The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

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House Passes Financial Regulatory Reform Legislation

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UNIT INVESTMENT TRUST MEMBERS No. 11-09
VARIABLE INSURANCE PRODUCTS ADVISORY COMMITTEE No. 24-09 RE: HOUSE PASSES FINANCIAL REGULATORY REFORM LEGISLATION

On December 11, the U.S. House of Representatives passed H.R. 4173, the “Wall Street Reform and Consumer Protection Act of 2009,” by a vote of 223-202. [1] This sweeping legislation addresses a broad range of topics including, among others:

- heightened regulation of financial companies and activities for financial stability

purposes
- dissolution of failing non-depository institution financial companies
- establishment of a new federal agency to protect consumers of certain financial products
- regulation of over-the-counter derivatives
- strengthening of the Securities and Exchange Commission and the federal securities laws (referred to as the Investor Protection Act)
- consolidated supervision of securities holding companies
- requirements relating to corporate governance, executive compensation, and proxy access
- registration of hedge 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 Services Oversight Council (Council) comprised of the heads of the Treasury Department (serves as Council chair), the Federal Reserve Board, the Comptroller of the Currency, the Office of Thrift Supervision, the SEC, the Commodity Futures Trading Commission (CFTC), the Federal Deposit Insurance Corporation (FDIC), the Federal Housing Finance Agency, the National Credit Union Administration, and the new Consumer Financial Protection Agency (CFPA) (discussed further below).

- The Council, in consultation with the Federal Reserve and any other primary financial regulator, identifies financial companies for heightened supervision and regulation by determining whether material financial distress at a financial company, or the nature, scope, size, scale, concentration, and interconnectedness, or mix of the company's activities, could pose a threat to financial stability or the economy.

- The Council's determinations are to be based on various criteria, including "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." Criteria also include, among others: the extent of the company's leverage; the extent to which assets are simply managed and not otherwise owned by the company and the extent to which ownership of assets under management is diffuse; and the degree to which the company is already regulated by one or more Federal financial regulatory agencies.

- The Federal Reserve, acting as agent for the Council, then must impose "stricter prudential standards" on the identified companies. These standards "shall" include risk-based capital requirements and leverage limits, unless the Federal Reserve determines that "such requirements are not appropriate because of the company's activities (such as investment company activities or assets under management)," in which case the Federal Reserve must apply other standards that result in "appropriately stringent controls." Additional required standards include, among others, liquidity, concentration, and overall risk management requirements.

- The Federal Reserve is required to consider whether a company subject to stricter standards that is not a bank holding company or treated as a bank holding company owns or controls a depository institution. The Federal Reserve must adapt the standards applied to such company in light of any predominant line of business, including assets under management or other activities for which capital requirements are not appropriate.

- The Council can also identify activities or practices to be subjected to stricter prudential standards if it determines that the conduct of the activity or practice "could create or increase the risk of significant liquidity, credit, or other problems spreading among financial institutions or markets . . . and thereby threaten the stability of the financial system." The Federal Reserve, as agent for the Council, recommends stricter prudential standards to the relevant primary regulatory agency.

- Possible application to registered investment companies (funds) and their investment advisers:
    - Unlikely that most funds would be captured by risk criteria and determined to be systemically significant.
    - Money market funds, however, may be captured, either individually or as an "activity" subject to stricter prudential standards.
    - Investment advisers that are part of large financial services organizations could be captured.

Enhanced Dissolution Authority

- Upon the recommendation of the Federal Reserve and the appropriate regulatory agency, the Treasury Secretary (in consultation with the President) has authority to determine that a financial company is in default or danger of default, and that the company's failure and its dissolution under other law would imperil the financial system. Upon such a determination, the FDIC would be appointed as receiver for the company and authorized to take various emergency stabilization actions.
- A "Systemic Dissolution Fund" would be established to cover the costs of actions taken under the enhanced dissolution authority provisions. All financial companies, including funds, may have to contribute to the Systemic Dissolution Fund (designed to be pre-funded at $150 billion).

- Assessments are to be made on a risk-weighted basis from financial companies (other than hedge funds) with at least $50 billion in assets on a consolidated basis (hedge funds would be captured at $10 billion). Factors to be considered include, among others, "the potential exposure to sudden calls on liquidity precipitated by economic distress," the amount of assets of the company and its affiliates, 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. How assessments will be applied to funds and advisers (e.g., how assets will be measured) is unclear.

- Rights of fully secured creditors (including funds) could decrease in the event that a financial company is "dissolved."

    - If the amounts realized from the dissolution of the company are insufficient to satisfy completely amounts owed to the U.S. or the dissolution fund, certain secured claims in the assets of the company may be subject to a haircut of up to10%. This treatment is permitted if the security interest involves a "qualified financial contract" with an original term of 30 days or less, the collateral does not include certain U.S. government securities, and, as a result of the dissolution of the company, no funds are available to satisfy any claims of unsecured creditors or shareholders.
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- Additional risk-based assessments may be imposed on financial companies, including funds, as necessary to pay for any shortfall in the Troubled Asset Relief Program (TARP) that would add to the deficit or national debt.

Consumer Financial Protection Agency

- The bill generally tracks the Administration's proposal to create a new federal agency. The CFPA would have a broad consumer protection mandate as regards consumer financial products such as mortgages and credit cards.

- The CFPA will not have rulemaking, supervisory, enforcement or other authority over "persons regulated by the SEC." This exclusion specifically identifies registered investment companies, registered investment advisers, registered broker-dealers, and registered transfer agents, among others.
    - The exclusion covers employees/agents/contractors of SEC-regulated entities, to the extent that the individuals are acting in a registered capacity.

    - During floor consideration of the bill, the exclusion was expanded to include "an investment company that . . . is excepted from the definition of investment company under section 3(c)" of the Investment Company Act, as well as employees/agents/contractors acting for (or providing services to) the section 3(c) fund.

- Also excluded from the CFPA's jurisdiction are 401(k) and other retirement plans, the employers that sponsor and maintain those plans, IRAs, and 529 plans. The services provided to these plans and arrangements are not specifically excluded.

Derivatives

- The bill covers a broad range of issues impacting derivatives including, most significantly, the regulation of market participants and the clearing and trading of certain derivatives.

- "Major swap participants" would have to register with the CFTC and/or SEC and comply with reporting, recordkeeping, capital and margin, business conduct and other regulatory requirements.
    - It appears that funds would fall under the definition of "major swap participant."

- The bill imposes a central clearing requirement, with certain exceptions, on swaps

that derivatives clearinghouses will accept for clearing and that the CFTC and/or SEC requires to be cleared.

- It also requires that all swaps that are subject to a clearing requirement be exchange-traded or traded on a "swap execution facility."

Investor Protection Act

- The bill generally increases SEC's inspection, examination and enforcement powers.

- *Investment adviser/broker-dealer harmonization.* The bill attempts to create a parallel fiduciary standard for brokers.

- *Point of sale disclosure.* The bill requires a study by the SEC with follow-up rulemaking. The study is broadly based on all products and services under the SEC's jurisdiction.

- *Distribution practices.* The bill would allow the SEC to adopt rules governing distribution practices and compensation for financial intermediaries.

- *SEC self-funding.* SEC regulation of investment advisers would self-funded through assessments on advisers.

- *Short sale disclosure.* The bill would require reports to the SEC each day that an institutional investment manager effects a short sale of an equity security. It also would require, at a minimum, public monthly disclosure of information about short sales effected by an institutional investment manager. These requirements go beyond what the SEC had required, and later rescinded, with respect to disclosure of short sales by investment managers.

Securities Holding Companies

- The Federal Reserve will become the consolidated supervisor for any "securities holding company"—defined to include any entity that owns or controls one or more brokers or dealers—that is required by a foreign regulator or foreign law to be subject to comprehensive consolidated supervision but is not already subject to such supervision by a federal banking regulator.
- The Federal Reserve is required to prescribe risk management and capital requirements for such holding companies, but it would have some flexibility to take into account different types of business activities in prescribing the requirements. To the fullest extent possible, the Federal Reserve is to make use of reports already required by another regulator of the company. The Federal Reserve is permitted to examine securities holding companies and their affiliates and to impose recordkeeping requirements.

Corporate Governance and Executive Compensation

- The SEC must adopt rules requiring public companies to hold non-binding shareholder votes on executive compensation ("say on pay" votes) and payments to executives in connection with a merger or similar transaction ("golden parachute" votes).
- Each large institutional investment manager must disclose how it voted on say on pay and golden parachute votes, unless such vote is otherwise required to be publicly reported (as is the case with respect to fund votes).

- Listed companies must have compensation committees consisting of independent directors.
- Banking and securities regulators must jointly adopt rules that require reporting of incentive-based compensation arrangements and prohibit compensation arrangements that could threaten the safety and soundness of financial institutions or have serious adverse effects on economic conditions or financial stability. Covered financial institutions include broker-dealers and investment advisers with over $1 billion in assets. It is unclear how assets are to be measured for this purpose.

Proxy Access

- The bill clarifies the SEC's authority to adopt rules requiring issuers to include in their proxy materials shareholder nominees for 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 would require 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, unless all of the adviser's clients are private funds and the adviser's assets under management in the U.S. total less than $150 million.

- The bill would exempt 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.

- SEC-registered advisers would be required to maintain records and file reports regarding the private funds they advise that the SEC determines are "necessary or appropriate in the public interest or for the assessment of systemic risk." Such reports may be shared on a confidential basis with the Federal Reserve and the Financial Stability Oversight Council and are not subject to the Freedom of Information Act.

- SEC may issue rules requiring certain disclosures (with the exception of certain proprietary information) to investors, prospective investors, counterparties, and creditors of any private fund advised by an SEC-registered adviser.

Credit Rating Agencies

- All credit rating agencies, with certain exceptions, must register as NRSROs by filing an application with the SEC. The SEC must, at least annually, examine each registered credit rating agency's ratings, policies, procedures, and methodologies.

- The bill imposes new requirements for the disclosure of information by rating agencies to the public.

- It also imposes new enforcement and liability provisions including clarifying that rating agencies can be sued under private rights of action and renders rating agencies experts subject to Securities Act liability when ratings are included in a registration statement.

- Credit rating agencies would be required to establish, maintain, and enforce policies and procedures reasonably designed to address, manage, and disclose conflicts of interest that can arise from their business.

Municipal Securities

- The bill reconstitutes the Municipal Securities Rulemaking Board with a majority of board members (including at least one municipal securities investor and one municipal securities issuer) that are not affiliated with municipal securities brokers or municipal securities dealers.

- It also requires SEC regulation of municipal financial advisers (broadly defined as a person who provides advice for compensation to a municipal securities issuer with respect to, among other things, the issuance of securities, investment of proceeds, the hedging of investment risks, and the preparation of disclosure documents), including requirements relating to registration, training, experience, and other qualifications of associated persons.

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endnotes

[1] The full text ofH.R. 4173 as passed by the House, when available, may be accessed at http://thomas.loc.gov/.