at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h4173enr.txt.pdf.

[2] Register for the webinar at https://guest.cvent.com/EVENTS/Register/IdentityConfirmation.aspx?i=006d5dab-8f8e-4ee4-9634-be292f3895d6.