Financial Regulatory Reform Legislation: Implications for Registered Investment Companies and Their Advisers

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July 22, 2010
<table>
<thead>
<tr>
<th>Topic</th>
<th>Slides</th>
</tr>
</thead>
<tbody>
<tr>
<td>Systemic Risk Regulation</td>
<td>2-11</td>
</tr>
<tr>
<td>Orderly Liquidation Authority</td>
<td>12-21</td>
</tr>
<tr>
<td>Volcker Rule Provisions</td>
<td>22-34</td>
</tr>
<tr>
<td>Derivatives Regulation</td>
<td>35-54</td>
</tr>
<tr>
<td>Securities Enforcement and Litigation</td>
<td>55-61</td>
</tr>
<tr>
<td>Funding and Other Changes to the SEC/Studies of the SEC</td>
<td>62-63</td>
</tr>
<tr>
<td>Point of Sale Disclosure</td>
<td>64</td>
</tr>
<tr>
<td>Studies on Investor Literacy and Mutual Fund Advertising/Other Studies</td>
<td>65-66</td>
</tr>
<tr>
<td>Standards of Care for Broker-Dealers and Investment Advisers</td>
<td>67-68</td>
</tr>
<tr>
<td>Beneficial Ownership Reporting and Short Sales</td>
<td>69</td>
</tr>
<tr>
<td>Credit Rating Agencies</td>
<td>70-73</td>
</tr>
<tr>
<td>Municipal Securities</td>
<td>74-76</td>
</tr>
<tr>
<td>Corporate Governance</td>
<td>77-82</td>
</tr>
<tr>
<td>Consumer Financial Protection Bureau</td>
<td>83-87</td>
</tr>
</tbody>
</table>
Systemic Risk Regulation

- Financial Stability Oversight Council (Council)
  - Builds upon and codifies the President’s Working Group on Financial Markets
  - 10 voting members: Treasury (chair), Federal Reserve, OCC, FDIC, SEC, CFTC, Federal Housing Finance Agency, National Credit Union Administration, new Bureau of Consumer Financial Protection (see slide 83), and an independent member with insurance expertise
  - 5 non-voting members: one representative each from state securities, banking, and insurance regulators; new Federal Insurance Office; new Office of Financial Research (see slide 11)
Systemic Risk Regulation

• Financial Stability Oversight Council (cont’d)
  ▪ Purposes: (1) identify risks to U.S. financial stability; (2) promote market discipline; (3) respond to emerging threats to U.S. financial system stability
  ▪ Duties include: (1) monitoring financial services marketplace; (2) monitoring domestic and international regulatory proposals and developments, including insurance and accounting issues, and making recommendations to Congress; (3) identifying gaps in regulation that could pose risks to financial stability
Systemic Risk Regulation

• Designation of Systemically Significant Companies
  ▪ Council, by 2/3 vote and in consultation with appropriate primary regulator, may designate nonbank financial companies for heightened prudential regulation and supervision by the Federal Reserve
  ▪ Standard – If (1) material financial distress at the company or (2) the nature, scope, size, scale, concentration, interconnectedness, or mix of the company’s activities could pose a threat to U.S. financial stability
Designation of Systemically Significant Companies (cont’d)

- Council must consider various enumerated factors and any other risk-related factors it deems appropriate
- Potentially helpful factors for funds and advisers:
  - Extent of the company’s leverage
  - Extent to which assets are managed rather than owned by the company
  - Extent to which ownership of assets under management is diffuse
  - Degree to which company is already regulated by one or more federal financial regulators
Systemic Risk Regulation

- Implication for Systemically Significant Companies: Heightened Prudential Standards
  - Required: risk-based capital requirements and leverage limits (but if Federal Reserve determines these standards are not appropriate because of company’s activities, such as fund activities/assets under management, it must impose other “similarly stringent risk controls”)
  - Also required: liquidity and overall risk management requirements, resolution plan and credit exposure report requirements, and concentration limits
  - Optional: contingent capital requirement, enhanced public disclosures, short-term debt limits, or other standards
Systemic Risk Regulation

• Other Implications for Systemically Significant Companies
  ▪ Additional capital requirements:
    • Minimum leverage capital and risk-based capital requirements
      ▪ Regulators do not appear to have discretion to tailor these requirements or adopt alternative risk controls
    • Capital requirements to address activities determined to be systemically significant (see slide 9)
      ▪ Specifically identified: significant volumes of activity in derivatives, securitized products, financial guarantees, securities borrowing and lending, and repos
Other Implications for Systemically Significant Companies (cont’d)

- Stress tests: annually by the Federal Reserve; semi-annually by the company
- Reporting and disclosure requirements

All of the foregoing standards and requirements applicable to systemically significant companies also apply to bank holding companies with total consolidated assets of $50 billion or more.
Systemic Risk Regulation

• Applicable to Financial Companies Generally:
  ▪ Regulation of Systemically Significant Activities
    • Council can recommend that primary financial regulator(s) impose new or heightened regulation on a financial activity or practice
    • Standard – If the conduct, scope, nature, size, scale, or interconnectedness of the activity or practice could create/increase the risk of significant liquidity, credit or other problems spreading among bank holding companies, nonbank financial companies, the U.S. financial markets, or low-income, minority, or underserved communities
Systemic Risk Regulation

- **Regulation of Systemically Significant Activities (cont’d)**
  - Primary regulator must impose the recommended standards or similar standards acceptable to the Council, or explain in writing its decision not to do so

- **Stress tests of financial companies**
  - Federal Reserve has discretion to conduct annual tests of bank holding companies and nonbank financial companies other than those subject to mandatory testing (see slide 8)
  - Companies supervised by a financial regulator that have total consolidated assets of more than $10 billion must conduct annual tests
Systemic Risk Regulation

• Office of Financial Research
  ▪ Established within Treasury to support the work of the Council and its member agencies
  ▪ Will collect and maintain data, including financial transaction and position data, and perform research on systemic risk-related topics
  ▪ Must issue rules to standardize the types and formats of data reported and collected on behalf of the Council
  ▪ Funded for first two years by Federal Reserve, then through assessments on large bank holding companies and systemically significant companies supervised by the Federal Reserve
Dodd-Frank Act: 
Orderly Liquidation and Volcker Rule

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July 22, 2010
Orderly Liquidation
Eligible Companies – Financial Companies

• “Financial Companies” are the following US companies
  – US Bank Holding Companies
  – US Nonbank Systemically Significant Financial Companies
  – Company “predominantly engaged” in financial activities
    – “Predominantly engaged” = at least 85% of consolidated revenues are financial in nature
  – Subsidiary of the above predominantly engaged in financial activities
    – Except insurance companies/insured banks
• Insurance companies exempted from the orderly liquidation procedure; liquidation covered under state law
• FDIC must appoint SIPC as trustee for BD under SIPA
Liquidation Determination

- Generally, FDIC/FRB make recommendation to Treasury Secretary
- If entity/largest subsidiary is a SIPC member, SEC/FRB make recommendation in consultation with FDIC
- Treasury Secretary (in consultation with President) makes final determination if, among other things:
  - Financial company in default/danger of default
  - Failure under otherwise applicable law would have serious adverse effects on US financial stability
Liquidation Procedure – General Principles

• Bankruptcy Code does NOT apply
• General Principles
  – Creditors and shareholders bear financial losses
  – Management to be removed
  – All parties bear losses consistent with responsibility
• Covered financial company must be liquidated; no use of taxpayer funds
• Generally under FDIC direction, but FDIC consults with primary regulators/foreign authorities as appropriate
Liquidation Procedure – General FDIC Powers

• Establish a “bridge” financial company and transfer assets/liabilities
• Avoid fraudulent/preferential transfers similar to the Bankruptcy Code
• Repudiate contracts within “reasonable time”
• Enforce contracts notwithstanding *ipso facto* provision
• Qualified Financial Contracts
  – Close-out rights suspended for 1 business day after FDIC becomes receiver
Liquidation Procedures – Claims

• General process similar to that applied by FDIC to banks
• Creditor in no event will receive less than would receive in Chapter 7 process
• Unsecured Claims
  – Amounts owed to US given 2d priority (after admin expenses)
  – Generally each class within priority treated equally
    – Possibility of “additional payments” to some creditors in specified circumstances
      – Payments from FDIC funds
      – Subject to recoupment assessment
Liquidation Fund – Payments

- Established in the US Treasury
- FDIC authorized to issue obligations to Treasury when appointed receiver
- FDIC may not issue or incur any obligation hereunder if it would exceed
  - 10% of book value of consolidated assets of failed company during the first 30 days of receivership, and
  - 90% of fair value of the consolidated assets available for repayment after the first 30 days
- Note: funding occurs as part of receivership
Liquidation Fund – Repayment

• Treasury may not provide any funding unless it can be repaid in 60 months
• FDIC first assesses claimants receiving “additional payments”
  – Assessment equal to additional payment
Liquidation Fund – Repayment (cont’d)

• If above assessment insufficient, then assess “eligible financial companies”
  – Systemically significant firms, BHCs with assets of at least $50B and other financial companies with assets of at least $50B
  – Assessment based on risk matrix
Volcker Rule
Volcker Rule – In Brief

“Unless otherwise provided in this section, a banking entity shall not –

(A) engage in proprietary trading; or
(B) acquire or retain any equity, partnership, or other ownership interest in or sponsor a hedge fund or a private equity fund.”
Volcker Rule – Scope and Timing

• Scope – “Banking Entities”
  – Virtually all insured banks or thrifts
  – The companies that control them
  – Their affiliates and subsidiaries
  – Foreign banks with U.S. banking presence

• Timing
  – Effective Date: Earlier of 12 months after issuance of final rules, and 2 years after date of enactment
  – Transition Period: Bank entities must comply within 2 years after effective date (2014)
  – Extensions: Available at FRB discretion
Beware Broad Reach of Affiliates

* = Likely Affiliate of Banking Entity

Note: All 100% owned except as noted
Volcker Rule – Prop Trading

Proprietary Trading:

“engaging as principal for the trading account” of the banking entity to purchase, sell, or otherwise acquire or dispose of any security, derivative, future, option, or other financial instrument, as determined by the agencies’ rules.

Trading Account:

an account used “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 such accounts as determined by the agencies’ rules.
Volcker Rule – PE and Hedge Funds

- Private Equity and Hedge Funds – Scope:
  - Any issuer that would be an investment company as defined under the Investment Company Act of 1940 but for the exemptions provided by Sections 3(c)(1) or 3(c)(7) of that Act.
  - And “similar” funds as may be determined by the agencies by regulation.
Volcker Rule – PE and Hedge Funds

Private Equity and Hedge Funds – Prohibitions:

- **No investing:** acquiring any “equity, partnership, or other ownership interest in” a private equity or hedge fund

- **No sponsoring:**
  - serving as a general partner, managing member, or trustee of a fund;
  - selecting or controlling (or having employees, officers, directors or agents who constitute) a majority of the directors, trustees, or management of the fund; or
  - sharing the same name or a variation of the same name with a fund.
Volcker Rule – Affiliate Transactions

- Private Equity and Hedge Funds – Affiliate transaction rules for sponsored and advised/managed funds
  - No “covered transactions” (e.g., loans, purchases of assets or securities); prime brokerage exception
  - Other transactions on market terms (what would be offered to an unaffiliated fund)
Volcker Rule – Permitted Activities

- U.S., agency, GSE, state/municipal securities
- “On behalf of customers”
- Underwriting and market making
- Risk-mitigating hedging
- Foreign banking activities “solely outside the U.S.”
- Regulated insurance company – “for the general account”
- SBICs and public welfare investments (12 U.S.C. 24)
- Other activities that the agencies determine promote safety and soundness
- Fiduciary funds (see below)
“Fiduciary Fund” Exception

Banking entity may organize, control and offer a fund if:

– Banking entity provides *bona fide* trust, fiduciary, or investment advisory services

– Fund organized in connection with, and to customers of, such *bona fide* trust, fiduciary, or investment advisory services

– Only a “de minimis” interest retained by the banking entity

– Banking entity complies with affiliate rules

– Banking entity does not guarantee or insure fund performance

– Banking entity does not share name or variation of name with fund

– No director/officer retains interest, unless providing services

– Banking entity makes clear any losses to be borne by LPs
De Minimis Investments

• De Minimis investments permitted in the context of “Fiduciary” Private Equity/Hedge Funds
  – 3% ownership of a fund
  – Aggregate 3% of banking entity’s tier 1 capital across funds
Volcker Rule – Conflicts

• **Limitations on Permitted Activities** – Permitted activities may not:
  
  (i) involve a material conflict of interest with clients, customers, or counterparties;
  
  (ii) result in a material exposure to high-risk assets or trading strategies;
  
  (iii) pose a threat to the safety and soundness of the banking entity or to U.S. financial stability.
Volcker Rule – Regs and Studies

- Six months from enactment, FRB special rulemaking on conformance period for divestitures

- Six months from enactment, Council study and recommendations; 9 months thereafter, interagency implementing rules

- Fifteen months from enactment, GAO study regarding risks and conflicts associated with trading (and PE/hedge fund investing) by –
  - banking entities
  - “any other entity” as GAO may determine
Dodd-Frank: The Regulatory Reset of Derivatives Regulation

July 2010
Overview

• Historic regulatory overhaul of derivatives markets

• Statutory recognition of global de-risking process

• Effect on mutual funds
  – Major swap participant?
  – Exchange trading tomorrow = commodity futures trading today?
  – Clearing of swaps and counterparty credit risk
  – Remaining investment management flexibility
What’s a ‘major swap participant’?

Person that is not a swap dealer and:

• Maintains a ‘substantial position’ in swaps
  – other than
    • positions held for hedging or mitigating commercial risk, and
    • positions maintained by ERISA plans

• Swap dealer
  – holds self out as dealer
  – makes markets in swaps
  – regularly enters into swaps
What’s a ‘major swap participant’?

• Whose swaps create ‘substantial counterparty’ exposure that:
  – could have ‘serious adverse effects’ on
  – the ‘financial stability of the United States banking system or financial markets’
What’s a ‘major swap participant’?

• ‘Financial entity’ that is
  – ‘highly leveraged’ relative to the amount of capital it holds and that is not subject to capital requirements, and
  – maintains a ‘substantial position’ in outstanding swaps.

• Financial Entity
  – swap dealer
  – MSP
  – commodity pool
  – certain private funds
  – ERISA plan
  – persons engaged in certain banking activities
What is a ‘substantial position’?

• To be defined by the CFTC/SEC

• Dodd Frank requires that the definition:
  
  – be a threshold amount the CFTC/SEC determines prudent for effective monitoring, management and oversight of entities that are:

    systemically important or can ‘significantly impact the financial system of the United States’
What is a ‘substantial position’?

• CFTC/SEC must consider the person’s relative position in cleared versus uncleared swaps

• CFTC/SEC may consider the value and quality of collateral held against counterparty exposure
What if a fund is a ‘major swap participant’?

Registration

- Registration required with the CFTC and/or SEC
- Commissions to determine form, manner and information to be provided
- MSP will have on-going reporting requirements

Timing

- Registration for MSPs required not later than 1 year after Dodd Frank is enacted
What if a fund is a ‘major swap participant’?

Directed Rule Making

- Commissions will adopt rules for MSPs, unless a prudential regulator has jurisdiction
- Rules “may limit the activities” of swap dealers and MSPs
- Capital and margin requirements for uncleared swaps
- Reporting and recordkeeping requirements
Capital and margin requirements

- Commissions will adopt rules for MSPs, unless a prudential regulator has jurisdiction imposing
  - capital requirements
  - initial and variation margin requirements on all swaps that are not cleared
Capital and margin requirements

• Standards for Setting Capital and Margin Requirements
  – Help ensure the “safety and soundness” of the MSP
  – Be appropriate for the risk associated with the non-cleared swaps held by the MSP

• Non-Cash Margin
  – Commissions may permit the use of non-cash margin, consistent with:
    • preserving the financial integrity of markets trading swaps
    • preserving the stability of the United States financial system
Clearing of Swaps

• Standard for clearing
  – Unlawful for any person to enter into a swap unless submitted to a “derivatives clearing organization” or DCO

• DCO rules (“Open Access Rules”)
  – Swaps with the same terms and conditions must be treated as economically equivalent and capable of being offset with each other
  – Non-discriminatory clearing
Clearing of Swaps

- **Commission-initiated review**
  - Commissions will review types of swaps to determine if such types of swaps should be required to be cleared

- **DCO-initiated review**
  - DCOs must submit to the Commissions each type of swap it plans to accept for clearing
    - Commissions shall make a determination not later than 90 days after receipt
    - Must consider outstanding notional exposures, liquidity, adequate pricing data, operational capacity, effect on mitigating risk, etc.
Clearing of Swaps

• Timing
  – **Within 1 year**, the Commissions will adopt rules for reviewing a DCO’s clearing of a type of swap accepted for clearing

• Transition
  – Swaps entered into **before enactment are exempt** from clearing requirements
    • Must be reported to a “swap data repository” (SDR) within 180 days after enactment
  – Swaps entered into **after enactment but before rule adoption** are exempt
    • Must be reported to a SDR within the later of 90 days after effective date or such other time as the Commission may determine
Exchange Trading

• Exchange trading for swaps is **mandatory for all cleared swaps**
  – Cleared on a “swap execution facility”

• Swap execution facility
  – a trading system or platform
  – in which **multiple participants**
  – can execute or trade swaps
  – by accepting bids and offers
  – made by multiple participants
  – through any means of interstate commerce
FX swaps and forwards

- Treasury Amendment

- Foreign exchange swaps and forwards are considered “swaps” and potentially subject to regulation
  - FX swaps will be exempt from regulation if:
    - Treasury determines that FX swaps should not be regulated
    - Treasury determines such FX swaps have not been structured to evade regulation
Business Conduct Standards

• Special requirements for MSP that acts as an advisor to a “special entity”

• Special entity
  – federal agency
  – state, state agency, city, country, municipality
  – ERISA plans
  – endowment

• Special requirements
  – unlawful for MSPs to engage in fraudulent, deceptive or manipulative activities
Business Conduct Standards

• Special requirements for MSP that is a counterparty to a “special entity”

• Special requirements
  – MSP must have a “reasonable basis” to believe the counterparty has an independent representative that, among other things:
    • has sufficient knowledge to evaluate the transaction and related risks
    • is independent of the MSP
    • acts in the best interest of its client
    • is a fiduciary if such special entity is an ERISA plan
Swap Dealers

• Swap dealer is a person that:
  – holds itself out as a dealer in swaps
  – makes a market in swaps
  – regularly enters into swaps with counterparties in its ordinary course of business
  – engages in any activity causing the person to be known as a dealer or market-maker in swaps

• Regulation of swap dealers
  – Registration with CFTC/SEC
  – Capital and margin requirements
  – Record keeping and reporting requirements
Swap Push-out Rule

• “Federal assistance” may not be provided to “swap entities”

• Federal assistance
  – certain advances from Federal Reserve credit facilities or discount window
  – loans to, purchases of equity of, swaps entities
  – guarantees, assistance arrangements, profit/loss sharing

• Swap entities
  – MSPs (other than banks that are MSPs)
  – swap dealers (other than a swap dealer entering into a swap as part of a loan origination)

Kathleen N. Massey
Whistleblower Incentives and Protection

• Incentives
  – Monetary Reward – 10% to 30% of Recovery
  – For Voluntary Provision of Original Information
  – That Leads to a Successful Action = Sanctions > $1 Million

• Protections
  – Retaliation Prohibited
  – Whistleblowers Can Sue in Federal Court – Reinstatement, 2x Back Pay, Fees and Costs

• Implementation
  – Final Regulations Due Within 270 Days After Passage
  – Annual Report Required on Operation of Program

• Possible Future Developments
  – SEC IG Will Study Whether to Allow Whistleblowers to Sue on Behalf of the Government

(§ 922-24)
Administrative Improvements

- **Deadlines for Completing Investigations, Examinations and Inspections (§ 929U)**
  - Investigations
    - Within 180 Days of Issuing a Wells Notice, Enforcement Action or Explanation
    - 180-Day Extensions with Notice to Chairman, and then with Notice & Approval of SEC
  - Examinations and Inspections
    - Within 180 Days of On-Site Review or Document Receipt, Resolution or Request for Corrective Action
    - One 180-Day Extension with Notice to Chairman

- **More Information Sharing (§ 929K)**
  - No Waiver of Privilege for Sharing with Specified Agencies and Organizations
  - No Compelled Disclosure of Privileged Information from Foreign Law Enforcement

- **Greater Protection of Confidential Information (§ 929I)**
  - Protection of Information Obtained for Surveillance, Risk Assessment & Oversight

- **Self Evaluation (§ 961)**
  - Annual Report due on Conduct of Investigations, Examinations and Related Supervisory Controls
Enhanced Enforcement and Litigation Capability

Expanded Aiding and Abetting and Control Person Liability

- New Aiding & Abetting Liability under the ’40 Act & ’33 Act (§ 929M)
- Relaxed Intent Standard for Aiding and Abetting Violations of the ’34 Act (§ 929O)
- Control Person Liability for Controlling Another Liable under the ’34 Act to the SEC (§ 929P)

Enhanced Remedies

- Civil Penalties in Cease and Desist Proceedings (§ 929P)
- Civil Penalties under the Advisers Act (§ 929N)

Additional Procedural Tools in Litigation

- Nationwide Service of Subpoenas (§ 929E)
- Extraterritorial Jurisdiction under the ’33, ’34 and Advisers Acts (§ 929P)
Studies To Be Conducted

Private Rights of Action for Aiding and Abetting (§ 929Z)

- Comptroller General will address possible private right of action for aiding and abetting securities law violations, with study to cover role of secondary actors in issuance of securities, scope of liability for secondary actors and lawsuits under the PSLRA.
- Report Due Within 1 Year After Passage

Extraterritorial Private Rights of Action (§ 929Y)

- SEC will address possible private right of action relative to conduct within the U.S. that constitutes a significant step in furtherance of a violation, even if the transaction at issue occurs outside the U.S. and involves foreign investors only, and conduct outside the U.S. that has a foreseeable substantial effect within the U.S.
- Report Due Within 18 Months After Passage

Whistleblower Protection (§ 922)

- SEC Inspector General will address adequacy of rules and regulations, timeliness of communications between the SEC and whistleblowers, adequacy of award levels, and whether whistleblowers should be empowered to bring cases on behalf of the government.
- Report Due Within 30 Months After Passage
Funding and Other Changes to the SEC

- Streamlines the SEC’s hiring process for positions that require “specialized knowledge of financial and capital market formation or regulation, financial market structures or surveillance, or information technology”

- Creates a staff of compliance examiners within the Divisions of Trading and Markets and Investment Management
  - Provision does not specify whether these examiners are in addition to, or in lieu of, OCIE

- Institutes “match funding” for the SEC
  - Proposed budget must go through Congressional appropriations, but may not be modified by the President
  - Bill preliminarily authorizes substantial increases in the SEC’s budget for the next 5 years
  - SEC may create a “reserve fund” of $100M out of fee income to supplement its budget and facilitate long-range planning
Studies of the SEC

• Comptroller General must conduct a study on the SEC’s oversight of national securities associations

• SEC must hire an independent consultant to examine the agency’s operations, structure, funding, and relationships with SROs, as well as the need for comprehensive reform of the SEC

• Comptroller General must conduct a study on the employees that leave the SEC to work for regulated institutions, including whether those employees worked on cases involving those institutions and whether this has led to inefficiencies in enforcement. Study also must consider internal controls and other post-employment restrictions
Point of Sale Disclosure

• “Clarification” of SEC authority to adopt rules designating documents or information to be provided by a broker or dealer to retail investors before the purchase of an investment product or service
  - Any designated information must be in a summary format and contain clear and concise information about:
    - Investment objectives, strategies, costs and risks
    - Any compensation or other financial incentive received by a broker, dealer or other intermediary in connection with the purchase of retail investment products
  - In developing rules, SEC must consider investor protection, efficiency, competition, and capital formation
Studies on Investor Literacy and Mutual Fund Advertising

- SEC study on financial literacy among retail investors
  - Study must consider: (1) methods to improve disclosure to investors; (2) the most useful and relevant information for investors; and (3) methods to increase the transparency of expenses and conflicts of interest in transactions
  - Report required within 2 years

- Comptroller General study on mutual fund advertising
  - Study must consider: (1) current regulatory requirements and marketing practices, including the use of past performance data; and (2) recommendations to improve investor protections in mutual fund advertising and ensure investors can make informed decisions
  - Report required within 18 months
Other Studies

• Enhancing investment adviser examinations (SEC)
• Conflicts of interest between investment banking and analyst divisions of the same firm (Comptroller General)
• Improved access to registration information on investment advisers and broker-dealers (SEC)
• Financial planners and financial designations (Comptroller General)
Standard of Care for Broker-Dealers and Investment Advisers

• SEC must study the standards of care applicable to broker-dealers and investment advisers giving personalized investment advice to retail customers
  ▪ Agency must seek public comment and complete the study within six months

• SEC authorized (after considering study results) to commence a rulemaking addressing broker-dealer and investment adviser standards of care for providing personalized investment advice about securities to retail customers
Standard of Care for Broker-Dealers and Investment Advisers

- SEC may establish a fiduciary duty for broker-dealers, when providing personalized investment advice about securities to retail customers (and other customers as determined by SEC), that is the same as the standard of care applicable to investment advisers under the Investment Advisers Act of 1940
  - May require broker-dealers that sell only proprietary or an otherwise limited range of products to provide notice to retail customers and obtain the customer’s consent or acknowledgment

- SEC required to examine and, where appropriate, promulgate rules prohibiting or restricting broker-dealer and investment adviser sales practices, conflicts of interest, and compensation schemes that the SEC deems contrary to the public interest and the protection of investors
Beneficial Ownership Reporting and Short Sales

- SEC authorized to require beneficial owner to file Section 13(d) and 16(a) schedule/forms less than 10 days after crossing 5 percent and 10 percent thresholds.

- SEC required to adopt rules requiring (at least) monthly disclosure of short positions by institutional investment managers subject to Section 13(f), including aggregate number of short sales of each security.

- SEC authorized to adopt rules to address manipulative short selling.

- Broker-dealers required to provide notice that customer may elect not to allow use of fully paid securities in connection with short sales.
Credit Rating Agencies

Federal Agency Obligations

• Creates Office of Credit Ratings within SEC and requires SEC to conduct annual examination of each NRSRO

• Requires SEC to promulgate rules on: ratings analyst qualifications, ratings agency procedures and methodologies, and disclosure of ratings performance information

• Provides SEC with authority to penalize individuals associated with rating agencies for specified misconduct
Credit Rating Agencies

Federal Agency Obligations (cont’d)

- Federal agencies must review and modify regulatory references to credit ratings – substituting standard of creditworthiness

- SEC must study rating process for structured finance products and then establish a system that prohibits issuers of such products from selecting the rating agency that will provide the initial rating

- Studies on: rating agency independence, standardizing ratings terminology and/or market stress conditions under which ratings are evaluated, and alternative means for compensating rating agencies
Credit Rating Agencies

Liability

• Creates a private right of action against rating agencies for knowing or reckless failure to conduct a reasonable investigation of facts related to a rating or to obtain reasonable verification of facts from an independent source

• Eliminates exemption for rating agencies from Regulation Fair Disclosure and “expert liability” regime (when ratings are included in a registration statement)

• Subjects rating agencies to liability for material misstatements in certain submissions to the SEC
Rating Agency Obligations

• Requires rating agency to have independent board of directors and establishes requirements for chief compliance officer

• Requires rating agency to have internal controls and report annually to SEC documenting compliance therewith

• Requires look-back reviews when rating agency employees go to work for rated entity, underwriter, or obligor

• Requires attestation with each credit rating affirming rating was not influenced by the rating agency’s other business activities
Municipal Securities

Federal Agency Obligations

• Creates Office of Municipal Securities within SEC
• Provides source of funding for Government Accounting Standards Board
• Studies on: municipal issuer disclosure/repeal of the Tower Amendment and municipal securities markets (e.g., transparency, liquidity, use of derivatives)
Municipal Securities

Municipal Adviser Obligations

• Imposes fiduciary duty on “municipal advisers”
• Requires municipal advisers to register with SEC
Municipal Securities

MSRB Obligations

• Requires majority of “independent” board members
• Requires MSRB to meet with SEC and FINRA at least twice a year
• Authorizes MSRB to assist SEC and FINRA in examinations and enforcement actions regarding MSRB rules
Corporate Governance

- Proxy Access
  - SEC expressly authorized to issue rules permitting shareholders of any company, including registered investment companies, to nominate directors on the company’s proxy statement
    - Provision resolves questions some have raised about SEC’s authority in this area
  - SEC also may exempt companies from any proxy access requirements
Corporate Governance

• Broker Voting
  ▪ Broker discretionary voting prohibited in uncontested director elections for all listed companies, except registered investment companies
    • Brokers may vote on behalf of their customers in any uncontested director election held by a registered investment company
  ▪ Outcome is consistent with current NYSE Rule 452
Corporate Governance

• Shareholder Advisory Votes and Disclosure
  ▪ Shareholders in public operating companies are given two new non-binding advisory votes:
    • An advisory vote on executive compensation (“say on pay”) at least once every three years
    • An advisory vote on “golden parachute” packages 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 do so
Corporate Governance

• Reporting and possible prohibition of incentive-based compensation
  ▪ Applies to enumerated financial institutions, including investment advisers, with at least $1 billion in “assets” (not defined)
  ▪ Directed rulemaking with 9-month deadline
    • Covered advisers will be required to report incentive-based compensation to the SEC
    • Federal financial regulators will prohibit any type, or feature, of incentive-based compensation arrangements that they jointly determine “encourages inappropriate risks”
Corporate Governance

- Disclosure on Chairman and CEO structures
  - Issuers must disclose in annual proxies the reasons why they have chosen the same person or different persons to be Chairman and CEO
    - Similar to new disclosure requirements on board structure that took effect earlier this year (see SEC Release IC-29092, Dec. 16, 2009)
  - Applies to all issuers, including registered investment companies
  - Directed rulemaking with 180-day deadline
Corporate Governance

• Disclosure on employee and director hedging
  ▪ Issuers must disclose in proxies whether any employee or director is permitted to purchase financial instruments that are designed to hedge or offset any decrease in the value of the issuer’s shares held by the employee or director
  ▪ Applies to all issuers, including registered investment companies
  ▪ Directed rulemaking with no deadline
Consumer Financial Protection Bureau (CFPB)

• Independent bureau established within Federal Reserve with broad consumer protection mandate and authority to regulate and enforce standards for persons who offer or sell a “consumer financial product or service”

• Director to be appointed by the President and confirmed by the Senate

• Council has authority to temporarily stay or to veto a CFPB regulation

• Many exclusions from CFPB jurisdiction
• Exclusion for SEC-Regulated Persons
  – CFPB has no authority to enforce the law with respect to a “person regulated by the [SEC]”
  – Among those specifically excluded are: registered investment companies; registered investment advisers; registered broker-dealers; and registered transfer agents
  – Exclusion also covers employees, agents, and contractors of SEC-regulated entities, if those individuals act “in a regulated capacity”
• Exclusion for SEC-Regulated Persons (cont’d)
  ▪ SEC authority preserved
  ▪ SEC required to consult and coordinate with CFPB “where feasible” on rules regarding investment products or services that are the same type as, or compete directly with, products or services subject to CFPB jurisdiction
Exclusion for Retirement Plans and Other Tax-Favored Savings Vehicles

- CFPB has no rulemaking or enforcement authority with respect to certain tax-favored savings vehicles, such as: (1) employer-sponsored retirement plans (e.g., DB pension plans and 401(k) plans) and the employers sponsoring them; (2) IRAs; (3) education savings arrangements (e.g., 529 plans) and the states sponsoring them; and (4) health savings accounts.
- Treasury/IRS and DOL authority preserved.
• Exclusion for Retirement Plans and Other Tax-Favored Savings Vehicles (cont’d)
  ▪ Products and services relating to excluded plans and arrangements:
    • Services would become subject to CFPB authority if granted jointly by Secretaries of Labor and Treasury (either in response to CFPB request or at request of Labor and Treasury)
    • Products and services otherwise subject to CFPB jurisdiction not excluded just because they relate to an excluded plan or arrangement