The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

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Senate Passes Financial Regulatory Reform Legislation

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VARIABLE INSURANCE PRODUCTS ADVISORY COMMITTEE No. 2-10 RE: SENATE PASSES FINANCIAL REGULATORY REFORM LEGISLATION

On May 20, the U.S. Senate passed the "Restoring American Financial Stability Act of 2010," by a vote of 59-39. [1] This sweeping 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) comprised of the heads of various federal financial regulatory agencies and the new Consumer Financial Protection Bureau (CFPB) (discussed further below). The Secretary of the Treasury will chair the Council, which, among other things, will monitor for risks to financial stability and respond to emerging threats to the financial markets. The bill also establishes an Office of Financial Research within Treasury; 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.

- The Council, in consultation with the appropriate primary financial regulator, identifies U.S. nonbank financial companies for heightened supervision and regulation by determining whether material financial distress at the company would pose a threat to U.S. financial stability. Foreign nonbank financial companies with substantial assets or operations in the U.S. 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 financial system." Criteria also include, among others: the degree 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; and any other 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 "large, interconnected bank holding companies" (i.e., those having total consolidated assets of at least $50 billion). These standards "shall" include risk-based capital requirements, leverage limits, liquidity requirements, resolution plan and credit exposure report requirements, and concentration limits. Additional standards "may" include a contingent capital requirement, enhanced public

disclosures, and overall risk management requirements.

- The Council may issue recommendations to one or more primary financial regulatory agencies to apply "new or heightened standards and safeguards" upon determining that the conduct of a financial 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 or the financial markets of the United States." 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.
- During floor debate, the Senate approved an amendment by Senator Collins (R-ME) to require the federal banking agencies to establish, for insured depository institutions, depository institution holding companies, 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

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 SEC in the case of a broker-dealer), 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 would be appointed as receiver and would be required to liquidate the company.
- The bill establishes an "Orderly Liquidation Fund" to cover the costs of actions taken under the orderly liquidation authority provisions. (A requirement to establish a $50 billion "pre-fund" through assessments on financial companies was eliminated by amendment on the Senate floor.)
- The FDIC would be authorized to issue debt securities to the Treasury Department, up to a specified maximum amount. Borrowings from Treasury would be repaid through post-event assessments—first, on claimants that received more than they would have received in a Chapter 7 bankruptcy proceeding. If those assessments are insufficient to allow the FDIC to repay Treasury within 60 months, then the FDIC would be required to impose assessments on bank holding companies with total assets of $50 billion or more, identified nonbank firms, and other financial companies with total consolidated assets of $50 billion or more.
- Assessments are required to be graduated, with higher assessments imposed based on a company's larger size and higher risk. Assessments also must take into account other specified criteria, including the company's degree of leverage.
- The orderly liquidation provisions authorize treatment of creditors, including funds, in certain ways that differ from the FDIC's existing bank resolution authority and/or from treatment under the bankruptcy code, including:
    - There would be a delay of up to three business days in the enforcement of

"qualified financial contracts," including repurchase agreements.
    - The FDIC would have broad discretion to treat similarly situated creditors differently.

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 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, and education savings arrangements. Products or services relating to a plan or arrangement also are generally exempt, but Treasury and the Department of Labor may jointly request that the Bureau adopt consumer protection standards with respect to the provision of services to a plan or arrangement.

OTC 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. The CFTC would regulate "swaps" and the SEC would regulate "security-based swaps," both defined terms under the legislation.
- "Major swap participants" and "major security-based swap participants" (which definitions appear to cover funds) will 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 imposes a central clearing requirement for all swaps, except (i) swaps for which no clearing house will accept the swap for clearing and (ii) swaps entered into by a "commercial end user" using the swap to hedge commercial risk. Funds would not be considered "commercial end users."
- 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 Fed 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 most 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."
- The bill imposes a fiduciary duty on swap dealers that provide advice regarding, offer to enter into, or enter into a swap with a government entity or agency, pension plan, endowment or retirement plan.

Investor Protection and SEC Authority

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

- *Investment adviser/broker-dealer harmonization.* The bill requires the SEC to conduct a study and report to Congress on the effectiveness of existing legal or regulatory standards of care for broker-dealers and investment advisers for providing personalized investment advice and recommendations about securities to retail customers. If the study concludes that gaps or overlaps exist, the SEC must commence rulemaking within two years of the bill's enactment.

- *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 would establish—by statute—an Investor Advisory Committee to advise and consult with the SEC on specified topics and provide findings and recommendations.

- *Studies.* The bill calls for numerous investor protection-related studies, including studies on financial literacy and mutual fund advertising.

- *SEC self-funding.* The bill requires the SEC Chairman to submit a budget to Congress. The budget would not be considered an appropriations request.

"Volcker Rule" Provisions

- The bill prohibits 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 the Bank Holding Company Act, and any of their subsidiaries, from engaging in "proprietary trading" and from "sponsoring" and investing in "hedge funds and private equity funds."
    - The term "proprietary trading" is defined to include purchasing or selling stocks, bonds, options, commodities, derivatives, or other financial instruments by one of the entities enumerated above "for the trading book (or such other portfolio as the Federal banking agencies may determine)" of such entity. The term excludes any trading "on behalf of a customer, as part of market making activities, or otherwise in connection with or in facilitation of customer relationships, including [related] risk-mitigating hedging activities," but these

exclusions are “subject to such restrictions as the Federal banking agencies may determine.”
    - 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 or “a similar fund, as jointly determined by the appropriate Federal banking agencies.”
    - The term “sponsoring,” 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 a fund for corporate, marketing, promotional or other purposes.
- The bill also impacts any identified nonbank firm that engages in proprietary trading or sponsors or invests in hedge funds or private equity funds. Specifically, the legislation requires the Federal Reserve to adopt rules “imposing additional capital requirements and specifying additional quantitative limits” on such institutions.

- The bill requires the Council to conduct a study on implementation of the Volcker Rule provisions, and the study results must include any recommended modifications to the definitions, prohibitions, requirements and limitations “that the Council determines would more effectively implement the purposes of” these provisions. The Council’s recommendations must in turn be reflected in the implementing rules adopted by the Federal banking agencies and the Federal Reserve.

Securities Holding Companies

- The Federal Reserve will become the consolidated supervisor for any “securities holding company”—defined to include firms that own or control a SEC-registered broker-dealer, but are not identified nonbank firms, are not subject to comprehensive supervision by a Federal banking agency, and are 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, including closed-end funds and ETFs.
- The bill clarifies the SEC’s authority to adopt proxy access rules.
- The bill mandates majority voting in uncontested director elections and plurality voting in contested director elections for all public companies, including registered investment companies.
- Public operating companies would be required to have non-binding shareholder votes

on executive compensation (“say on pay” votes).
- The bill enhances executive compensation practices for public operating companies, including through requirements for compensation committee independence, new disclosures, and “clawback” procedures.

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. Registration would not be required for advisers to venture capital or private equity funds (as defined by the SEC).
- 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.
- The bill requires private fund advisers to keep records in several identified areas (e.g., use of leverage, valuation policies) 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 to $100 million in assets under management.
- 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 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 SEC must establish a self-regulatory organization to assign rating agencies to provide initial ratings for structured finance products.
- The bill requires the removal of statutory references to credit ratings. It also creates a private right of action for statements made by rating agencies in the same manner as statements by registered public accounting firms or securities analysts.
- 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 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 requires “municipal advisers” to register with the SEC. As regards rulemaking

and enforcement actions, the SEC must coordinate with the Municipal Securities Rulemaking Board (MSRB).

- 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) an expansion of the MSRB's authority over municipal market participants and advice provided to or on behalf of "obligated persons;" and (3) authorization for the MSRB to impose penalties and 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., quality of trade executions, market transparency, how to improve liquidity).

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.

Emergency Financial Stabilization

- 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.

Karrie McMillan
General Counsel

endnotes

[1] The full text of the legislation passed by the Senate is available at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h4173eas.txt.pdf.