

The Impacts of the Dodd-Frank Wall Street Reform and Consumer Protection Act on Registered Investment Companies and Advisers

Largely in response to the recent financial crisis, Congress has just approved the “Dodd-Frank Wall Street Reform and Consumer Protection Act” (“Act”). The Act is an historic and wide-ranging piece of legislation that will result in significant changes to the regulatory framework, operations and supervision of the financial services industry.

The Act is largely focused on improving the regulation and supervision of the financial institutions that were viewed as triggering the 2008 financial crisis, namely banking institutions as well as other firms that acted as major players in the derivatives marketplace or were involved in subprime lending and securitization of such loans.¹ Nevertheless, the Act's extremely broad reach leaves very few financial services firms untouched.

Notwithstanding that registered investment companies and registered investment advisers (also referred to herein as “funds” and “advisers,” respectively) were widely viewed as minor players in the financial crisis,² there are a number of statutory provisions, rulemaking directives, and required studies that we believe could have an impact on funds (and their boards) and advisers. In this regard, it is

important to note that, in addition to implementing various new and amended statutory provisions, the Act defers many of the “details” of this comprehensive regulatory initiative to future regulations and studies by a variety of federal regulatory agencies. These future regulations and studies, the substance and findings of which cannot be predicted, are likely to impact funds and advisers in a variety of ways for years to come.

This update focuses on those specific provisions of the Act that could affect funds and advisers. In particular, we consider these impacts in the following manner.

Regulatory Impacts to Registered Funds and Advisers

While the Act does not include many direct amendments to the Investment Company Act of 1940 (“1940 Act”) or the Investment Advisers Act of 1940 (“Advisers Act”) (other than the new private fund adviser registration requirements), it does contain a number of regulatory changes that will, or could in the future, impact registered funds and advisers:

- Establishment of an Investor Advisory Committee and Investor Advocate – new

¹ Conspicuously absent from this list of institutions are Fannie Mae and Freddie Mac.

² While money market funds were hit very hard in 2008, the problems relating to money market funds were largely a symptom, rather than a cause of the problems arising in the financial markets, including problems with asset-backed commercial paper, the bankruptcy of Lehman and finally the temporary loss of confidence by investors in any debt obligation not guaranteed by the US government.

areas within the SEC separately tasked with addressing consumer-oriented concerns;

- Eventual removal of credit ratings from securities laws and regulations – most notably, this would require major changes to Rule 2a-7 under the 1940 Act;
- Increasing and enhancing the enforcement tools and focus of the SEC, including changes to the examination structure and organizational reform;
- Increased regulation of consumer financial products and services;
- Private fund adviser registration; and
- Bringing nonbank financial companies (i.e., non-bank holding companies that are predominantly engaged in financial activities) that are determined to be significant to U.S. financial stability under comprehensive financial regulation and supervision.

Studies that Could Impact Registered Funds and Advisers

Among the approximately 67 studies that are mandated by the Act, the following could directly impact funds and advisers:

- Study and rulemaking regarding the effectiveness of existing legal and regulatory standards of conduct and obligations of broker-dealers and advisers, improved investor access to information, and disclosure of information regarding the available range of products;
- Studies on mutual fund advertising, retail investor disclosures, financial literacy, and other topics that are intended to lead to regulatory changes;
- SEC study and report on short selling;
- SEC study on enhancing adviser examinations;
- GAO study and report on accredited investors and self-regulatory organization for private funds; and
- GAO study on conflicts of interest between investment banking and analyst functions.

Impacts to Registered Funds and Advisers as “Buy-Side” Participants in the Financial Marketplace

As was the case with almost all investors, most registered funds experienced substantial losses in value in late 2007 and most of 2008. A number of provisions in the Act are aimed at improving regulation in areas that either are viewed as precipitating the crisis or that experienced problems once the crisis began. These include the following:

- Changes to derivatives regulation;
- Changes to municipal securities regulation;
- Changes to asset-backed securities regulation; and
- Securities lending rulemaking.

Changes in Governance of Public Companies and Systemic Risk Regulation

Finally, there are a number of provisions in the Act, particularly those in Subtitle E of Title IX, that impact most public companies. These will impact certain funds and advisers in the following ways:

- Corporate governance and executive compensation reforms applicable to public companies generally; and
- Systemic risk regulation applicable to entities that are deemed to be “systemically important.”

Regulatory Impacts to Registered Funds and Advisers

Raising the Bar – a Heightened SEC Level of Activity

The provisions in several of the subtitles of Title IX of the Act (i.e., Subtitles A, B, C, and F) are intended to implement changes to the functions, authority, and enforcement capability of the SEC. These changes reflect Congressional concerns as to the ability of the SEC to effectively discharge its role of protecting investors and appear to be designed to make the SEC a more aggressive agency.

Investor Advisory Committee, the Investor Advocate, and the Ombudsman – New Internal Functions Within the SEC Designed to Represent the Interests of Investors

Investment Advisory Committee. The Act establishes an Investor Advisory Committee, the members of which are (i) the Investor Advocate (a newly created position within the SEC, as described below); (ii) a representative of State securities commissions; (iii) a representative of the interests of senior citizens; and (iv) between 10 and 20 members appointed by the SEC who represent the interests of individual or institutional investors, including the interests of pension funds and investment companies.

The stated purpose of the Investor Advisory Committee is to advise and consult with the SEC on: (i) regulatory priorities of the SEC; (ii) issues relating to the regulation of securities products, trading strategies, fee structures, and the effectiveness of disclosure; (iii) initiatives to protect investor interests; and (iv) initiatives to promote investor confidence and the integrity of the securities marketplace. The Act directs the Committee to study and submit its findings and recommendations to the SEC, including recommendations for proposed legislative changes.

Separately, the Act clarifies the SEC's authority to engage in temporary investor testing programs and to consult with investors, the public, academics, and consultants for the purpose of developing new programs and rulemaking initiatives.

Investor Advocate. The Act also creates a new position within the SEC, the Investor Advocate, who is appointed by, and reports to, the Chair of the SEC. The Investor Advocate will assist retail investors in resolving significant problems with the SEC or self-regulatory organizations ("SROs"), identify areas in which investors would benefit from changes in SEC regulations or SRO rules, identify problems investors have with financial service providers and investment products, analyze the impact of proposed rules and regulations on investors, and propose appropriate changes to the SEC and Congress.

The Investor Advocate is required to submit reports to Congress regarding the objectives of the Investor Advocate for the following year and the activities of the Investor Advocate during the preceding year. The SEC must establish, by regulation, procedures requiring a formal response to these reports.

Ombudsman. Within 180 days of his or her appointment, the Investor Advocate must appoint an Ombudsman, who will report directly to the Investor Advocate. The Ombudsman must (i) act as a liaison between the SEC and any retail investor in resolving problems the retail investor may have with the SEC or an SRO; (ii) review and make recommendations regarding policies and procedures to encourage persons to present questions to the Investor Advocate regarding compliance with the securities laws; and (iii) establish safeguards to maintain confidentiality between retail investors and the Ombudsman. The Ombudsman must submit a semi-annual report on his or her activities and their effectiveness, which the Investor Advocate is required to include in his or her reports to Congress.

Coordination. It seems curious that Congress determined that, in addition to the resources and personnel the SEC already has, it needs an Investor Advisory Committee, an Investor Advocate, and an Ombudsman, all of whom are charged with the goal of representing the interests of investors.

These provisions in the Act suggest that Congress may not appear to be convinced that the SEC currently has the resources and personnel to most effectively fulfill its mission as "the investor's advocate."³ On the other hand, those working at the SEC already view their role to be advocates for investors. The addition of new functions within the SEC with an overlapping mandate could present an interesting dynamic. For example, the Investor Advisory Committee, an Investor Advocate, and an Ombudsman might develop an agenda and recommend rulemaking objectives that are at odds with the SEC's existing regulations, functions, or vision. Similarly, it is possible these new functions might conflict with the watchdog role of fund independent directors. On the other hand, these new offices and positions within the SEC should be able to find a meaningful role that will allow them to work in a complementary fashion with existing SEC offices and personnel. At the very least, funds and advisers should expect to see a more aggressive and investor-oriented regulatory agenda in the coming years.

³ In addition to these two new groups within the SEC, this is also seen by the choice of the GAO, rather than the SEC, to conduct the study on mutual fund advertising as well as the GAO study on so-called "revolving door" regarding former SEC employees.

Changes to the Management and Organization of the SEC – Increases to the Enforcement Capabilities and Jurisdiction of the SEC and More Organizational Supervision

The Act also mandates a number of internal organizational reforms for the SEC, including certified reports of internal supervisory controls, reports on personnel management, annual audits of financial controls, reports on oversight of national securities associations, a “suggestion program” for SEC employees, deadlines for the completion of enforcement investigations, examinations and inspections, and further organizational studies and reforms.

The Act includes a number of other provisions that are intended to give the SEC additional tools in its enforcement capacity. These include the following:

- **Increased aiding and abetting liability** – the Act provides explicit authority for the SEC to bring actions for aiding and abetting violations of the 1940 Act and Advisers Act for “knowing” or “reckless” conduct; changes the aiding and abetting standard under the Securities Exchange Act of 1934 to add a recklessness standard; and directs a study regarding the advisability of providing a private right of action for aiding and abetting violations of the securities laws.
- **Stronger whistleblower protections** – the Act contains a number of provisions to increase whistleblower protections to areas not previously covered, provides for significant rewards to whistleblowers, prevents retaliation against whistleblowers, and provides an express private right of action to whistleblowers who believe they have been the subject of retaliation.
- **Other enforcement tools** – the Act also broadens the SEC’s subpoena authority; increases the SEC’s extraterritorial authority; provides broader authority with respect to civil penalties, collateral bars, and authority over formerly associated persons; and provides for broader information sharing authority among governmental and law enforcement authorities without creating a waiver of privilege.

These initiatives will be supplemented by several studies (discussed further below) that are intended to examine the workings of the SEC and bolster its effectiveness as a regulator. As with the new investor protection personnel and functions being added to the SEC, it is unclear how these new powers will be used by the SEC. However, it seems reasonable to expect that a more aggressive Division of Enforcement will be using its enhanced

authority to bring more high profile cases to demonstrate that it is vigilantly and effectively protecting investors.

Changes to Existing Laws

While the changes described above are designed to impact the “tone at the top” of the SEC (to borrow a phrase often used by the SEC Staff), the Act also includes more concrete changes to the existing regulatory framework for funds and advisers.

Eventual Removal of Statutory References to Credit Ratings and Review of Reliance on Ratings – Impacts on Rule 2a-7 Under the 1940 Act

Within two years, specified statutes, including the 1940 Act and Securities Exchange Act of 1934 (“Exchange Act”), must be amended to remove references to credit ratings. As a result, regulatory agencies would be required to develop standards of creditworthiness rather than relying on credit ratings provided by Nationally Recognized Statistical Rating Organization (“NRSROs”). The Act requires the SEC to establish an Office of Credit Ratings to administer the SEC’s rules regarding credit rating agencies.

Within one year, each federal agency, including the SEC, is required to review any regulation requiring an assessment of the creditworthiness of a security or money market instrument and any references to credit ratings in those regulations. Each agency is required to (i) modify their regulations to remove any reference to credit ratings; and (ii) substitute an appropriate standard of creditworthiness, seeking to establish uniform standards of creditworthiness for use by the agency. Each agency is required to submit a report to Congress detailing any such modifications.

This is a noteworthy directive likely to affect many registered funds and advisers. For example, the SEC will be required to substantially amend Rule 2a-7 under the 1940 Act to replace references to NRSROs with “standards of creditworthiness” that are appropriate for use by money market funds. Such future amendments to Rule 2a-7, and other regulations that rely on NRSRO ratings, will require fund complexes to revise their Rule 2a-7 compliance procedures and portfolio management processes accordingly.

While the NRSROs have received a great deal of criticism for their ratings of certain collateralized debt obligations and other asset backed securities, it is by no means clear that removing NRSRO ratings from Rule 2a-7 will do anything to enhance the safety and soundness of money

market funds. In fact, an earlier SEC proposal⁴ to remove references to NRSRO ratings was deferred due in part to industry objections that removing NRSRO references from the rule could open the door to lesser quality investments.

Private Fund Adviser Registration and Related Issues

The Act reflects a perception that private funds, in particular hedge funds and private equity funds, present the potential for systemic risk to the financial system. Consequently, the Act subjects more private fund managers to the registration requirements of the Advisers Act. In addition, the Act also empowers the SEC to subject private fund managers to additional regulatory and reporting requirements.

Registration

The Act eliminates the private adviser exception of Section 203(b)(3)⁵ of the Advisers Act, as well as several other exceptions on which investment advisers to private funds (including hedge funds and private equity funds) have historically relied. While the Act also adds several new exceptions to the Advisers Act, the net effect of the changes is that many private fund advisers will be required to register under the Advisers Act.

Advisers with more than \$100 million of assets under management (“AUM”) will be required to register with the SEC. However, advisers with AUM of less than \$150 million in the United States whose only clients are private funds will remain exempt from registration under the Advisers Act, subject to recordkeeping and reporting requirements to be established by the SEC. With limited exceptions, advisers with AUM between \$25 and \$100 million of AUM that are subject to state registration requirements will not be permitted to register under the Advisers Act.

Nevertheless, the Act excludes from registration requirements under the Advisers Act, the following investment advisers:

- Commodity trading advisors (“CTA”) registered with the Commodity Futures Trading Commission

⁴ References to Ratings of National Statistical Ratings Organizations, Release No. IC-28327 (July 1, 2008).

⁵ This provision excludes from the Adviser Act registration requirements advisers with less than 15 clients. Rule 203(b)(3)-1 provides that, for the purposes of that exclusion, each fund managed by an adviser would be viewed as a single client.

(“CFTC”) that advise a private fund as long as the business of the CTA is not predominately the provision of securities-related advice;

- Advisers solely to venture capital funds (to be defined by the SEC within one year from the date of enactment of the Act);⁶
- Foreign private advisers, i.e., non-U.S. based advisers that (i) have no place of business in the United States; (ii) have fewer than 15 U.S. clients; (iii) have AUM of less than \$25 million from U.S. clients; and (iv) that do not hold themselves out publicly in the United States as an investment advisers;
- Advisers to “small business investment companies” that are licensees under the Small Business Investment Act, have received notices to proceed to qualify as “small business investment companies” or certain other persons affiliated with “small business investment companies”.

In addition, the Act excludes from the definition of an “investment adviser” any “Family Office,” as defined by the SEC.

Recordkeeping and Reporting Obligations for Private Fund Advisers

The Act permits the SEC to impose new recordkeeping and reporting obligations on registered investment advisers that are advisers to private funds beyond those previously required under the Advisers Act, including information relating to:

- AUM and use of leverage (including off-balance sheet leverage);
- Counterparty credit risk exposure;
- Valuation policies and practices;
- Types of assets held;
- Side letters;
- Trading practices; and
- Such other information as the SEC may determine is appropriate, following consultation with the

⁶ Nevertheless, advisers to venture capital funds will be required to maintain and provide the SEC with certain records and reports (as the SEC determines are necessary or appropriate in the public interest).

Financial Stability Oversight Council (“Oversight Council”)

The Act also provides for information sharing between the SEC, the Oversight Council, and other federal agencies, although such information is required to be kept confidential.

Custody Issues for Funds and Advisers

The Act specifically authorizes the SEC to prescribe rules requiring registered investment advisers to safeguard client assets over which the adviser has custody, including verification of such assets by an independent public accountant. Within three years, the General Accounting Office (“GAO”) will also study the compliance costs associated with current SEC rules (Rule 204-2 (books and records), and Rule 206(4)-2 (custody rule)) regarding custody and the additional compliance costs that would result if Rule 206-4(b)(6) (which provides an exception from the independent verification requirement if custody is maintained by a related person who is operationally independent of the adviser) were eliminated.

Recordkeeping and examination requirements have been expanded for custodians of securities, deposits, or credits of investment companies or investment adviser clients. Additionally, the SEC has authority to examine all records relating to custody of securities, deposits, or credits of investment companies or investment adviser clients.

Accredited Investor Standard Changed

Current SEC rules define “accredited investor” for purposes of certain rules under the Securities Act of 1933. The applicable rules currently categorize a natural person as an “accredited investor” based on either the person’s net worth (\$1 million, including the person’s primary residence) or the person’s prior or anticipated net income.

The Act requires the SEC to set the individual net worth standard for an “accredited investor” at \$1 million (excluding the value of the primary residence) and may periodically adjust this standard. Similar authority is granted to the SEC under Section 205(e) of the Advisers Act.

SEC Authority To Require Point of Sale Disclosure

The Act specifically authorizes the SEC to issue rules designating documents or information that must be

provided by a broker-dealer to a retail investor before the purchase of an investment product or service.⁷

One potential outcome is that the SEC could bifurcate the disclosure given to retail investors. For example, the SEC could provide that (i) sponsors of investment products would be responsible for furnishing a summary of the investment objectives and risks of a product to broker-dealers for delivery by broker-dealers to their customers prior to purchase; *and* (ii) the broker-dealer would be required to separately provide the investor with a summary of its compensation prior to purchase. The current registered fund summary prospectus regime accommodates such a formulation, but future rulemaking or further amendments to registration statement forms may be forthcoming in response to this directive.

Compliance Examiners

The Act mandates that each of the SEC’s Division of Trading and Markets and the SEC’s Division of Investment Management have a staff of examiners that report directly to the Director of that Division to examine entities under the jurisdiction of these Divisions. This is likely to result in a restructuring and/or refocusing of activities of the SEC’s Office of Compliance, Inspections, and Examinations. Considering the Division of Investment Management will have an in-house compliance and inspection staff dedicated only to fund and adviser issues, the likely result is more examinations of funds and advisers which are fully supported by the regulatory expertise of the Division, as compared to the current structure where a separate examinations office is responsible for all SEC-regulated entities.

Consumer Financial Protection Bureau

Under Title X of the Act, a Consumer Financial Protection Bureau (“Bureau”) will be established within the Federal Reserve Board with broad regulatory powers over persons offering or providing “consumer financial products or services.” The Bureau is expressly prohibited from exercising rulemaking, supervisory, enforcement, or other authority with respect to persons regulated by the SEC, as well as certain other identified entities, unless the entity or person is offering a “consumer financial product or service.” The term “consumer financial products or services” is very broadly defined in the Act

⁷ Many would argue that the SEC already has this authority, though the specificity of this provision would seem to increase the likelihood that the SEC would exercise this authority.

but specifically excludes investment company products or investment advisory services, except those financial advisory services not otherwise subject to SEC or state securities regulation. Accordingly, the investment advisory services of advisers regulated by the SEC and all registered investment company products are exempt from direct Bureau regulation. However, activities of or products offered by persons regulated by the SEC that (i) come within the definition of consumer financial products and services; and (ii) are *not* within the regulatory reach of the SEC would come within the jurisdiction of the Bureau. This would include, for example, advice to investors about financial services or assets other than securities.

Systemic Risk Regulation

Title I of the Act establishes a new Oversight Council, consisting of the heads of various federal financial regulatory agencies, in order to (i) identify risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected bank holding companies or non-bank financial companies, or that could arise outside the financial services marketplace; (ii) promote market discipline, by eliminating expectations on the part of investors, creditors, and counterparties of such companies that the U.S. government will shield them from losses in the event of failure; and (iii) respond to emerging threats to the stability of the U.S. financial system.

The Oversight Council is empowered to determine that a U.S. non-bank financial company is “systemically important” and thus should be subject to the Federal Reserve Board’s supervision and prudential standards if the Oversight Council determines that “material financial distress” at the company or the “nature, scope, size, scale, concentration, interconnectedness, or mix of the activities” of the company could pose a threat to U.S. financial stability.

In determining that a U.S. non-bank financial company may be systemically important, the Oversight Council is directed to consider the following factors as they relate to the company’s U.S. AUM, activities, operations, and exposure: (i) the extent of leverage; (ii) the extent and nature of the company’s off balance sheet exposures; (iii) the extent and nature of the transactions and relationships of the company with other significant non-bank financial companies and bank holding companies; (iv) the importance of the company as a source of credit for households, businesses, and State and local governments and as a source of liquidity for the U.S. financial

system; (v) the importance of the company as a source of credit for low income, minority, or underserved communities, and the impact that the failure of such company would have on the availability of credit in such communities; (vi) the extent to which (a) assets are managed rather than owned by the company; and (b) ownership of assets under management is diffuse; (vii) the nature, scope, size, scale, concentration, interconnectedness, and mix of the activities of the company; (viii) the degree to which the company is already regulated by one or more primary financial regulatory agencies, such as the SEC; (ix) the amount and nature of the financial assets of the company; (x) the amount and types of the liabilities of the company, including the degree of reliance on short-term funding; and (xi) any other risk-related factors that the Oversight Council deems appropriate.

The Oversight Council will play an important role as the primary systemic risk regulator of financial institutions and it is likely that its existence and regulations may have an impact on funds and advisers that are classified as “systemically important” and thus subject to the Oversight Council’s oversight and regulation.⁸

Studies that Could Impact Registered Funds and Registered Advisers

Study Regarding Mutual Fund Advertising

The Act requires the GAO, within 18 months, to report to Congress the results of a study on mutual fund advertising to identify existing and proposed regulatory requirements; current marketing practices, including the use of past performance data in general and with respect to funds that have merged and incubator funds; the impact of such advertising on consumers; and recommendations to improve investor protections.

Through no-action letters and other interpretative guidance, the SEC staff has over many years specified the criteria for the presentation of past performance, including the performance of merged funds and incuba-

⁸ Earlier versions of the Act included a \$19 billion assessment to be paid by banks with at least \$50 billion in assets and hedge funds with at least \$10 billion in assets. Although the assessment was stricken from the final version of the legislation, it strongly indicates that private funds with assets of at least \$10 billion may, in some instances, be deemed “systemically important”—a designation which would subject those funds to Council oversight. See Silla Brush, *Frank: Banks, hedge funds to pay up to \$19 billion for Wall Street overhaul*, The Hill, June 24, 2010.

tor funds, with an eye toward making sure that investors receive complete and accurate information that is fairly presented. Empowering the GAO to revisit the subject may lead to recommendations contrary to the SEC and FINRA guidance with respect to mutual fund advertising.

Study and Rulemaking Regarding Broker-Dealers and Investment Advisers

Within six months, the SEC is directed to report to Congress the results of a study evaluating (i) the effectiveness of existing legal or regulatory standards of care for broker-dealers, investment advisers and their associated persons providing personalized investment advice and recommendations about securities to “retail customers;”⁹ and (ii) whether there are legal or regulatory gaps, shortcomings or overlaps that should be addressed by rule or statute. Following the results of that study, the SEC may, but is not required to, commence rulemaking to address such standards of care. The SEC is authorized to establish a standard of conduct to act in the best interest of the customer, without regard to the financial or other interest of the broker-dealer providing advice, that would be applicable to broker-dealers providing personalized investment advice to retail customers, as well as such other customers as the SEC may by rule provide. Any material conflicts of interest of the broker-dealer (or its registered representatives) would have to be fully disclosed to the affected customers for their consent.

From the outset of debate regarding financial regulatory reform, the harmonization of duties owed by broker-dealers with the fiduciary standards already imposed on investment advisers has been a key area of focus. Although the legislation does not specifically mandate harmonization, the compromise language within the final Act empowers and encourages the SEC to proceed with rulemaking.¹⁰ Accordingly, future rulemaking in this area should be expected. The adoption of a fiduciary or higher standard of care could impact the sales practices of broker-dealers offering investment company shares, including, perhaps, mutual fund distributors that market fund shares directly to investors. In particular, the SEC is

⁹ A “retail customer” is defined as a natural person who receives personalized investment advice about securities primarily for personal, family or household purposes.

¹⁰ Rep. Barney Frank (D-Mass.) made this point during the final floor debate prior to House passage (“[w]e gave the SEC the power to do it and they’re going to do it.”). Mark Schoeff, Jr., *SEC will impose fiduciary standards on brokers: Barney Frank*, Investment News, July 1, 2010.

authorized to require broker-dealers selling only proprietary or other “limited range” products (as determined by the SEC) to provide notice to each retail customer and obtain the consent or acknowledgement of the customer.

Study on Improved Investor Access to Information on Investment Advisers and Broker-dealers

Within six months, the SEC is directed to study ways to improve investor access to registration information about investment advisers and broker-dealers, including consideration of (i) consolidating the Central Registration Depository and Investment Adviser Registration Depository systems further; and (ii) identifying additional information that should be made publicly available. Any needed changes are to be implemented within 18 months of the study’s completion.

It is currently premature to assess if there will be any direct impact to advisers following this study, but potential Form ADV amendments (in addition to those that will be considered by the SEC in July 2010) or other changes could lie ahead depending on the study’s findings.

Study Regarding Financial Literacy Among Investors

Within two years, the SEC shall report to Congress the results of a study to identify the existing level of financial literacy among retail investors; methods to improve disclosure; the most useful and understandable, relevant information retail investors need to make informed financial decisions; methods to increase transparency of expenses and conflicts of interest; the most effective means to educate investors; and a strategy to increase financial literacy of investors.

Any findings identifying needed disclosure improvements could serve as a starting point for future rulemaking or amendments to forms governing fund registration statements. However, in light of the recent summary prospectus rulemaking and other SEC initiatives to make disclosures more understandable and “plain English,” it is not yet clear what, if anything, this study will add.

Study on Conflicts of Interest

The Act mandates that, within 18 months, the GAO is directed to report to Congress the results of a study regarding potential conflicts of interest between the staffs of the investment banking and equity and fixed income securities analyst functions within the same firm. The report will consider among other things: (i) the forms of misconduct engaged in by the several securities firms

and individuals that entered into the Global Analyst Research Settlements in 2003; (ii) the nature and benefits of the undertakings that those firms agreed to, including firewalls, separate reporting lines, dedicated legal and compliance staffs, employee performance evaluations, coverage decisions, limitations on soliciting investment banking business, disclosures, transparency, and other measures; (iii) whether those undertakings should be codified in rulemaking applicable to such firms; and (iv) whether to recommend other regulatory or legislative measures designed to mitigate possible adverse consequences to investors arising from conflicts of interest.

To the extent firms are subject to the 2003 Global Analyst Research Settlements, those firms (as well as, perhaps, other firms) may be required to revisit policies and procedures in light of future guidance or rulemaking following the publication of the GAO study.

Study on SEC Revolving Door

Within one year, the GAO is directed to conduct a study and must report to Congress the results of its study regarding (i) former SEC employees who are employed by SEC-regulated financial institutions; (ii) the necessity of related internal controls; (iii) the necessity of post-employment restrictions on such employees; and (iv) any related impact on the SEC's effectiveness. Any additional restrictions on post-employment opportunities for SEC employees could have a detrimental effect on the ability of the SEC to hire qualified individuals.

Study on Enhancing Adviser Examinations

Within 180 days, the SEC is directed to review and analyze the need for enhanced examination and enforcement resources for investment advisers, including (i) the number and frequency of SEC examinations over the past five years; (ii) whether the creation of a SRO to augment the SEC's efforts would improve the frequency of adviser examinations; and (iii) current and potential approaches to examining the investment advisory activities of dually registered broker-dealers and investment advisers or affiliated broker dealers and investment advisers. These provisions appear to be largely a response to the problems detailed by the SEC Inspector General following the examination of Bernard L. Madoff and related companies.¹¹ In addition, they are consistent

with the trend elsewhere in the Act towards an increased enforcement focus for the SEC.

GAO Study and Report on Accredited Investors and SRO for Private Funds

Within three years, the GAO is directed to report to Congress on a study regarding the appropriate criteria for determining financial thresholds or other criteria needed to qualify for accredited investor status and eligibility to invest in private funds. Within one year, the GAO is directed to report to Congress on a study regarding the feasibility of forming a SRO to oversee private funds. Again, this could potentially increase the oversight of advisers to private funds.

SEC Study and Report on Short Selling

The SEC Division of Risk, Strategy, and Financial Innovation is directed to conduct (i) a study, and report to Congress within two years, on the state of short selling with particular attention to the impact of recent rulemaking and the incidence of the failure to deliver shares sold short or delivery on the fourth day following the short sale transaction; and (ii) a study, and report to Congress within three years, of the feasibility and cost-benefit analysis of requiring real time reporting of short sale positions of publicly listed securities to the public or to the SEC and the Financial Industry Regulatory Authority, Inc. and the feasibility and cost-benefit analysis of a voluntary pilot program where public companies will agree to have all trades of their shares marked "short," "market maker short," "buy," "buy-to-cover," or "long," and reported real time through the Consolidated Tape.

Federal Reserve Study on Bankruptcy

Within one year, the Federal Reserve, in consultation with the Administrative Office of the U.S. Courts, is directed to conduct a study and report to Congress regarding the resolution of financial companies under chapters 7 and 11 of the U.S. Bankruptcy Code. Among the issues to be studied include the effectiveness of chapters 7 and 11 of the U.S. Bankruptcy Code in facilitating the orderly resolution or reorganization of systemically important financial companies.

¹¹ *Investigation of Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme - Public Version* – (August 31, 2009) available at <http://www.sec.gov/news/studies/2009/oig-509.pdf>.

Impacts to Registered Funds and Advisers as “Buy-Side” Participants in the Financial Marketplace

Derivatives Regulation

The Act will require, among other things, clearing and exchange trading for most over-the-counter (“OTC”) derivatives, and will impose new capital and margin requirements and various reporting and record-keeping obligations on “major swap participants” (“MSPs”) such as OTC swap dealers and most large OTC swap participants. The Act will also require MSPs to register with either the SEC or CFTC, as applicable.

MSPs are persons (i) who maintain a “substantial position” in swap transactions, excluding positions held for hedging or mitigating the participant’s commercial risk (commonly referred to as “commercial end users”) and positions held by employee benefit plans; (ii) whose outstanding swaps create “substantial counterparty exposure” that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets; or (iii) who are financial entities that (A) are “highly leveraged relative to the amount of capital [they] hold” and “are not subject to capital requirements established by an appropriate federal banking agency” and (B) maintain a substantial position in outstanding swaps transactions. While there would seem to be a strong argument that (i) it is unlikely that a registered fund could have sufficient counterparty exposure to cause serious adverse effects on the U.S. banking system or financial markets and (ii) the limitations on investment companies’ use of swaps imposed by Section 18 of the 1940 Act would prevent the type of leverage component described, funds and advisers will want to closely monitor and participate in the ongoing rulemaking and comment process as these issues are determined by the SEC and CFTC.

Increased regulation of exchange trading and clearing of MSPs is expected to mitigate risk exposure for registered funds and advisers that regularly enter into derivatives contracts. These changes may also limit some of the flexibility registered funds and advisers have with respect to individually negotiated derivative trades. As with many other provisions of the Act, future rulemaking and implementation will determine the ultimate effect of these provisions on registered funds and advisers.

Additional Regulation in the Municipal Securities Area

A number of new requirements are imposed on municipal securities offerings and persons involved with such offerings. Municipal advisers must be registered under the Exchange Act to provide advice or solicit services. Registered investment advisers that provide advice to municipalities or on municipal securities will not need to register, but certain of their activities will be subject to regulation. The Act also requires the SEC to establish an Office of Municipal Securities by October 1, 2010 to have responsibility for administering SEC rules related to practices of municipal securities broker-dealers, municipal securities advisors, municipal securities investors, and municipal securities issuers and for coordinating rulemaking and enforcement with the MSRB. There are also a number of studies mandated that relate to the municipal securities market.

Asset-Backed Securities

Within 270 days, certain federal regulatory agencies, including the SEC, are directed to jointly issue regulations requiring the “securitizer” of an asset-backed security (“ABS”) to retain (without hedging) at least 5% of the credit risk of the securitized assets collateralizing the ABS that are not qualified residential mortgages. The regulations are required to differentiate among asset classes, including residential mortgages, commercial mortgages, commercial loans, auto loans, and other classes the ABS agencies deem appropriate. The regulations are also to address the risk retention requirements for collateralized debt obligations (“CDOs”) and securities collateralized by CDOs or other ABS.

Enhanced Regulation, Accountability, and Transparency of NRSROs

As noted above, the Act requires the SEC to establish an Office of Credit Ratings to administer the SEC’s rules regarding credit rating agencies. The Office will conduct annual compliance examinations of each NRSRO and will publish the results of those examinations. Each NRSRO is required to include attestations to its credit ratings and the SEC is directed to prescribe rules regarding procedures and methodologies to be used by NRSROs, including qualitative and quantitative data and models for ratings.

During negotiations regarding the legislation, certain Members of Congress argued that the best approach to dealing with the problems of NRSROs was to increase regulatory oversight, while others advocated a free

market approach and supported the elimination of all references to NRSROs in statutes and rules so that issuers (including funds) would be free to determine how best to use credit ratings. Instead of choosing a particular path, the Act utilizes both approaches.

Securities Lending Rulemaking

The Act amends Section 10 of the Exchange Act to make it unlawful to effect, accept or facilitate a transaction involving the loan or borrowing of securities in contravention of SEC rules. The amendment requires the SEC to promulgate rules, within two years, designed to increase the transparency of information available to broker-dealers and investors with respect to the loan or borrowing of securities.

Securities lending is an area that has become subject to more SEC scrutiny in recent years, particularly following losses experienced by certain cash collateral funds. At the recent SEC Roundtable on Securities Lending, several participants noted the lack of recent SEC guidance in this area. This provision may encourage the SEC to provide registered funds and others with additional guidance.

Changes in the Governance Requirements of Public Companies and Systemic Risk Regulation

Non-Binding Shareholder Votes on Executive Compensation

The Act requires public companies to include in their proxy materials non-binding votes on executive compensation and golden parachutes. Because funds are typically externally managed and do not provide direct executive compensation, the impact of these provisions should be minimal on funds and on advisers that are not public companies. Nevertheless, each institutional investment manager subject to Section 13(f) of the Exchange Act is required to publicly disclose, in 13F reports, its voting record on non-binding executive compensation and golden parachute proposals.

Compensation Committee Independence

Listing standards of national securities exchanges and rules of national securities associations must require that, to the extent a listed public company has a compensation committee, the committee must consist entirely of directors, and that those directors must be independent. Open-end registered investment compa-

nies, including exchange-traded funds, are specifically excluded from this requirement. However, the requirement applies to closed-end registered investment companies and business development companies whose shares are listed on an exchange. The Act does not specify the meaning of “independence” for purposes of compliance with this requirement; it is likely that the national securities exchanges and associations will establish this definition through subsequent rulemaking. National securities exchanges could choose to apply a definition consistent with the “interested person” definition in the 1940 Act the way many exchanges (e.g., the NYSE) do with respect to the composition of the audit committee, rather than imposing a more burdensome or different independence requirement. However, this remains to be seen.

A compensation committee of a listed company is also permitted to retain compensation consultants after considering their independence. If a compensation consultant is retained, the company must disclose this fact in any proxy statement (commencing one year from the enactment of the Act), and must disclose whether the work of the consultant raised any conflicts of interests.

Increased Disclosure and Possible Prohibition of Certain Incentive Compensation Arrangements

Within nine months of enactment of the Act, certain federal regulators, including the SEC, are required to jointly issue regulations or guidance requiring certain “covered financial institutions” to disclose the structure of all incentive-based compensation arrangements providing an executive officer, employee, director or principal shareholder with “excessive compensation, fees or benefits” or that could lead to “material financial loss to the financial institution.” Additional regulations or guidance must be adopted to prohibit compensation structures that are deemed to be excessive or risky. This very broad mandate contains little specific guidance, including no definition of “incentive compensation.”

Included within the definition of “covered financial institution” are broker-dealers and investment advisers that have assets (not assets under management) of \$1 billion or more and “any other financial institution that the appropriate federal regulators, jointly, by rule, determine should be treated as a covered financial institution.” The definition of “covered financial institution” also contains a catch-all provision to allow regulators to include other types of firms with similar characteristics and also to prevent firms with several different types of businesses from restructuring around these restrictions by moving employees to an unregulated

subsidiary. Accordingly, financial services firms with large investment advisory and broker-dealer businesses should prepare for rulemaking regarding incentive-based compensation, including potential rulemaking or other guidance discouraging or restricting certain compensation practices that are deemed to encourage excessive risk-taking.

Voting by Brokers

The Act prohibits brokers from voting shares held in street name on behalf of their beneficial owner clients without receiving specific voting instructions from the beneficial owners for certain “significant matters” such as election of directors, executive compensation, or any other matter determined to be “significant” by the SEC. This provision specifically does not apply to uncontested director elections for registered investment companies.

This provision is similar in many respects to New York Stock Exchange (NYSE) Rule 452 and American Stock Exchange (AMEX) Rule 577. However, unlike NYSE Rule 452, AMEX Rule 577 does not prohibit broker discretionary voting with respect to the uncontested election of directors for listed companies except for registered investment companies. FINRA Rule 2251 does not permit discretionary broker voting except in accordance with the rules of an exchange of which a broker is a member, such as the NYSE or the AMEX. The Act and related SEC rulemaking would likely harmonize the treatment of discretionary broker voting across the national securities exchanges and national securities associations. Further, and more significantly, SEC rulemaking could broaden the types of matters to which the prohibition would apply. For example, fund reorganizations requiring a shareholder vote could be subject to broker voting restrictions, if deemed a “significant matter” by SEC rule. Such a change would likely result in higher expenses and more difficult proxy solicitations for registered investment companies.

Shareholder Access to Proxy Ballots

The Act provides specific authority to the SEC to adopt rules requiring public companies to include shareholder nominees for director in their proxy materials. The SEC is permitted to exempt certain companies (e.g., small issuers) or classes of companies from this requirement. The SEC could, in its rulemaking, exempt registered investment companies from this requirement. However,

the legislation does not specifically mention registered investment companies as it does in other corporate governance-related provisions, which may make it less likely that registered investment companies will be exempt.

The SEC has sought to increase shareholder access to proxy ballots in recent years (including a rule proposal to require the inclusion of shareholder nominees in company proxy materials), and the SEC’s new authority to adopt rules in this area will continue to encourage this trend. If registered investment companies are not exempted from this requirement, this change could result in higher expenses and an increased likelihood of changes in the composition of fund boards of directors.

Disclosure Regarding Chairman and CEO Structures

Within 180 days of enactment of the Act, the SEC must adopt rules requiring public companies to disclose in their annual proxy statement why the company has determined to combine or not to combine the roles of chairman of the board and chief executive officer. Closed-end registered investment companies, business development companies and other exchange listed companies that mail an annual proxy statement are subject to this additional reporting requirement.

Currently, Item 407(h) of Regulation S-K, which was adopted by the SEC in December 2009 as part of the enhanced disclosure requirements (and which is incorporated by reference into Item 22(b)(11) of Schedule 14A), requires that a public company must disclose “whether the same person serves as both principal executive officer and chairman of the board” and “why [the company] has determined that its leadership structure is appropriate given the specific characteristics or circumstances of [the company].” It remains to be seen whether any SEC rulemaking pursuant to the Act will impose additional requirements or will further modify this disclosure obligation.



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