

FINANCIAL REGULATORY REFORM POLICY UPDATE (PRELIMINARY)

From: Patton Boggs Financial Services Policy Group
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Subject: House Passes Financial Regulatory Reform Legislation
“The Wall Street Reform and Consumer Protection Act” (H.R. 4173)

On December 10, 2009, the U.S. House of Representatives voted 223 – 202 to approve a comprehensive financial regulatory reform proposal entitled “The Wall Street Reform and Consumer Protection Act” (H.R. 4173). The legislation was supported by Democrats (223 – 27) and unanimously rejected by Republicans (0 – 175). As described in greater detail below, HR 4173 would overhaul the financial services regulatory system and make significant changes to the oversight of banks and other financial institutions.

The following is a preliminary summary of the proposal based on an initial review. Further analysis will be included in a follow-up report.

I. Executive Summary

H.R. 4173 is a comprehensive package that encompasses individual bills previously passed out of the House Financial Services Committee (“HFSC”) and reflects portions of the Obama Administration’s previously announced initiatives for an overhaul of the U.S. financial regulatory framework. Key components of the legislation include the creation of a systemic risk regulator, creation of a resolution authority, expanded powers of the Federal Reserve, establishment of a consumer protection agency for financial products, regulation of investment advisers and derivatives, insurance companies, credit rating agencies, among myriad other provisions.

Timing. This bill will still need to be reconciled with a Senate proposal, the “Restoring American Financial Stability Act” (“RAFSA”), which has yet to be reported out of the U.S. Senate Banking Committee. RAFSA will most likely be formally considered by the Senate Banking Committee towards the end of January 2010 and it is still likely that the Senate Agriculture Committee will offer its own derivatives legislation and other provisions that relate to Senator Dodd’s proposal.

Assuming that the Senate acts on their legislation sometime in the beginning of 2010, negotiations to reconcile Senate and House versions are anticipated to continue through early to mid-2010, as numerous key differences between the House and Senate versions (further discussed below) remain.

II. Key Elements of the Legislation

The following is a summary of selected key provisions of the legislation, including (1) expanded role of the Federal Reserve and consolidation of OTS into OCC; (2) creation of a systemic risk regulator; (3) creation of a resolution authority; (4) creation of a Consumer Financial Protection Agency; (5) regulation of credit rating agencies; (6) regulation of the insurance industry; (7) increased investor protection; (8) regulation of derivatives; (9) regulation of investment advisers; and (10) executive compensation provisions.

1. Expanded Role of the Federal Reserve; Consolidation of OTS into OCC

HR 4173 would grant the Federal Reserve the power to direct any large financial holding company to reduce its size by selling or transferring assets or curtailing certain activities if the Federal Reserve determines there is “an existing or foreseeable threat to the safety and soundness of such company or to the financial stability of the United States.” It also would empower the Federal Reserve to set concentration limits for large financial holding companies, prohibiting the companies from having credit exposures to purchase an unaffiliated entity that exceeds 25 percent of the holding company’s capital stock and surplus. Additionally, the legislation would require that the Board of Governors of the Federal Reserve (as well as the FDIC and Secretary of the Treasury) approve the FDIC’s extension of credit or guarantee of obligations of solvent insured depository institutions or other solvent companies. The legislation also would give the Federal Reserve the power to force a financial holding company into bankruptcy if the Federal Reserve determines that the entity is significantly undercapitalized, and requires the Federal Reserve to define the term “significantly undercapitalized” by rule or regulation at a threshold the Federal Reserve deems prudent for the effective monitoring, management and oversight of the financial system.

The legislation restricts the powers of the Federal Reserve to act as a lender of last resort in “unusual and exigent circumstances” as provided by Section 13(3) of the Federal Reserve Act. In order to offer credit, the Financial Stability Oversight Council must find, by a vote of its members, that a “liquidity event exists that could destabilize the financial system.” At the same time, the Financial Stability Oversight Council must provide notice of the determination to Congress. Only after such a determination is made, and with the written consent of the Secretary of the Treasury, may the Federal Reserve System provide access to its discount window, “as part of a broadly available credit or other facility and may not authorize a Federal Reserve bank to discount notes, drafts or bills of exchange for only a single and specific individual, partnership or corporation.” The legislation further limits the amount available at \$4 trillion.

However, several additional provisions would specifically limit the Federal Reserve’s power, including the creation of a Consumer Financial Protection Agency, which would strip the Federal Reserve of its consumer oversight powers. Also, the bill would require the Comptroller General to perform an audit of the Federal Reserve’s lending programs and monetary policies during the current economic crisis pursuant to the authority granted under section 13(3) of the Federal Reserve Act to be completed “as expeditiously as possible” after the enactment of the legislation.

Notably, Chairman Dodd’s proposal in the Senate would strip even more powers from the Federal Reserve, and would instead create a Financial Institutions Regulatory Administration

(“FIRA”) as a single prudential regulator by consolidating the oversight duties of the Office of Thrift Supervision (“OTS”), the Office of the Comptroller of Currency (“OCC”), the state bank supervisory functions of the Federal Reserve and the Federal Deposit Insurance Corp (“FDIC”), and the bank holding company authority supervision of the Federal Reserve.

Consolidation of OTS into OCC. The legislation would integrate the OTS into the OCC. The OCC would have a new division of thrift supervision which will have all of the powers that had previously been vested in the OTS. The OCC and the FDIC would be required to work together to provide improved regulation of banking institutions and to provide a report one year after integration of the OTS into the OCC discussing the steps taken to improve regulation.

2. Systemic Risk Regulator

The legislation would establish a Financial Services Oversight Council (“FSOC”) as a systemic risk regulator to identify financial companies and financial activities that pose a threat to financial stability. The FSOC’s voting members would include the Secretary of the Treasury (who serves as the Chairman of the Council), the Chairman of the Board of Governors of the Federal Reserve, the Comptroller of the Currency, and the head of the Consumer Financial Protection Agency, among others. The FSOC’s non-voting members would include a state insurance commissioner, a state banking supervisor, and a representative of the state securities commissioners (or other office performing similar functions). The bill, as amended, provides that non-voting members may not be excluded from any of the FSOC’s proceedings, meetings, discussions and deliberations.

The bill would empower the FSOC to act as a systemic risk regulator, monitoring and implementing tougher controls on these systemically significant bank and nonbank financial institutions that could cause systemic risk in the event of a failure. Essentially, systemically significant companies and activities would be subjected to more stringent prudential oversight, standards and regulation. The legislation, however, clarifies that financial institutions, private funds, investment advisors and others cannot be required to waive any privilege (such as attorney-client privilege) when providing data to the FSOC.

Notably, the legislation provides that the Federal Reserve may act at the discretion of the FSOC to administer and enforce the tougher controls on systemically significant bank and nonbank financial institutions. It would grant the Board of Governors of the Federal Reserve the authority to administer and enforce actions against financial holding companies subjected to the stricter standards “as if such financial holding company subject to stricter standards were a bank holding company that has elected to be a financial holding company.”

With respect to financial companies that are organized or incorporated in a country other than the United States, the Board of Governors of the Federal Reserve System would prescribe regulations regarding the application of stricter prudential standards, giving due regard to the principle of national treatment and equality of competitive opportunity and taking into account the extent to which such companies are subject to home country standards comparable to those applied to companies in the United States.

Additionally, the FSOC would advise Congress on financial regulation, making recommendations on how to enhance the integrity, efficiency, competitiveness, and stability of the United States financial markets. It would issue formal recommendations for agencies with members on the FSOC to adopt heightened prudential standards for firms they regulate to mitigate risk. Finally, the legislation would facilitate information-sharing and mitigate jurisdictional or regulatory disputes between agencies with members on the council.

Divestiture Authority for “Too Big to Fail.” The legislation would give the government the ability to preemptively limit the size, complexity and risk of any financial institution. It would grant authority to the FSOC to break up firms posing too great of a risk to the economy and orders the divestiture of assets, regardless of the firm’s health. It further would require the approval of the Secretary of Treasury for the sale, transfer, or divestiture of more than \$10 billion, and a consultation with the President for amounts in excess of \$100 billion, indexed to inflation. Also, the legislation extends the ability of the Federal Reserve to prevent a merger, acquisition or consolidation of a non-bank financial holding company under the Bank Holding Company Act.

Generally, this power would be limited to situations where the firm is so large and so interconnected that the United States economy would still be threatened even if the resolution authority followed the firm’s failure plan and wound the firm down in the event of a collapse. The provision requires that regulators consider an institution’s size, exposure, leverage and interconnectedness when deciding whether this extreme action should be taken.

3. Resolution Authority

The legislation would establish a resolution authority under the FDIC to wind down large, financially-troubled non-bank financial institutions. The winding down process would be facilitated by a \$150-billion dollar systemic dissolution fund to be used for the orderly and complete dissolution of the failed financial company that is posing a systemic threat to the economy.

In addition, further powers would be given to the FDIC, with the approval of the Treasury Department and Federal Reserve, to create a debt guarantee program to make loans or offer guarantees for a solvent company if necessary to “prevent financial instability during times of severe economic distress.” The FDIC’s guarantee authority would be capped at \$500 billion under the debt guarantee program, and limits the institutions that may participate.

Assessments to Pay for the Systemic Risk Dissolution Fund; Changes to the Federal Deposit Insurance Fund. The dissolution fund would be funded by fees charged to financial companies with more than \$50 billion in assets and hedge funds with more than \$10 billion in assets under management on a consolidated basis. The legislation makes explicit that the fund will be financed exclusively with assessments on industry, without taxpayer money. The fees would be based upon individual risk assessments conducted by the FDIC and the Securities and Exchange Commission (“SEC”), as described below.

The FDIC and the SEC would utilize a risk matrix to establish the assessments to each individual financial company that considers many factors, including: (1) the actual or expected risk of losses to the Fund; (2) the economic conditions generally affecting financial companies; (3) the type

of financial company being assessed; and (4) the extent to which the financial company has benefitted or would likely benefit from the dissolution of another financial company through this process. In establishing the assessment system for the Fund, the FDIC and SEC are able to differentiate among financial companies to “ensure that the assessments charged equitably reflect the risk posed to the Fund by particular classes of financial companies.” Any back-up special assessments to cover losses on the program would be imposed solely on participants in the program.

Several additional provisions of the legislation would ensure that money taken from the systemic dissolution fund and FDIC guarantee program will be repaid. It would require a reordering in bankruptcy of the FDIC’s claim on the assets of a borrower that has issued debt guaranteed by the resolution authority, and would authorize the FDIC to demand the pledge of collateral in return for any guarantee. It also would ensure that the guarantee fees collected on a guarantee program will be actuarially sufficient to cover losses.

When winding down a covered financial company organized or incorporated in a country other than the United States, the FDIC, as receiver, would coordinate with the appropriate foreign financial authorities regarding the resolution of subsidiaries of the covered financial company that are established in a country other than the United States.

Additionally, the legislation would authorize the FDIC to make risk-based assessments on financial companies for the Systemic Dissolution Fund to pay for the repayment of any shortfalls of the Troubled Asset Relief Program (“TARP”) so that these losses do not add to the national deficit.

The fund would be capped at \$150 billion, with a provision allowing the regulators to raise another \$50 billion with the approval of Congress, the US Treasury and the President. The FDIC dissolution authority would end on December 31, 2013, unless extended by Congress and the President.

4. Consumer Financial Protection Agency

The legislation would establish a Consumer Financial Protection Agency (“CFPA”) responsible for rulemaking and the examination and enforcement of regulation on financial institutions that provide consumers with financial products and services. The independent CFPA would be headed by a Director serving a five year term, who is Presidentially appointed and Senate confirmed. The CFPA would have rulemaking authority transferred from the consumer banking laws of the Federal Reserve and other Federal banking agencies. The CFPA would have broad rulemaking authority to address unfair, deceptive, and abusive acts and practices that it identifies in financial institutions.

Carve-Out for SEC-Regulated Entities. The SEC would retain its authority to adopt rules, initiate enforcement proceedings, or take any other action with respect to an entity regulated by the SEC that acts in a registered capacity. The CFPA would not have authority to exercise any power to enforce this title with respect to such person regulated by the SEC. The persons in this carve-out include, for example: a broker or dealer registered under the Securities Exchange Act of 1934; an investment adviser registered under the Investment Advisers Act of 1940; an investment company required to be registered under the Investment Company Act of 1940; a national securities

exchange required to be registered under the Securities Exchange Act of 1934; a clearing corporation registered under the Securities Exchange Act of 1934; any municipal securities dealer registered with the SEC; and any national securities exchange registered under the Securities Exchange Act of 1934. In addition, the bill preserves the right of state securities commissions to adopt rules and initiate enforcement proceedings over entities registered with a State securities commission that are acting in a regulated capacity.

Preemption. The bill, as modified by the Manager's Amendment, provides that state consumer financial protection laws may be preempted after a written finding by the OCC that a state law "prevents, significantly interferes with, or materially impairs the ability of a national bank to engage in the business of banking." The finding must be made by a court, by regulation, or by order of the OCC on a case-by-case basis. The legislation further provides that equivalent state standards could be preempted after the OCC, in consultation with the CFPA, determines that a state consumer financial law of another state is substantively equivalent to another preempted by the OCC. The bill retains language that operating subsidiaries of national banks and Federal thrifts that are state-chartered business entities will be subject to state consumer protection laws. In addition, state attorneys general would be authorized to enforce CFPA regulations, provided they consult with the CFPA prior to initiating such action.

CFPA Back-Up Role for Smaller Banks with Assets Less than \$10 Billion from CFPA Examination, Enforcement. The measure gives the CFPA a back-up role for smaller banks and credit unions with assets of less than \$10 billion. These smaller banks and credit unions would have CFPA regulations generally enforced by their functional regulators instead of the CFPA. However, the legislation gives the CFPA backstop powers, including the ability to remove a functional regulator as a consumer compliance regulator on an institution-by-institution basis if it determines the regulator failed to adequately carry out consumer compliance supervision with regard to the particular institution.

5. Credit Rating Agencies

The legislation would provide for increased regulation of nationally recognized statistical rating organizations ("NRSRO"). Among its provisions, it would require the SEC to conduct reviews of NRSROs for the establishment of certain internal controls, methodologies, and due diligence in the issuance of credit ratings. Further, under the legislation, the SEC must promulgate rules managing conflicts of interest in the issuance of credit ratings by such NRSROs.

With respect to internal governance, the legislation would require at least one-third of the board of directors of each NRSRO to be independent, with no less than two independent directors seated on a board. Independent director compensation may not be linked to the business performance of the NRSRO, and the term of office for such independent directors must be for a pre-agreed, non-renewable, fixed period not to exceed five years. Under the proposal, each NRSRO must designate a compliance officer charged with ensuring the organization's compliance with required policies and procedures and, in consultation with the board, resolving any conflicts of interest. The designated compliance officer reports directly to the NRSRO's board.

The legislation is designed to increase transparency and accountability to the credit rating agencies, providing additional information to all market participants, including issuers, investors, and companies who rely upon their credit rating to do business. Along with each credit rating issued, the NRSRO must provide a report “for free or a reasonable fee” that discloses, among other things, the main assumptions included in constructing procedures and methodologies, potential shortcomings of the credit ratings, information on the reliability, accuracy, and quality of the data analyzed, and any other information required by the SEC.

The legislation would also establish within the SEC an office responsible for administering those rules and regulations governing NRSROs. Additionally, the SEC would be required to establish a Credit Ratings Agency Advisory Board to serve as an advisory panel to the SEC in its implementation of the provisions of the Accountability and Transparency in Rating Agencies Act. The bill would require the SEC to study ratings standardization, including: the feasibility and desirability of (1) standardizing credit ratings terminology, so that all credit rating agencies issue credit ratings using identical terms; (2) standardizing the market stress conditions under which ratings are evaluated; (3) requiring a quantitative correspondence between credit ratings and a range of default probabilities and loss expectations under standardized conditions of economic stress; and (4) standardizing credit rating terminology across asset classes, so that named ratings shall correspond to a standard range of default probabilities and expected losses independent of asset class and issuing entity. Within a year after enactment of the bill, the SEC is required to transmit to Congress a report containing the findings of the study and recommendations of the SEC.

The legislation, as amended during floor debate, would allow rating agency firms to deregister as NRSROs, provided such NRSRO certifies that it received less than \$250 million during its last full fiscal year in compensation for providing credit ratings on securities and money market instruments issued in the United States.

6. Regulation of the Insurance Industry

The legislation would establish a Federal Insurance Office (“FIO”) in the Department of Treasury to monitor and regulate the insurance system at the Federal level, while preserving state regulation. The FIO would share its authority with the Office of the U.S. Trade Representative (“USTR”) in supervising the insurance system. The FIO would also have the authority to manage the global insurance system and represent the U.S. internationally. Additionally, the FIO Director would be required to conduct a study and present a report one year after FIO creation. The report would assess ways to modernize insurance regulations based on the six principles given by the Obama Administration.

The FIO would be empowered to broadly monitor insurance, including: (1) identifying issues or gaps in the regulation of insurers that could contribute to a systemic crisis in the insurance industry or the United States financial system; (2) to recommend to Federal Reserve System or other systemic risk regulator that it designate an insurer, including its affiliates, as an entity subject to heightened regulation; (3) to assist the Treasury Secretary in administering the Terrorism Insurance Program; (4) to coordinate Federal efforts and develop Federal policy on prudential aspects of international insurance matters, including representation as appropriate in the International Association of Insurance Supervisors and assisting the Secretary in negotiating international

insurance agreements on prudential measures; (5) to determine whether state insurance measures are preempted by international insurance agreements on prudential measures; and (6) to consult with the states regarding insurance matters of national importance and prudential insurance matters of international importance.

The adopted legislation requires states to adopt annuity suitability standards that are at least as strict as those given in the Suitability in Annuity Transactions Model Regulation that was created by the National Association of Insurance Commissioners.

Additionally, Federal regulators must follow state law when “resolving” a troubled, state-regulated insurer. See Section 3 for greater detail on the FDIC’s resolution authority.

7. Investor Protection

The provisions of the Investor Protection Act are designed to provide the SEC with additional oversight authority to better protect investors and prevent future fraudulent or abusive practices revealed in the recent Madoff and Stanford Financial scandals.

Most notably, the Investor Protection Act establishes a new Federal fiduciary duty for broker-dealers and investment advisers who provide personalized investment advice to their clients. The measure harmonizes the standard for broker-dealers by imputing the standard of conduct required for investment advisers under the Investment Advisers Act of 1940 when providing personalized investment advice about securities to a retail customer. The legislation also clarifies that the receipt of compensation based on commission or other standard compensation for the sale of securities shall not, in and of itself, be considered a violation of the fiduciary duty owed by a broker or dealer.

During the House debate, a provision was deleted from the legislation which would have permitted the Financial Industry Regulatory Authority (“FINRA”) to regulate member investment advisers that are associated with broker dealers.

8. Regulation of Derivatives

The Derivative Markets Transparency and Accountability Act of 2009 is a compromise between the proposals offered by the House Financial Services Committee and the House Agriculture Committee. It would require the clearing of all swaps and security-based swaps accepted by a registered clearing agency or derivatives clearing organization and the CFTC or SEC has determined that clearing is mandatory for such swap, though there exists an exemption from clearing if one of the counterparties is not a swap dealer or major swap participant and can demonstrate business or risk management practices for non-cleared swaps.

A registered clearing agency or derivatives clearing organization must submit to the CFTC or SEC for prior approval each swap, or any type of swaps that it seeks to accept for clearing. It would further require that all “functionally or economically similar” swaps and security-based swaps shall be treated similarly. If either the SEC or CFTC believes that a final rule, regulation, or order of the other agency would result in the treatment of functionally or economically similar products or

entities differently, then the complaining agency may obtain an expedited review by the United States Court of Appeals for the District of Columbia Circuit.

With respect to reporting of transactions, a clearing agency or derivatives clearing organization that clears swaps shall provide to the SEC or CFTC the information determined by the regulator to be necessary to perform its oversight function. The SEC and CFTC will adopt data collection and maintenance requirements for swaps cleared by clearing agencies and derivatives clearing organizations that are comparable to the corresponding requirements for swaps accepted by swap repositories and swaps traded on swap execution facilities.

Non-cleared trades that are not accepted for clearing by any derivatives clearing organization or clearing agency must be reported either to a repository or, if there is no repository that would accept the trade, then it must be reported to the SEC or CFTC (depending on the product type). Counterparties to a trade may determine which counterparty will report the trade to the repository or regulator. Further, the SEC and CFTC may designate a clearing agency, derivatives clearing organization or a swap repository to carry out its public reporting described obligations.

The SEC and CFTC will share the information with its counterpart, the Federal Reserve, banking agencies, the Financial Services Oversight Council, and the Department of Justice or other persons the deemed appropriate, including foreign financial supervisors, foreign central banks, and foreign ministries. Further, the SEC and CFTC will make aggregate data on swap trading volumes and positions available to the public in a manner that does not disclose the business transactions and market positions of any person. The SEC and CFTC may designate a derivatives clearing organization, clearing agency or a swap repository to carry out this public reporting requirement.

Swaps would be required, with limited exception, to be executed through a board of trade designated as a contract market or a registered SEF. This legislation, as amended during debate on the House floor, would define a SEF as “a person or entity that facilitates the execution or trading of security-based swaps between two persons through any means of interstate commerce, but which is not a national securities exchange, including any electronic trade execution or voice brokerage facility.”

The legislation would require each SEF to register with the CFTC or SEC even if already registered with and subject to the supervision of the other agency (though it may seek an exemption from registration). Each SEF must also comply with a list of core principles, which include monitoring trading for market manipulation, obtaining and providing information to regulators, publishing price, volume and other trading data and prohibiting trades in swaps readily susceptible to manipulation. The legislation mandates that each SEF enforce position limitations or position accountability for speculators who establish positions in contracts made available for trading on the SEF. Beyond those core principles enumerated in Senator Dodd’s discussion draft, this legislation would include SEFs must maintain adequate financial resources to carry out its responsibilities and establish safeguards to guarantee operational risk and business continuity.

Additionally, the House proposal would permit the CFTC and SEC to adopt rules and regulations requiring registration of a foreign board of trade that provides the members located in the United States direct access to the electronic trading and order matching system of the foreign

board of trade. The legislation would include an exemption to this requirement for any foreign board of trade granted direct access by the CFTC or SEC prior to enactment of this legislation.

For each of the primary market participants (SEFs, clearing agencies, swap repositories, swap dealers or swap participants), the SEC or CFTC would be able to exempt the participant from registration, if it finds that the entity is subject to comparable and comprehensive supervision and regulation on a consolidated basis by appropriate governmental authorities in the organization's home country.

The derivatives regulatory framework includes two controversial provisions that have not yet been resolved by the Senate. The first is the so-called "Lynch Amendment," which would limit the amount of ownership certain swap dealers and major swap participants can have in a clearing agency, derivatives clearing organization, board of trade or swap execution facility. The second provision, frequently called the "Peterson Amendment," makes explicit that no provision of the legislation can be construed to authorize Federal assistance to support a derivatives clearing organization or a clearing agency, except where explicitly authorized by an Act of Congress.

9. Regulation of Investment Advisers

The legislation is unrelated to other proposed legislative initiatives of the same name that have been introduced in recent months by various members of Congress and by the Obama administration.¹

Limitations on Certain Exemptions. The Private Fund Investment Advisers Registration Act of 2009 ("Private Fund Registration Act") would eliminate the private fund adviser exemption contained in Section 203(b) of the Investment Advisers Act of 1940 ("Advisers Act"). As such, an exemption from registration would no longer be available to an investment adviser of a "private fund," which the Private Fund Registration Act defines as a fund that would be an "investment company" under the Investment Company Act of 1940 ("Company Act"), but for the exceptions to that definition under Sections 3(c)(1) and 3(c)(7) of the Company Act. This definition would include all such funds wherever organized or located, whether in the US or in off-shore jurisdictions, unlike the definition for "private fund" contained in the Senate's version of the Private Fund Registration Act, which was limited to funds organized in the U.S. or which are at least 10%-owned by U.S. persons.

The Private Fund Registration Act would leave in place the foreign private fund adviser exemption already contained in the Advisers Act, but would define the term "foreign private fund adviser" as an investment adviser (1) with no place business in the U.S.; (2) during the preceding 12

¹ Recent unrelated legislative proposals of the same name include: the "Private Fund Investment Advisers Registration Act of 2009" (Treasury Bill) introduced by the Obama administration on July 15, 2009; the "Private Fund Investment Advisers Registration Act of 2009" (Kanjorski Bill) introduced by Representative Paul E. Kanjorski (D-PA), chairman of the House Financial Services Subcommittee on Capital Markets, Insurance and Government-Sponsored Enterprises, issued in discussion draft on October 1, 2009, and thereafter introduced as H.R. 3818 on October 15, 2009; and the "Private Fund Investment Advisers Registration Act of 2009" included in Title IV of the "Restoring American Financial Stability Act of 2009" introduced by Senator Christopher Dodd (D-CT), Chairman of the Senate Banking Committee.

months, (a) has had in total fewer than 15 clients and investors in the U.S. in “private funds” advised by the investment adviser, and (b) aggregate assets under management attributable to clients and investors in the U.S. in private funds advised by the investment adviser of less than \$25 million; and (3) does not hold itself out to the public as an investment adviser, nor acts as an investment adviser to a registered investment company or a business development company. This modification of the foreign private fund adviser exemption closely resembles the modifications contained in the other legislative proposals. However, unique to the Private Fund Registration Act, pursuant to an amendment made prior to the House passing the legislation, the 15 client and investor threshold relates to such number of clients and investors in private funds. It will be interesting to see how this legislation, if enacted, would affect the current Rule 203(b)(3)-1 promulgated under the Advisers Act, which provides a safe harbor that generally allows a private fund to be considered a “single client.”

Unlike the other legislative proposals, the Private Fund Registration Act would exempt from registration any investment adviser to licensed small business investment companies, entities that have received from the Small Business Administration a notice to proceed to qualify for a license, or applicants related to licensed small business investment companies which have license applications pending.

In addition, the Private Fund Registration Act would add language to Section 203(c) of the Advisers Act obligating the SEC to consider the relative risk profile of different classes of private funds as it establishes the rules and regulations for the registration of investment advisers to private funds.

Collection of Data. The Private Fund Registration Act contains provisions for the collection of certain types of data from investment advisers and their managed funds, mirroring the terms included in the initial draft offered by Rep. Paul Kanjorski (D-PA) (“Kanjorski Bill”). In particular, the SEC would be authorized to require any registered investment adviser to maintain records of and file with the SEC reports regarding the private funds they manage, which the SEC may disclose to the Board of Governors of the Federal Reserve and to the Financial Services Oversight Council. Information to be disclosed with respect of private funds would specifically cover: amount of assets under management, use of leverage, counterparty credit risk exposures, trading and investment positions, trading practices, and such other information as deemed appropriate. The SEC would also be authorized to set different reporting requirements for different classes of private fund advisers based on the types and sizes of funds advised.

The Private Fund Registration Act would eliminate Section 210(c) of the Advisers Act, which in its current form severely limits the SEC’s ability to require an investment adviser to disclose the identity, investments or affairs of its clients.

Non-Disclosure of Proprietary Information and Confidentiality. Although there is expanded authority to collect data, the Private Fund Registration Act also provides that any proprietary information of an investment adviser ascertained in required reporting will be subject to the same limitations on public disclosure as any facts collected during an exam by the SEC. Further, the SEC may not be able to compel private funds to disclose proprietary information to counterparties and creditors. “Proprietary information” is defined to include sensitive, non-public

information concerning the investment adviser's investment or trading strategies, analytical or research methodologies, trading data, computer hardware or software containing intellectual property, and any additional information the SEC determines to be proprietary.

Exemption for Venture Capital Fund Advisers. The Private Fund Registration Act contains substantially the same registration exemption for advisers to venture capital funds as contained in the Kanjorski Bill. Specifically, the SEC would be tasked with defining the term "venture capital fund," and although advisers to venture capital funds would be exempt from registration, the SEC would require such advisers to maintain records and provide annual or other reports as the SEC deems necessary. While the Senate's version of the Private Fund Registration Act also has an exemption from registration for venture capital fund advisers, it does not impose any record and reporting requirements on such advisers.

Exemption for Certain Private Fund Advisers. The Private Fund Registration Act also contains a registration exemption for advisers to private funds where the investment adviser acts solely as an adviser to private funds and the adviser has less than \$150 million of assets under management. Notwithstanding this registration exemption, such private advisers would still be required to maintain records and provide annual and other reports to the SEC as it deems necessary. This is in slight contrast to the Senate's version of the Private Fund Registration Act, which contains a registration exemption for advisers to "private equity funds," which the SEC would be required to define under that Act. In addition, the Private Fund Registration Act contains a provision under which the SEC would be obligated to prescribe regulations for the registration and examination of advisers to "mid-sized" private funds taking into account the size, governance and investment strategy of such funds. No definition is provided for the term "mid-sized" nor is it clear that "mid-sized" has a relation to the \$150 million threshold discussed above.

Additionally, The Private Fund Registration Act would clarify the SEC's rulemaking authority in much the same way proposed in the Kanjorski Bill. As such, the SEC would be permitted to issue, amend and rescind rules and regulations defining technical, trade and other terms used in the Private Fund Registration Act. In particular, the SEC may classify investment advisers and funds based upon their size, scope, business model, compensation scheme or potential to create or increase systemic risk. And in doing so, the SEC may prescribe different requirements for different classes of such advisers and funds and generally ascribe different meanings to terms used in different sections of the Private Fund Registration Act.

Comptroller General Study. The Comptroller General of the U.S. would be directed to perform a study to assess the annual costs on industry members and their investors due to registration requirements and ongoing reporting requirements, and to submit a report to Congress no later than the second anniversary of the date of the Private Fund Registration Act's enactment. This provision of the Private Fund Registration Act is different than the "study" provision contained in the Senate's version of the Private Fund Registration Act, which enumerates three other kinds of studies.²

² The Private Fund Registration Act calls for studies to be conducted on: (i) the appropriate criteria for determining "accredited investor" status and eligibility to invest in hedge funds; (ii) the feasibility of forming a self-regulatory body to

The Private Fund Registration Act would go into effect on the one-year anniversary of its enactment, although investment advisers may register with the SEC prior to such date pursuant to rules and regulations prescribed by the SEC. Finally, the Private Fund Registration Act proposes that the SEC periodically determine new dollar amount thresholds used as factors in determining a person's financial sophistication, experience and knowledge as may be required to enter into a contract with an investment adviser. The SEC would have to make its first determination, based on the effects of inflation, no later than one year following the enactment of the Private Fund Registration Act, and thereafter, every five years.

Annual Assessments. Under Section 7302, the SEC would be directed to establish rules to collect fees from registered investment advisers to help recover the cost of inspections and examinations of such registered advisers. Such fees would be payable upon registration and during each fiscal year thereafter in an amount that is "fair and reasonable" as determined by the SEC, which shall consider the following factors: the investment adviser's size; the number of clients of the investment adviser; the types of clients of the investment adviser; and such other relevant factors as the SEC deems appropriate. The aggregate fees that would be determined by the SEC are required to be greater than the amount the SEC spent on inspections and examinations of registered investment advisers during the 2009 fiscal year. Fee rates would be reviewable by the SEC and adjustments could be before the end of a fiscal year. Penalties for late payment of fees could also be assessed by the SEC.

10. Executive Compensation

The legislation includes provisions requiring shareholder vote and disclosure upon the occurrence of certain events, independent compensation committees, and disclosure of incentive-based compensation.

"Say on Pay" Shareholder Vote. The legislation requires nonbinding shareholder vote on executive compensation upon the occurrence of certain events (such as a transaction that effects a change in control of the employer or proxies solicited in respect of any security registered under Section 12), as well as a nonbinding vote on golden parachute arrangements. Also, institutional investment managers must disclose their votes on executive compensation and golden parachute packages.

Independent Compensation Committee. In order to list securities on national exchanges, an issuer must ensure all members of its compensation committee of the board of directors are independent (e.g., not paid any compensatory fee by the issuer). In addition, any compensation consultants or other advisors to the committee must be independent. The SEC will review the use of compensation consultants by issuers and report to Congress on their findings within 2 years.

oversee hedge funds, private equity funds and venture capital funds; and (iii) the state of short selling in the stock market, including the impact of recent short sale rule changes and the incidence of failure to deliver short sold shares.

Perverse Incentives. In the next nine months, regulations would be promulgated to require disclosure of all incentive-based compensation offered by all covered financial institutions (though there will be no identification of the actual persons who receive compensation). Financial institutions subject to these rules are broadly defined to include depository institutions, broker-dealers, credit unions, investment advisers, or any other financial institution deemed includible by certain regulatory agencies. Any financial institution with less than \$1 billion in assets will not be subject to these rules. In addition, the Government Accountability Office (“GAO”) will study whether there is a connection between compensation and excessive risk taking. The GAO will take into account compensation structures from 2000 to 2008 as well as comparisons between companies that failed and those that remained viable throughout the 2007 and 2008 financial crisis.