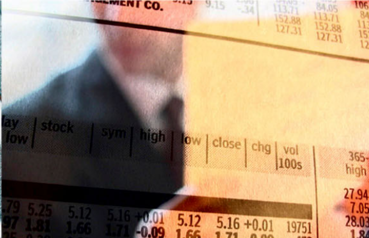
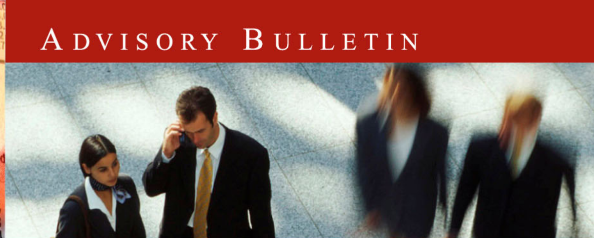

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INVESTMENT MANAGEMENT UPDATE

The Administration's Plan for Financial Regulatory Reform and Its Impact on Investment Companies, Investment Advisers and Broker-Dealers

On June 17, the Department of the Treasury (Treasury) issued a white paper, *Financial Regulatory Reform—A New Foundation: Rebuilding Financial Supervision and Regulation* that proposes legislative and regulatory reforms to meet five key objectives:

- Promote robust supervision and regulation of financial firms.
- Establish comprehensive supervision of financial markets.
- Protect consumers and investors from financial abuse.
- Provide the government with the tools it needs to manage financial crises.
- Raise international regulatory standards and improve international cooperation.

The following is a summary of the white paper's proposals and recommendations that may affect mutual funds, hedge funds, private equity funds, investment advisers and broker-dealers.

TIER 1 FINANCIAL HOLDING COMPANIES

The white paper proposes subjecting any financial firm whose combination of size, leverage and interconnectedness could pose a threat to financial stability if it failed to robust consolidated supervision and regulation, regardless of whether the firm owns an insured depository institution. The white paper refers to these firms as Tier 1 Financial Holding Companies (Tier 1 FHC). The Federal Reserve Board (Federal Reserve) would have the authority to supervise and regulate Tier 1 FHCs. Mutual funds, hedge funds, private equity funds, investment advisers and broker-dealers could be classified as Tier 1 FHCs if they meet the criteria established by the Federal Reserve.[1]

Identifying Tier 1 FHCs. The white paper recommends that the following factors be considered in identifying Tier 1 FHCs:

- The impact the firm's failure would have on the financial system and the economy;
- The firm's combination of size, leverage (including off-balance sheet exposures) and the degree of reliance on short-term funding; and
- The firm's criticality as a source of credit for households, businesses, and state and local governments and as a source of liquidity for the financial system.

While the Federal Reserve would have ultimate responsibility for prudential standard-setting and supervision for Tier 1 FHCs, if a firm has one or more subsidiaries subject to prudential regulation by other federal regulators (such as the Securities and Exchange Commission (SEC) or the Commodities Futures Trading Commission (CFTC)), the Federal Reserve would be required to consult with those

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regulators before requiring the firm to be regulated as a Tier 1 FHC. To enable the Federal Reserve to identify financial firms that require supervision and regulation as Tier 1 FHCs, the white paper recommends that Congress authorize the Federal Reserve to collect periodic and other reports from all U.S. financial firms that meet certain (unspecified) minimum size thresholds.[2]

The white paper also proposes that the Federal Reserve have the ability to examine *any* U.S. financial firm that meets certain minimum size thresholds if the Federal Reserve is unable to determine whether the firm's financial activities pose a threat to financial stability based on regulatory reports, discussions with management and review of publicly available information, provided that the scope of the examination is limited to that which is reasonably necessary to determine whether the firm is a Tier 1 FHC.

Prudential Standards for the Tier 1 FHC and Its Subsidiaries. Firms identified as Tier 1 FHCs would be subject to stricter and more conservative capital, liquidity, disclosure and risk management standards than those applicable to other financial firms. In addition, Tier 1 FHCs would be required to comply with the non-financial activities restrictions currently applicable to bank holding companies. The Federal Reserve also would have the authority to impose and enforce more stringent prudential requirements on the regulated subsidiaries of a Tier 1 FHC to address system risk concerns, but only after consulting with the subsidiary's primary federal or state supervisor and the Treasury. These subsidiaries could include investment companies, investment advisers and broker-dealers.

Examination of the Tier 1 FHC and Its Subsidiaries. The white paper proposes that subsidiaries of a Tier 1 FHC, such as investment advisers or broker-dealers, continue to be regulated by their functional regulator (*e.g.*, the SEC), but that the constraints imposed on the Federal Reserve by the Gramm-Leach-Bliley Act be removed and the Federal Reserve be able to request reports from, and conduct examinations of, the Tier 1 FHC and all of its subsidiaries, including those that have another primary regulator.

Macroprudential Supervision. Supervision of Tier 1 FHCs would be "macroprudential" in focus; that is, regulators would consider the potential impact of the activities and risk exposures of these companies on each other, on critical markets and on the broader financial system. To permit this assessment, the white paper recommends that the Federal Reserve require each Tier 1 FHC to regularly report the nature and extent to which other major financial firms are exposed to it.

Rapid Resolution Plan. The white paper recommends that the Federal Reserve require each Tier 1 FHC to prepare and continuously monitor a credible plan for the rapid resolution of the firm in the event of severe financial distress. The Federal Reserve would regularly review the adequacy of each firm's resolution plan.

Resolution Regime. The white paper recommends the creation of a resolution regime to avoid the disorderly resolution of a failing Tier 1 FHC if a disorderly resolution would have serious adverse effects on the financial system or the economy. The regime would supplement, not replace, bankruptcy procedures and would be modeled on the "systemic risk exception" contained within

the existing Federal Deposit Insurance Corporation (FDIC) resolution regime.[3] The white paper proposes the following formal process for determining whether use of this special resolution regime is necessary for a particular firm and the form that the resolution process should take:

- The process would be initiated by the Treasury or the Federal Reserve; however, the process could be initiated by the FDIC or, when the largest subsidiary of the failing firm is a broker-dealer or securities firm, the SEC.
- The authority to decide to resolve a failing firm would be vested in the Treasury, which could invoke the authority only after consulting with the president and only upon the written recommendation of two-thirds of the members of the board of governors of the Federal Reserve and two-thirds of the members of the FDIC board; however, if the largest subsidiary of the failing firm is a broker-dealer or securities firm, approval of the FDIC board is not required and two-thirds of the commissioners of the SEC must approve.[4]
- To invoke its authority, the Treasury must determine that the firm is in default or in danger of falling into default, the failure of the firm and its resolution under otherwise applicable law would have serious adverse effects on the financial system or the economy, and use by the government of the special resolution regime would avoid or mitigate these adverse effects.
- The authority to decide how to resolve a failing firm under the special resolution regime also would be vested in the Treasury. The Treasury may elect to establish a conservatorship or receivership and generally would appoint the FDIC to act as conservator or receiver. However, the Treasury would have the authority to appoint the SEC as conservator or receiver when the largest subsidiary of the failing firm is a broker-dealer or securities firm. The conservator or receiver would have broad powers to take action with respect to the financial firm.

Financial Services Oversight Council.

The white paper proposes creation of a Financial Services Oversight Council consisting of:

- The secretary of the Treasury
- The chair of the board of governors of the Federal Reserve
- The director of the National Bank Supervisor[5]
- The director of the Consumer Financial Protection Agency[6]
- The chair of the SEC
- The chair of the CFTC
- The chair of the FDIC
- The director of the Federal Housing Finance Agency

The Council would be supported by a full-time staff housed in an office within the Treasury and could require periodic and other reports from *any* U.S. financial firm solely for the purpose of assessing the extent to which a financial activity or financial market in which the firm participates poses a threat to financial stability.[7]

Coordination and Advice. The Financial Services Oversight Council would:

- Facilitate information sharing and coordination among the principal federal financial regulatory agencies regarding policy development, rulemaking, examinations, reporting requirements and enforcement actions.
- Identify gaps in regulation and prepare an annual report to Congress on market developments and potential emerging risks.
- Provide a forum for discussion of cross-cutting issues among the principal federal financial regulatory agencies.
- Advise the Federal Reserve on the identification of firms that qualify as Tier 1 FHCs.

The Federal Reserve would be required to consult with the Council in developing rules for the identification of Tier 1 FHCs, in setting material prudential standards for Tier 1 FHCs and in setting risk management standards for systematically important payment, clearing and settlement systems.

Hedge Funds and Private Investment Pools

The white paper states that because private funds are not required to register, the government lacks reliable, comprehensive data with which to assess potential systemic implications of the activities of these funds. Therefore, the white paper suggests, there is a compelling investor protection rationale to fill the gaps in regulation of investment advisers and the funds that they manage.

Adviser Registration. The white paper proposes that advisers to hedge funds, private equity funds, venture capital funds and other private investment pools be required to register under the Investment Advisers Act of 1940 if assets under management exceed a certain modest threshold.[8] Requiring SEC registration would facilitate data collection that would permit an informed assessment of industry developments and whether any private fund has become so large that it should be supervised or regulated as a Tier 1 FHC.

Recordkeeping and Disclosure Requirements. Further, the white paper proposes that all "investment funds" advised by SEC-registered investment advisers be subject to certain recordkeeping requirements, as well as requirements regarding disclosures to investors, creditors and counterparties.

Regulatory Reporting. The white paper recommends that funds advised by SEC-registered investment advisers be required to report on a confidential basis the amount of assets under management, borrowings, off-balance sheet exposures and other information necessary to assess whether a fund or fund family is so large, highly leveraged or interconnected that it poses a threat to financial stability. The SEC would share these reports with the Federal Reserve, which would use the information to determine whether a fund or fund family meets the Tier 1 FHC criteria and should be regulated and supervised as such.

Examinations. The white paper recommends that the SEC conduct regular, periodic examinations of funds advised by SEC-registered investment advisers to monitor compliance with the proposed recordkeeping and reporting requirements.

MONEY MARKET FUNDS

The white paper states that the SEC should move forward with its plans to strengthen the regulatory framework around money market funds. In doing so, it should consider:

- Requiring money market funds to maintain substantial liquidity buffers.
- Reducing the maximum weighted average maturity of money market assets.
- Tightening the credit concentration limits applicable to money market funds.
- Improving the credit risk analysis and management of money market funds.
- Empowering money market fund directors to suspend redemptions in extraordinary circumstances to protect the interests of fund shareholders.

In addition, the white paper proposes that the President's Working Group on Financial Markets (PWG) prepare a report by September 15, 2009 that considers more fundamental changes, including moving away from a stable net asset value or requiring money market funds to obtain from private sources access to reliable and scalable emergency liquidity facilities.[9] At the same time, the white paper cautions that the SEC and the PWG should carefully consider ways to avoid any potential adverse effects of a stronger regulatory framework, such as driving investors to unregulated or less regulated money market investment vehicles or reducing the terms of money market liabilities issued by major financial and non-financial firms.

EXPANSION OF SEC AUTHORITY

To modernize the financial regulatory structure and to improve the SEC's ability to protect investors, the white paper proposes the following measures that focus on transparency, fairness and accountability.

Prospectus Delivery. The white paper recommends that the SEC be authorized to require that certain disclosures (including the summary prospectus) be provided to investors at or before the point of sale, if it finds that such disclosures would improve investor understanding of the particular financial products and their costs and risks. The white paper notes that currently, most prospectuses are delivered with the confirmation, after the sale has taken place.

Consumer Testing. The white paper suggests that the SEC engage in meaningful field testing, consumer outreach and testing of disclosures to individual investors.

Mandatory Arbitration. The white paper recommends legislation that would give the SEC clear authority to prohibit mandatory arbitration clauses in broker-dealer and investment advisory accounts with retail customers. The legislation also would provide that, before using such authority, the SEC conduct a study on the use of mandatory arbitration clauses in these contracts.

Protection for Whistleblowers. The white paper recommends that the SEC be given the authority to establish a fund to pay whistleblowers for information that leads to enforcement action resulting

in significant financial rewards. The fund would be funded with fines collected by the SEC that are not otherwise distributed to investors.

HARMONIZATION OF THE REGULATION OF INVESTMENT ADVISERS AND BROKER-DEALERS

Recognizing that investment advisers and broker-dealers are regulated under different statutory and regulatory frameworks, even though the services they provide are often virtually identical from the perspective of a retail investor, the white paper recommends that new legislation should bolster investor protections and bring important consistency to the regulation of investment advisers and broker-dealers by:

- Requiring that broker-dealers that provide investment advice about securities be held to the same fiduciary standard as registered investment advisers.
- Providing simple and clear disclosure to investors regarding the scope of the terms of their relationship with investment professionals.
- Prohibiting certain conflicts of interest and sales practices that are contrary to the interests of investors.

In addition, the white paper proposes that the SEC be empowered to examine and ban forms of compensation that encourage intermediaries to put investors into products that are profitable to the intermediary, but are not in the best interests of investors.

HARMONIZATION OF FUTURES AND SECURITIES REGULATION

The white paper notes the jurisdictional overlap between the SEC and CTFC, which results in economically equivalent instruments being regulated by two agencies operating under different and sometimes conflicting regulatory philosophies and statutes.

Eliminate Jurisdictional Uncertainties. The white paper proposes that the SEC and the CFTC recommend that Congress enact legislative changes to eliminate jurisdictional uncertainties between the agencies to ensure that economically equivalent instruments are regulated in the same manner, regardless of which agency has jurisdiction. The white paper states that this would lead to greater product innovation and competition, which would make the markets more efficient.

Coordination and Harmonization. The white paper notes that the CFTC follows a "principles-based approach" to regulation, while the SEC uses a "rules-based approach." Efforts should be made to build a common foundation for market regulation by an agreement between the two agencies on principles of regulation that are significantly more precise so that market practices that violate those principles can be readily identified and subjected to enforcement action by regulators. Harmonization also would require the development of consistent procedures by the agencies for reviewing and approving proposals for new products and rulemakings by self-regulatory organizations.[10]

Report to Congress. The white paper recommends that the SEC and the CFTC complete a report to Congress by September 30, 2009 that indentifies all existing conflicts in statutes and regulations

with respect to similar types of financial instruments and either explain why these differences are essential to the agencies' functions or recommend changes to eliminate the differences. If the two agencies cannot reach agreement on such recommendations by September 30, 2009, the differences should be referred to the Financial Services Oversight Council, which will address such differences and report its recommendations to Congress within six months of its formation.

Consumer Financial Protection Agency

The white paper recommends the creation of the Consumer Financial Protection Agency (CFPA), a new federal agency that would protect consumers of credit, saving, payment and other consumer financial products and services. The CFPA would have authority to regulate the providers of such products and services and to require disclosures, restrictions on contract terms and other protections against unfairness, abuse or deception. According to the white paper, investment products and services already regulated by the SEC or the CFTC would not fall under the jurisdiction of the CFPA.

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[1] The Financial Services Oversight Council, the Department of the Treasury and all of the principal financial regulators would play a role in recommending firms that should be subject to Tier 1 FHC supervision and regulation.

[2] For firms already subject to federal regulation, the white paper states that the Federal Reserve should have access to relevant reports submitted to other regulators, and its ability to require reports should be limited to information that cannot be obtained from reports to other regulators.

[3] Bankruptcy would remain the dominant tool for handling the failure of a Tier 1 FHC, unless the special resolution regime is triggered because of concerns about financial stability.

[4] If the failing firm includes an insurance company, the Office of National Insurance will provide consultation to the Federal Reserve and FDIC boards on insurance specific matters. *See also* note 5.

[5] A proposed agency within the Treasury that would conduct prudential supervision and regulation of all federally chartered depository institutions and all federal branches and agencies of foreign banks.

[6] A proposed federal agency dedicated to the protection of consumers in the financial products and services markets, except for investment products and services already regulated by the SEC or the CFTC.

[7] For firms already subject to federal regulation, the white paper states that the Council should, whenever possible, rely upon information that is already being collected by members of the Council in their role as regulators.

[8] The white paper does not specify what the "modest threshold" should be. However, on June 16, 2009, Senator Jack Reed (D-R.I.) introduced the Private Fund Transparency Act of 2009 that requires all hedge fund and other investment pool advisers that manage more than $30 million in assets to register as investment advisers with the SEC.

[9] The white paper states that these changes will more directly address the systemic risks posed by money market funds.

[10] As an example, the white paper suggests that the SEC recommend requirements to respond more expeditiously to proposals for new products and SRO rule changes and to expand of the types of filings that are deemed effective upon filing. Meanwhile, the white paper recommends that the CFTC recommend requiring prior approval for more types of rules and allowing the CFTC appropriate and reasonable time for approving rules that requires prior approval.