

Status of US Financial Reform Legislation: Systemic Risk, Derivatives, Consumer Protection and Investment Advisers



Alan Avery
April 6, 2010

This is a summary that we believe may be of interest to you for general information. It is not a full analysis of the matters presented and does not constitute legal advice.

You should consult with counsel to determine applicable legal requirements in a specific fact situation.

Goals

- Reduce contagion risks from “systemically significant” financial firms
 - Including clearer resolution / liquidation process

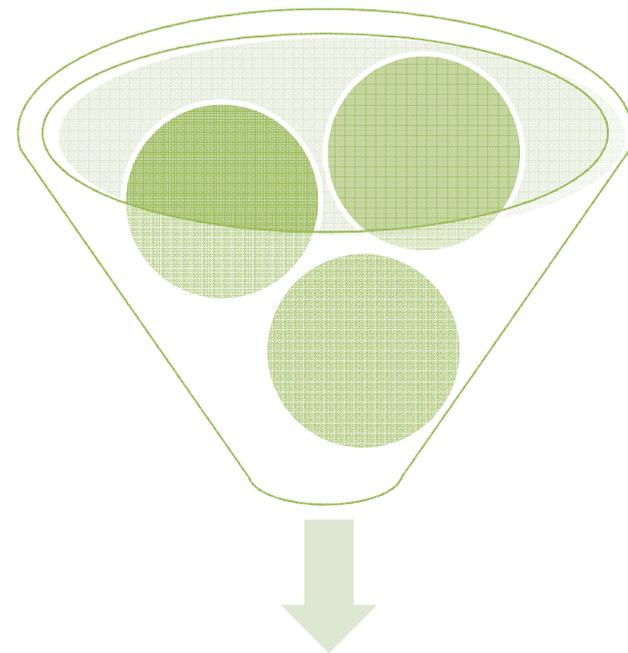
- Enhanced regulation / oversight of -
 - consumer financial products
 - over-the-counter derivatives
 - fund advisers
 - ratings agencies

- Align compensation and governance, to avoid excessive risk taking

- Reduce risks posed by securitizations

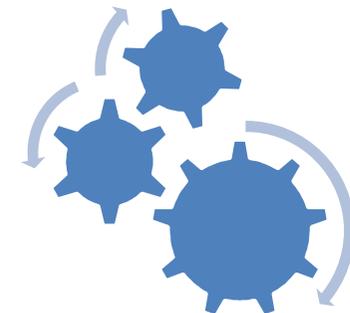
Status

- **Obama Administration:**
 - June 2009, released the concept paper “*Financial Regulatory Reform: A New Foundation*.”
- **House of Representatives:**
 - December 2009, passed the “*Wall Street Reform and Consumer Protection Act*.”
- **Senate:**
 - March 15, 2010, Senator Dodd introduced “*Restoring American Financial Stability Act of 2010*”.



Reduce Contagion / Systemic Risk

- Systemic Risk Regulator
 - Each plan would create a systemic risk regulator
 - Financial Stability Council / Financial Stability Oversight Council
 - Chair – Secretary of the Treasury
 - Identify and regulate systemically significant financial firms
 - Including financial activities of non-bank financial companies
 - Respond to emerging system-wide risks
 - Create a liquidation fund (\$50 - \$150 bn)
 - Main differences between plans:
 - Which entities are subject to designation
 - Role of the Federal Reserve
 - Consequences of designation as “significant”



Reduce Contagion / Systemic Risk

- Consequences of Being Designated as a Company that may be of Systemic Risk:
 - stricter standards (capital, leverage, liquidity, resolution plan, concentration limits, risk management, transfer of assets, or termination of activities)?
 - Supervision / regulation as if it were a financial holding company (financial activities)?
 - wall off financial activities from non-financial activities?

Reduce Contagion / Systemic Risk

- Special Resolution Authority
 - Would be available if a financial company
 - is determined by Treasury to be in default or danger of default,
 - failure would have severe adverse effects on US stability or economic conditions, and
 - FDIC assistance would avoid or mitigate the adverse effects
 - Procedure similar to bank receivership
 - Can be used only if using the Bankruptcy Code would be “systemically destabilizing”
 - Insurance companies are exempt
 - remain subject to state liquidation laws
- Living will / funeral plan

Reduce Contagion / Systemic Risk

- Volcker-lite
 - Volcker plan would prohibit depository institution holding companies from
 - Proprietary trading operations (“unrelated to serving customers”)
 - Owning/investing/sponsoring hedge funds and/or private equity funds
 - Proposed Senate bill
 - If systemically important nonbank financial company or BHC deemed to pose a “grave threat” to U.S. financial stability, then
 - restrictions on any activities or operations
 - proprietary trading investing in or sponsoring hedge funds or private equity funds
 - impose asset sale/breakup

Regulation | Consumer Protection

- Currently, consumer protection diffused among different federal and state regulatory agencies
 - Financial institutions – various federal bank regulatory authorities
 - Non-Financial institutions – state agencies and the FTC

- Increases consumer protection through:
 - Minimum standards, disclosures, fair dealing requirements
 - Creation of a federal consumer financial protection authority
 - But, significant differences between plans
 - Independent agency *or* part of the Federal Reserve?
 - Regulatory *and* enforcement powers?
 - Preemption of state authority?

Regulation | OTC Derivatives

- CFTC / SEC
 - supervise the purchase and sale of over-the-counter (OTC) derivatives
- Registration requirements for:
 - swap repositories,
 - swap dealers,
 - major swap participants, and
 - swap execution facilities
- Extraterritoriality
 - SEC / CFTC may exempt foreign facilities if subject to comparable home country regulation
 - limited exclusions for activities outside the United States that do not have a direct and significant connection in the US
 - Senate version does not address extraterritoriality

Regulation | OTC Derivatives

- Mandatory trading for many swaps on exchanges or swaps execution facilities
- Major swaps dealers and major swap participants:
 - capital requirements,
 - margin requirements,
 - recordkeeping requirements, and
 - reporting requirements
- Hinges on definitions of -
 - swaps dealers
 - major swap participants
- *However*, it is expected that a different version of derivatives provisions of Senate bill will be presented in full committee

Regulation | Private Fund Advisers

- Registration and Regulation
 - eliminates “private adviser” exemption from registration under the Investment Advisers Act of 1940
 - imposes SEC registration, reporting, and record-keeping obligations on advisers to “private funds”
 - aimed at hedge funds
 - private equity funds / family offices (*Dodd version exempts, House does not*)
 - exemptions from registration for:
 - foreign private advisers,
 - advisers to venture capital funds,
 - advisers to small business investment companies, and
 - any adviser that acts solely as an adviser to private funds and has US assets under management of less than \$150 million

Regulation | Credit Rating Agencies

- Heightened regulation
 - greater transparency
 - disclose procedures, methodologies, fees
 - reduce conflicts of interest
 - prohibited from consulting to companies that contract for ratings
 - reduce reliance on credit rating agencies
 - “scrubbing” federal regulations that rely on ratings
 - increased liability
 - provides investors with a private right of action against agencies
 - increased Securities Act liability if rating is included in disclosure
 - SEC given greater enforcement tools / examination powers
 - mandatory registration (most are already registered with the SEC)
 - dedicated SEC office

Regulation | Compensation

- Increased Federal role in determining compensation
 - “Say on Pay”
 - must provide shareholders with *non-binding* shareholder vote to approve the compensation of executive
 - compensation committee of independent directors
 - disclose the relationship between executive compensation and financial performance
 - “clawback” of “erroneously awarded” compensation
 - considered “unsafe and unsound practice” for a BHC to provide an employee, director or principal shareholder with compensation that is “excessive”

Regulation | Corporate Governance

- Majority Voting
 - uncontested elections, majority of votes cast
 - director must tender resignation if does not reach majority
 - contested elections, plurality standard
- Disclosure of Chairman / CEO Structure
 - disclose why the same or different persons serve as chairman and CEO
- Does not require -
 - shareholder ratification of classified boards
 - separate investor votes on severance packages
 - independent board chairs

Regulation | Insurance Companies

- Creation of a Federal Insurance Office within Treasury Department :
 - Monitor industry and insurance issues
 - Make recommendations on specific insurance companies becoming subject to stricter standards
 - May pre-empt state insurance measures