Financial Reform Act Has Broad Impact on Investment Management Industry

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act), signed into law by President Obama July 21, 2010, and effective one day after enactment (with exceptions noted in the Act), touches almost every aspect of U.S. financial markets. The Act’s broad reach will have a significant impact on the financial services industry, including implications for investment advisers, broker-dealers, participants in the derivatives market and registered investment companies.

I. Implications for Private Funds and Other Advisers

Registration Under the Advisers Act

Removal of *de minimis* and Intrastate Exemptions

The Act removes two important exemptions from the investment adviser registration requirements for advisers to private funds under the Investment Advisers Act of 1940, as amended (Advisers Act). First, Section 403 eliminates the so called “*de minimis*” exemption from the Advisers Act, which applies to an adviser with fewer than 15 clients in any 12-month period that does not hold itself out generally to the public as an investment adviser and does not advise registered investment companies. This exemption is commonly relied on by private fund managers advising fewer than 15 funds because each fund is generally treated as a single client of the manager without regard to the number of underlying investors in the fund under Rule 203(b)(3)-1 of the Advisers Act. Second, Section 403 provides that advisers to private funds are not eligible to use the current exemption for investment advisers whose clients are all residents of the adviser’s home state. A private fund is defined in Section 402 (for purposes of this change and for other sections of the Act) as any pooled investment vehicle that would be an investment company under the Investment Company Act of 1940, as amended (the 1940 Act) but for sections 3(c)(1) or 3(c)(7).

Exemption for Advisers with less than $150 Million Under Management

Section 408 creates a new exemption from registration for advisers to only private funds with total assets under management in the United States of less than $150 million. These
advisers are subject to the recordkeeping and reporting rules the Securities and Exchange Commission (SEC) determines are necessary or appropriate in the public interest and for the protection of investors. These advisers may have to register under one or more state laws.

Special Consideration for Mid-Size Private Fund Advisers

Section 408 provides that the SEC must consider the systemic risk posed by mid-sized private funds when prescribing registration and examination procedures for advisers to those funds. The Act does not define “mid-sized private funds” but, presumably, they are smaller private funds whose advisers are not eligible for the $150 million exemption.

Adjustment of Federal Registration Eligibility

While Section 410 of the Act maintains the minimum amount of assets under management for registration with the SEC at $25 million, it provides that investment advisers with between $25 million and $100 million in assets under management that would be required to be registered with the state in which they have their primary place of business (and would be subject to examination by such state) may not register with the SEC unless the adviser otherwise would be required to register with 15 or more states. The SEC may increase the $100 million threshold by rule.

Sections 403, 408 and 410 become effective one year after the date of enactment of the Act, except that any investment adviser may, at its discretion, register with the SEC under the Investment Advisers Act of 1940 during that one-year period, subject to SEC rules.

New Exemptions for Foreign Private Advisers, Family Offices and Venture Capital

A new de minimis exemption is created in Section 403 for “foreign private advisers.” A foreign private adviser is defined in Section 402 as an investment adviser that: 1) has no place of business in the United States; 2) has fewer than 15 clients in the United States (either directly or through a private fund managed by the adviser); 3) has assets under management attributable to clients in the United States of less than $25 million (or such higher amount as the SEC may prescribe); and 4) it does not generally hold itself out in the United States as an investment adviser and is not an investment adviser to a registered investment company or business development company.

Additionally, the Act changes the definition of investment adviser to exclude family offices (Section 409) and add exclusions from registration for advisers to venture capital funds (Section 407). The Act directs the SEC to define “venture capital fund” within one year of the Act’s enactment. Venture capital fund advisers relying on the exemption are subject to the recordkeeping and reporting rules the SEC determines are necessary or appropriate in the public interest and for the protection of investors. There are no recordkeeping or reporting obligations for family offices.

Recordkeeping and Reporting Requirements

In addition to the existing regulatory and reporting obligations of registered investment advisers, Section 406 requires registered investment advisers of private funds to provide the SEC and a newly created Financial Stability Oversight Counsel with additional information about each private fund they manage. The Act also directs the SEC to conduct periodic inspections of all records of private funds managed by registered investment advisers. These records will generally be treated as confidential and not subject to public
disclosure. The records must include a description of: 1) assets under management and use of leverage; 2) counterparty credit risk exposure; 3) trading and investment positions; 4) valuation methodologies; 5) types of assets held; 6) side agreements or side letters; 7) trading practices; and 8) any other information the SEC, in consultation with Financial Stability Oversight Counsel, deems necessary and appropriate in the public interest and for the protection of investors or for the assessment of systemic risk. These provisions become effective one year after enactment of the Act.

Other Provisions of Interest to Advisers

Independent Custody of Client Assets

Section 411 of the Act amends the Advisers Act to require registered investment advisers, within one year after the date of enactment of this Act, to follow SEC rules relating to the custody of client assets, including, without limitation, a requirement for verification of those assets by an independent public accountant. Custody requirements are currently imposed by Rule 206(4)-2 under the Advisers Act, commonly referred to as the Custody Rule.

Adjustment of Accredited Investor Standard; Modification of Rule 506

Section 413 immediately adjusts the accredited investor standard as set forth in the rules of the Securities Act of 1933, as amended (Securities Act), to exclude the value of primary residences from the determination of whether the individual net worth of a natural person (or joint net worth with that person’s spouse) exceeds $1 million. The SEC is prohibited from adjusting that amount prior to the expiration of the four-year period from enactment of the Act. The Act also allows the SEC, during this initial four-year period, to review other components of the accredited investor definition applicable to natural persons and enact rules relating to those other components. After that initial four-year period, and no less frequently than every four years thereafter, the SEC must undertake a review of the entire accredited investor definition applicable to natural persons and may enact rules adjusting that definition upon completion of each review.

Section 926 of the Act requires that, no later than one year from enactment, the SEC must enact rules disqualifying “bad actors” from relying on Rule 506 to conduct a private offering of securities. Virtually all hedge funds, private equity funds and venture capital funds offer their securities pursuant to Rule 506.

Adjustment of Qualified Client Standard

Section 418 requires the SEC to adjust the Qualified Client standard for inflation within one year of the date of enactment and every 5 years thereafter.

Short Sale Reform

Newly enacted Section 929X impacts the regulation of short sales in three ways. First, Section 929X(a) requires the SEC to prescribe rules requiring institutional investment managers to disclose information relating to short positions on Form 13F. Second, 929X(b) amends the Securities Exchange Act of 1934, as amended (Exchange Act) to prohibit “manipulative” short sales. Finally, 929X(c) requires broker-dealers to notify customers that: 1) they may elect not to allow their securities to be lent in connection with short sales; and 2) the broker-dealer may receive compensation for using a customer’s securities to effect a short sale.
Volcker Rule Limitation on Banks’ Hedge Fund and Private Equity Fund Activities

Section 619 of the Act, commonly referred to as the Volcker Rule, among other things, prohibits any banking entity from engaging in proprietary trading, or sponsoring or investing in a hedge fund or private equity fund. Under Section 619, a banking entity is defined as an insured depository institution, a company that controls an insured depository institution, a company treated as a bank holding company and any subsidiaries of such institutions or companies (including broker-dealer and fund manager subsidiaries). Sponsoring is defined as: 1) serving as a general partner, managing member or trustee of a fund; 2) selecting or controlling a majority of the fund’s directors, trustees or management; or 3) having the same name or variation of the same name of the fund. Hedge funds and private equity funds are broadly defined as companies exempt from registration under the Investment Company Act by virtue of Section 3(c)(1) or 3(c)(7) thereof.

Notwithstanding the general prohibition above, banking entities may still sponsor a private equity or hedge fund, provided that all of the following requirements are met:

> the bank provides bona fide trust, fiduciary or investment advisory services to the fund;
> the fund is offered only in connection with the provision of such services and only to customers of the bank;
> the bank and its affiliates do not engage in “covered transactions” with the fund and treat the fund as if it were an affiliate for purposes of Section 23B of the Federal Reserve Act;
> the bank does not guarantee the obligations or performance of the fund or any sub-fund;
> the bank and the fund do not have the same name or variations of the same name;
> only directors or employees of the bank who provide services to the fund have ownership interests in the fund;
> disclosure is made to investors in the fund that losses will not be borne by the bank; and
> the bank makes only a seed investment or other de minimis investment in the fund, provided that: 1) the bank must actively seek other investors; 2) the bank’s investment can not be more than 3 percent of the fund within one year after the fund’s establishment (with the possibility of a two-year extension); and 3) the investment must be “immaterial” to the bank, as defined by regulators pursuant to rulemaking, but in no case may the bank’s aggregate seed and de minimis investments exceed 3 percent of the bank’s Tier 1 capital.

The Volcker Rule becomes effective the earlier of: 1) 12 months after the issuance of final rules, which must be issued within 15 months of enactment; or 2) two years after enactment. Banks will then have more two years to dispose of prohibited investments or relationships subject to up to three possible one-year extensions by the Federal Reserve Board. The Federal Reserve Board may also grant one additional exemption of up to 5 years for illiquid funds on a case-by-case basis.
Authority to Restrict Mandatory Arbitration Clauses

Section 921 amends the Advisers Act to give the SEC the authority to conduct rulemaking to prohibit or limit mandatory predispute arbitration agreements by clients of investment advisers for disputes arising under the securities laws. The Act directs the SEC to conduct this rulemaking within 180 days of its enactment and to prohibit or limit arbitration clauses if it finds that this prohibition or limitation is in the public interest and for the protection of investors. A similar amendment to the Exchange Act requires the SEC apply the same rulemaking process to arbitration agreements of brokers, dealers or municipal securities dealers.

Studies and Reports

The Act requires several studies, including: 1) a study by the Comptroller General of the United States (Comptroller General) on appropriate criteria for accredited investor status for private funds (Section 415); 2) a study by the Comptroller General on the feasibility of a self-regulatory organization to oversee hedge funds, private equity funds and venture capital funds (Section 416); 3) a study by the Comptroller General on the compliance costs associated with the Custody Rule (Section 412); and 4) a study by the SEC on the state of short selling in the stock market (Section 417).

II. Implications for Broker-dealers

SEC Study and Rulemaking Regarding Broker-Dealer Standards of Care

Section 913 of the Act requires the SEC to conduct a comprehensive study on broker-dealer and investment adviser standards of care, and authorizes (but does not require) the SEC to promulgate rules imposing a fiduciary standard on broker-dealers when providing investment advice to retail customers. Section 913 generally defines “retail customer” as a natural person who receives personalized investment advice from a broker-dealer or investment adviser primarily for personal, family or household purposes, which would exclude institutional clients of broker-dealers from the fiduciary standard of care requirement.

Study and Report

The SEC is required to conduct a study evaluating the effectiveness of the current standards of care required of broker-dealers and investment advisers when providing advice to retail customers and to submit its findings in a report (Report) to Congress no later than six months after the Act’s enactment. The Report must consider public input and include the SEC’s findings, conclusions and recommendations.

Among other topics, the SEC’s study of broker-dealer and investment adviser standards of care shall consider the following items:

> substantive differences in standards of care required of broker-dealers and investment advisers when providing personalized investment advice, and gaps, shortcomings or overlaps between the standards;
> differences in the services provided to retail customers by broker-dealers, investment advisers and other financial services personnel;
> the effectiveness of current standards of care and specific instances in which each standard of care provides greater investor protection;

> retail customer understanding and/or confusion regarding the current standards of care;

> resources currently devoted to enforcement of standards of care and the frequency, effectiveness and duration of current examinations ensuring standard of care compliance;

> current broker-dealer and investment adviser standards of care required by states;

> the impact on retail customers, broker-dealers and investment advisers of requiring a fiduciary standard of care from broker-dealers;

> the impact of eliminating the current exclusion of broker-dealers from the statutory definition of “investment adviser”;

> benefits and harms to retail customers that may result from changing standard of care obligations; and

> projected additional costs and expenses associated with any such changes.

**Broker-Dealer Fiduciary Standard Authorized**

Section 913 authorizes the SEC to immediately promulgate rules harmonizing the standards of care required of broker-dealers and investment advisers when providing investment advice to retail customers by imposing a fiduciary standard on broker-dealers. Although such rulemaking is not required by the Act, the SEC must consider the findings of its Report if it promulgates such a rule.

Section 913 also amends the Exchange Act and the 1940 Act to accord with this authorization, and defines the scope of the SEC’s authorization. The amendments provide that:

> the standard of conduct for broker-dealers and investment advisers when advising retail customers shall be to act in the “best interest” of the customer without regard to the financial or other interests of the broker-dealer or investment adviser providing the advice;

> broker-dealers will not have an ongoing duty of care or loyalty to retail customers following the provision of personalized investment advice;

> the receipt by broker-dealers of transaction-based compensation or commissions for the sale of securities shall not, in and of itself, be considered a breach of their fiduciary duty;

> the SEC may require disclosure by broker-dealers in the event that they only offer proprietary or a limited range of products, and that such limited offerings shall not, in and of themselves, be considered a breach of the broker-dealer’s fiduciary duty; and

> the SEC shall harmonize enforcement of standard-of-care violations by investment advisers and broker-dealers.
Restrictions on Proxy Voting by Broker-Dealers

Effective immediately, Section 957 of the Act prohibits a broker-dealer that is not the beneficial owner of a security from voting that security’s proxy in certain “shareholder votes” unless the beneficial owner has instructed the broker-dealer to do so. “Shareholder votes” include board of director elections, matters related to executive compensation and other significant matters to be determined by the SEC, but excludes a vote in an uncontested election of a member of the board of directors of a registered investment company.

PCAOB Oversight of Broker-Dealers

Section 982 of the Act amends the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley) to provide the Public Company Accounting Oversight Board (PCAOB) with authority over audits of broker-dealers comparable to its current authority over audits of issuers of securities. Any audited balance sheet, income statement or other financial statement required to be filed by a broker-dealer must be certified by a public accounting firm registered with PCAOB.

Section 982 authorizes PCAOB to promulgate standards for audits of broker-dealers, to inspect broker-dealer audit reports, and to investigate and bring proceedings related to or arising from those audits. PCAOB is also authorized to identify public accounting firms that lack expertise or fail to exercise care in audits of broker-dealers, identify and address audit deficiencies, and suspend or bar non-compliant public accounting firms from conducting broker-dealer audits.

Sarbanes-Oxley as amended will also require broker-dealers to pay an annual accounting support fee to PCAOB. The fee is intended to offset the cost of PCAOB oversight of broker-dealers, and will be allocated among broker-dealers proportionately based on their net capital.

III. Implications for Trading Over-the-Counter Derivatives

Title VII of the Act provides for comprehensive regulation of over-the-counter OTC derivatives by the Commodity Futures Trading Commission (CFTC) and SEC. The exemptions from the Federal securities and commodities laws for OTC derivatives are eliminated and replaced with a system that gives the SEC regulatory authority over security-based swaps (SB swaps) and gives the CFTC regulatory authority over all other swaps. Participants in both the swap and SB swap markets will be regulated by both the CFTC and SEC.

The regulatory program will require most OTC derivatives to be traded on an exchange or swap execution facility and cleared through a clearing agency or other organization. It will also require most participants and firms engaged in trading such derivatives to register as swap market participants, satisfy capital requirements and report all derivatives activities to either the CFTC or SEC.

Non-financial entities that engage in swaps or SB swaps to reduce the commercial risks of their businesses will not be required (but may if they wish) to have their swaps and SB swaps traded on an exchange or other trading facility and cleared through a designated clearing organization. This so-called “end user” exemption recognizes the commercial hedging benefits arising out of customized OTC derivatives entered into by non-financial companies.
The CFTC and SEC will consult with each other and other regulators before each commission commences any rulemaking with regard to swaps, SB swaps and other related defined terms in Title VII. After consulting with each other and other regulators, each commission will issue its own rules, regulations or orders within 360 days after the date of enactment of Title VII. The CFTC and SEC, in consultation with the Federal Reserve Board of Governors, must also issue joint rules for the books and records that are to be kept and maintained regarding swap and SB swap agreements. In addition, the CFTC and the SEC are required to treat functionally or economically similar products or entities in a similar manner and issue joint regulations for mixed swaps.

Either commission may prohibit by rule an entity domiciled in a foreign country from participating in a swap in the US if the commission determines the foreign entity undermines the U.S. financial system. Either commission may also prohibit by rule U.S. persons from participating in foreign based swaps.

The CFTC and SEC have joint authority to investigate potentially abusive swaps.

**Swaps vs. SB Swaps and Other Definitions**

Title VII defines swap broadly enough to capture nearly all OTC derivatives other than SB swaps. SB swaps are swaps based on a narrow-based index, single security or loan, or the occurrence or nonoccurrence of an event relating to a single insurer. Other main defined terms are as follows:

- **Major Swap/SB swap participant** – any swap/SB swap dealer that maintains a substantial position in swaps/SB swaps for any of the major swap/SB swap categories determined by the commissions and those outstanding swaps/SB swaps create substantial counterparty exposure that could have serious adverse effects on the U.S. financial stability or banking system.

- **Financial Entities** is a broad category of major swap/SB swap participants. These are entities not subject to federal bank capital requirements with significant leverage or swap/SB swap positions, such as state banks, credit unions, mortgage lenders, insurance companies, hedge funds, commodity pools, ERISA plans and advisors to those entities.

- **Substantial position** – the CFTC and SEC shall define by rule or regulation the threshold of “substantial position.”

- **Swap/SB swap dealer** – holds itself out as a dealer in swap/SB swaps; makes a market in swaps/SB swaps; regularly enters in swap/SB swaps with counterparties in the ordinary course of business; or engages in any activity causing it to be commonly known in the trade as a dealer.

- **Regulated swap/SB swap entity** – is a swap/SB swap dealer or a major swap/SB swap participant.

- **Swap/SB swap execution facilities** – a trading system or platform in which multiple participants have the ability to execute or trade swaps/SB swaps by accepting bids and offers.

- **Swap/SB swap data repository** – any business that collects and maintains information or records with respect to transactions or positions in swaps/SB swaps entered into by third parties for the purpose of providing a centralized record-keeping facility for swaps/SB swaps.
Regulation of the Swaps/SB Swaps Markets

Mandatory Clearing for Swaps/SB Swaps

Title VII provides that central clearinghouses will clear swaps/SB swaps. All swaps/SB swaps must be submitted to a central clearinghouse if that clearinghouse has been approved to clear that particular type of swap/SB swap.

Swaps will be cleared by derivative clearing organizations (DCOs) and SB swaps will be cleared by clearing agencies. The DCOs’ and clearing agencies’ rules must prescribe that all swaps/SB swaps submitted to the DCO or clearing agency with the same terms and conditions are economically equivalent within the DCO or clearing agency and may be offset with each other. The CFTC and SEC must review each swap/SB swap or type of swap/SB swap to make a determination that such swap/SB swap or type of swap/SB swap should be required to be cleared. A DCO or clearing agency must submit to the CFTC or SEC for prior approval the type of swap/SB swap the clearing agency seeks to accept for clearing. The commission then must take action on the request within 90 days. The CFTC and SEC must establish rules within one year for a DCO’s or clearing agency’s submission for review of swaps/SB swaps or type of swaps/SB swaps.

The CFTC and SEC are required to take necessary actions if either determines swaps or SB swaps or any type of swap or SB swap should be subject to mandatory clearing but no clearing agency has listed the swap/SB swap. These actions may include imposing margin and/or capital requirements on the parties to such swap/SB swap.

Swaps/SB swaps entered into before the date of the enactment of the mandatory clearing requirement must be reported to a registered swap/SB swap data repository or the commissions no later than 180 days after Title VII’s effective date. The mandatory clearing requirement will not apply until the CFTC or SEC has required clearing of the swap/SB swap and a DCO or clearing agency has been approved to clear the swap/SB swap.

The CFTC and SEC are required to enact rules preventing evasion of Title VII’s mandatory clearing requirements.

Optional Clearing

Title VII anticipates that some types of swaps/SB swaps will be accepted for clearing at a DCO or clearing agency but will not be subject to mandatory clearing by the SEC or CFTC. These swaps may be cleared if the parties to the swap agree. These swaps must be cleared if 1) one party is a regulated swap entity, 2) the counterparty is an end user and 3) the end user wants the swap/security based swap to be cleared.

Swaps/SB Swap Execution Facilities

Swaps and SB swaps that are subject to the mandatory clearing requirement must also be executed on a regulated exchange. The mandatory exchange trading requirement will not apply to a swap/SB swap if no exchange lists it for trading.

Title VII requires that each facility for the trading or processing of swaps/SB swaps must be a derivatives clearing member (DCM), national securities exchange or newly created type of exchange called a “swap execution facility” or “SB swap execution facility.” Registered swap/SB swap execution facilities must establish various rules and enforce compliance of those rules, including trading and trade processing and related monitoring rules as well as participation rules aimed to deter abuses.
The swap/SB swap execution facilities also must:

- make public timely information on price, trading volume and other trading data as required by the commissions;
- maintain records of all activities relating to the business of the facility, including a complete audit trail, for a period of 5 years;
- establish rules to minimize conflicts of interest;
- have adequate financial, operational and managerial resources to discharge its responsibilities;
- establish and maintain a program of risk analysis and oversight to identify and minimize operation risk through controls, including reliable and secure automated systems; and
- designate a chief compliance officer whose duties include, among other items, to annually prepare a report on the compliance of the facility.

Exceptions to Clearing and Exchange Trading Requirements.

Title VII includes an exemption from the exchange trading and mandatory central clearing requirements if one of the parties is an “end user.” An end user is a person who is: 1) not a “financial entity”; 2) using the swap/SB swap to hedge or mitigate commercial risk; and 3) notifies the applicable regulatory agency how it will meet its financial obligations under the swap or SB swap.

Margin and Capital Requirements for Non-Cleared Trades

Title VII gives the CFTC and SEC broad authority to impose margin and capital requirements on non-cleared swaps/security based swaps.

Segregation of Collateral

Title VII requires segregation of collateral for both cleared and non-cleared swaps/SB swaps.

Similar to existing segregation requirements for broker-dealers and futures commission merchants, the money, securities and property of any swap/SB swap customer received to margin, guarantee or secure a SB swap cleared through a clearing agency must be treated as belonging to the swap/SB swap customer. Generally, no commingling of collateral is permitted subject to certain exceptions, including, for example, the collateral may be invested in U.S. obligations or may be commingled and deposited in a single bank account.

In the case of uncleared swaps, segregation of assets held as collateral is also required in some circumstances. Regulated swap entities must notify counterparties who are not regulated swap entities of the right to require segregation of the funds supplied to margin to secure the obligations of the counterparty.

Reporting Non-Cleared Trades

Title VII requires non-cleared swaps/SB swaps to be reported to the CFTC, the SEC or a “swap data repository.”

Swap/SB swap data repositories must be registered with the CFTC and/or SEC and are subject to examination and inspection. The Act sets forth core principles for the
repositories and requires that the CFTC and SEC, among others things, specify the data elements that will be collected and maintained by the repository. Each repository must also have a chief compliance officer who, among other things, produces an annual report on each policy and procedure of the repository.

Large Trader Reporting

Title VII requires reporting by large swap/SB swap traders whose swap/SB swap activity is not otherwise regulated.

Publication of Pricing Data

Title VII requires the CFTC and SEC to provide for real-time reporting of data on swaps/SB swaps. The commissions are directed to establish the specific data to be reported though their rulemaking processes. The commissions must issue a semi-annual and annual report available to the public releasing information about: 1) the trading and clearing in the major swap/SB swap categories; and 2) market participants and developments in new products.

Risk Disclosures to Unregulated Counterparties

Title VII requires regulated swap/SB swap entities to disclose material risks, characteristics, conflicts of interest and receipt of daily marks of the transaction to all unregulated counterparties.

Position Limits

Title VII gives the CFTC and SEC the authority to set position and trading limits for swaps/SB swaps. The Act directs the CFTC to incorporate swaps into its existing aggregate position and trading limits framework and to establish position limits with respect to swaps that are economically equivalent to futures or options on futures. The Act directs the SEC to set limits on the amount of positions a person may hold in any SB swap. The SEC may aggregate securities-based swap positions with holdings in related securities or loans.

Registration and Regulation of Swap Dealers and Major Swap Participants

Swap/SB swap dealers and major swap/SB swap participants must also register with the CFTC and/or the SEC. The commissions have broad authority to determine the substantive scope of regulation.

Swap/SB swap dealers and major swap/SB swap participants that are not banks must meet the capital and margin requirements that will be established by the commissions. Those entities that are banks must meet the capital and margin requirements established by the banks’ applicable regulator. The CFTC, SEC and bank regulators must consult with each other at least annually on the minimum capital and margin requirements. The CFTC, SEC and bank regulators also must establish rules for reporting and recordkeeping of these entities.

Title VII further lists the duties of each registered swap/SB swap dealer and major swap/SB swap participant. These duties include monitoring trading and establishing risk management procedures (including conflicts of interest procedures) and designating a chief compliance officer. The CFTC and SEC will have the authority to censure, place limitations on the activities, functions or operations of any swap/SB swap participant registered with CFTC or SEC.
Bank “Push Out” Rule

One of the most hotly debated aspects of the new OTC derivatives regulation, the so-called bank push-out rule proposed by Senator Blanche Lincoln, will allow banks to keep their business in certain “less risky” derivatives including interest rate swaps and investment grade credit default swaps. Banks that want to engage in other types of “more risky” derivatives, such as certain metals and below-investment-grade credit default swaps, will have to conduct this activity through a separately capitalized entity walled off from federally insured deposits.

After the transition period, which is currently up to 24 months, a bank must limit its swap or SB swap activity to hedging and other similar risk-mitigating activities or acting as a swap entity for swaps or SB swaps tied to certain permissible assets and certain credit default swaps as long as the swap is cleared through a registered derivatives clearing organization or clearing agency. If a bank qualifies as a “swaps entity,” it will have up to 24 months to divest the swaps entity or cease the activities that would require it to register as a swaps entity.

Finally, no federal assistance, including federal deposit insurance or access to the Federal Reserve discount window, may be provided to any swaps entity with respect to any swap, SB swap or other activity of the swap entity. No bank that is a swap entity that is put into receivership or declared insolvent as a result of a swap activity will receive taxpayer funds to prevent the receivership. A bank or bank holding company is not permitted to be or become a swap entity unless it conducts its swap or SB swap activity in compliance with minimum standards that are required to be set by the bank regulators.

Required Studies

Title VII requires various joint studies by the CFTC and SEC. These studies include reports on 1) the feasibility of requiring the derivatives industry to adopt standardized computer-readable algorithmic descriptions for financial derivatives; 2) swap regulation in the US, Asia and Europe and 3) whether “stable value contracts” are swaps. The Act also directs the CFTC to study the effects of position limits on excessive speculation and on the movement on transactions from U.S. exchanges to non-U.S. exchanges.

Conflicts-of-Interest Rules

Within 180 days after the date of enactment, the commissions must adopt conflicts-of-interest rules. These rules may include numerical limits on the control of or the voting rights with respect to any DCO, clearing agency or any swap or SB swap execution facility or national securities exchange that posts or makes available for trading swaps, including rules governing whether these entities may be owned or affiliated with certain bank holding companies or nonbank financial companies.

Other Provisions

Institutional Investment Managers

Section 13 of the Exchange Act is amended to require generally that certain SB swaps are deemed to constitute beneficial ownership of the underlying stock (i.e., a look-through) for purposes of the reporting levels.
Portfolio Margining

Title VII amends the Commodity Exchange Act and Exchange Act to specifically allow for portfolio margining so that futures and securities positions can be maintained in one account.

Foreign Exchange Contracts

The definition of swap includes foreign exchange forwards and swaps that are cleared through a DCO or traded on a DCM or swap execution facility. Foreign exchange forwards and swaps that are not cleared or traded through a DCO, DCM or swap execution facility may be excluded from the requirements of Title VII if the Treasury Secretary determines they were not structured to evade Title VII and should not be regulated as swaps under Title VII (these foreign exchange forwards and swaps need to be reported to a swap data repository). Retail foreign currency trading continues to be subject to the CFTC’s jurisdiction.

Ban on Motion Picture Box Office Receipts

Title VII specifically bans futures contracts based on motion picture box office receipts.

Preemption

Title VII preempts the States from regulating swap/SB swaps as insurance, gaming or bucket shop laws.

CFTC Anti-Manipulation Authority

Title VII clarifies that the CFTC’s anti-market manipulation authority extends to swaps.

International Harmonization

Title VII requires the CFTC and SEC to work with foreign regulators to harmonize the international regulations for swaps and security based swaps.

Effective Date

The provisions of Title VII become effective 360 days after the date of enactment unless Title VII provides otherwise.

IV. Implications for Mutual Funds

Along with a general restructuring of the system of federal financial regulation, the Act contains provisions affecting registered investment companies under the 1940 Act.

Section 917 directs the SEC to conduct a study of investors and report back to the Senate Banking Committee and the House Financial Services Committee. The study must examine:

> the existing level of financial literacy among investors;
> methods to improve the timing, content and format of disclosures to investors with respect to financial intermediaries, investment products and investment services;
The most useful information for retail investors considering a purchase of mutual fund shares;
methods to improve the disclosure of fees and conflicts of interest;
existing private and public efforts to educate investors; and
a strategy to increase the financial literacy of investors that results in a positive change in investor behavior.

The Comptroller General is required to submit a report to Congress on the results of the study within one year after the date of enactment of the Act.

Section 919 amends the Exchange Act to clarify that the SEC may require disclosures be provided by a broker or dealer to a retail investor before the purchase of an investment product (including mutual fund shares) or service by the retail investor.

**Mutual Fund Advertising**

Section 918 of the Act requires the Comptroller General to conduct a study on mutual fund advertising to identify:

- existing and proposed regulatory requirements for open-end investment company advertisements;
- current marketing practices for the sale of open-end investment company shares, including the use of past performance data, funds that have merged and incubator funds;
- the impact of such advertising on consumers; and
- recommendations to improve investor protections in mutual fund advertising and additional information necessary to ensure that investors can make informed financial decisions when purchasing shares.

The Comptroller General is required to submit a report to Congress on the results of the study within 18 months after the date of enactment of the Act.

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**V. Other Notable Changes**

**NRSRO Regulation**

Subtitle C of Title IX of the Act gives the SEC broader authority over nationally recognized statistical ratings organizations (NRSROs) in order to enhance the transparency and accountability of NRSROs. Notably, among other changes relating to NRSROs, the Act:

- requires NRSROs to maintain, enforce and document an effective internal control structure governing the implementation of and adherence to policies, procedures and methodologies for determining credit ratings and charges the SEC with issuing rules requiring each NRSRO to submit an annual internal controls report;
- permits the SEC to temporarily suspend or permanently revoke an NRSRO’s registration for a particular class or sub-class of securities if the NRSRO lacks ad-
equate financial and managerial resources to consistently provide credit ratings with integrity;

> directs the SEC to issue rules to prevent the sales and marketing considerations of an NRSRO from influencing the production of ratings by the NRSRO;

> imposes new governance requirements on NRSROs, including the requirement to have an independent board of directors; and

> expands on the duties of an NRSRO’s compliance officer and provides that this individual is responsible for establishing procedures for the receipt and retention of: 1) complaints pertaining to credit ratings, models, methodologies and compliance with the securities laws and compliance policies and procedures; and 2) confidential, anonymous complaints by employees or users of credit ratings.

Office of Credit Ratings

The Act requires the SEC to establish within the SEC an Office of Credit Ratings (OCR). The OCR is charged with administering the SEC’s rules with respect to the practices of NRSROs in determining ratings for the protection of users of credit ratings and in the public interest, to promote accuracy in credit ratings issued by NRSROs, and to ensure these ratings are not unduly influenced by conflicts of interest. The OCR is required to conduct an annual examination of each NRSRO. The SEC must publish an annual report that summarizes the essential findings of the examinations and catalogues the NRSROs’ responses to material deficiencies that the OCR examinations find.

Study on Ratings for Structured Finance Products

The Act directs the SEC to conduct a study of the credit ratings process for structured finance products and the conflicts associated with various compensation models for these ratings. The SEC will examine whether an entity should be created that assigns NRSROs to rate new structured finance products, how NRSRO fees should be calculated and certain related issues. After submission of the report to Congress, the SEC is empowered to create a system for the assignment of NRSROs to provide initial ratings for structured finance products in a manner that prevents the product’s issuer, sponsor or underwriter from selecting the NRSRO. If, however, the SEC finds that an alternative system for providing initial credit ratings is preferable, it may make rules as it finds appropriate.

Disclosure of Credit Ratings

In order to facilitate the transparency of ratings performance, the SEC must issue rules requiring each NRSRO to publicly disclose information on the initial credit ratings determined by the NRSRO for each type of obligor, security and money market instrument and any subsequent changes to those credit ratings.

Each credit rating published by an NRSRO must also be accompanied by a form disclosing information on assumptions underlying the NRSRO’s credit rating procedures and methodologies, the data relied on in determining the credit rating and, if applicable, how the NRSRO used third-party reports, and the frequency of these reports, to conduct surveillance of the credit quality, and general information on the NRSRO’s credit rating categories. The form must also explain the potential volatility of a credit rating and assumptions that could, without accounting for any other factor, have an impact on the rating.
Credit rating agencies are also no longer exempt from the requirements of the SEC’s Regulation FD.

Credit Ratings Procedures and Methodologies

The SEC must issue rules requiring each NRSRO to ensure that: 1) credit ratings are determined using procedures and methodologies, including qualitative and quantitative data and models, that have been approved by the NRSRO’s board and in accordance with the NRSRO’s policies and procedures for the development and modification of credit rating procedures and methodologies; 2) when material changes to these credit rating procedures and methodologies are made, the changes are applied consistently to all credit ratings to which the changed procedures and methodologies apply, the changes are applied within a reasonable period of time and the NRSRO publicly discloses the reason for the change; and 3) users of credit ratings are notified of the version of a procedure or methodology used with respect to a particular credit rating, when a material change is made to a procedure or methodology, when a significant error is identified that may result in credit rating actions and the likelihood of a material change resulting in a change in current credit ratings.

Liability Considerations

The Act provides that the enforcement and penalty provisions of the Exchange Act apply to statements made by a credit rating agency to the same extent that these provisions apply to statements made by a registered public accounting firm or a securities analyst under the federal securities laws, and these statements are not to be deemed forward-looking statements for purposes of the Section 21E safe harbor of the 1934 Act.

Credit ratings provided by an NRSRO are no longer exempt from being considered part of a registration statement prepared or certified by an “expert” pursuant to Sections 7 and 11 of the Securities Act of 1933. Accordingly, any registration statement containing a reference to a NRSRO rating will require the consent of the applicable NRSRO to be filed with the registration statement.

Reliance on NRSRO Ratings by Federal Agencies

The Act removes references to NRSRO ratings from a number of provisions in various laws, including the 1934 Act, the Investment Company Act of 1940 and the Federal Deposit Insurance Act, effective 2 years from enactment. Federal agencies that enforce these laws are instructed within one year of enactment of the Act to remove references to NRSRO ratings from their regulations and to substitute a standard of credit-worthiness that is appropriate to these regulations.

Effective Date

Unless otherwise specifically provided in Subtitle C of title IX, the SEC must issue final regulations, as required by the subtitle, not later that one year after the enactment of the Act.

Portfolio Margining

Section 983 of the Act amends the Securities Investor Protection Act of 1970 (SIPA) to extend the protections of SIPA to all futures contracts and options for futures contracts. Prior to enactment of the Act, only security futures were entitled to these protections. As a result, customers could not include securities and related futures in a single securities account.
Section 983 also allows customers to include both securities and related futures products in a single “portfolio margining account,” as permitted under a portfolio margining program approved by the SEC. Portfolio margining accounts can be margined based upon the net risk of the positions in those accounts.

**Loan or Borrowing of Securities**

In response to issues with various financial institutions’ securities lending programs, Section 984 of the Act amends Section 10 of the Exchange Act to require the SEC to promulgate rules, not later than two years after the date of enactment of the Act, that are designed to increase the transparency of information available to brokers, dealers and investors with respect to loaning or borrowing of securities. Section 984 also makes it unlawful for any person to effect, accept, or facilitate a transaction involving the loan or borrowing of securities in contravention of such rules and regulations as the SEC may prescribe. The foregoing provision does not limit the authority of other appropriate federal departments or agencies that have responsibility under federal law to adopt rules or regulations involving the loan or borrowing of securities in order to protect the safety and soundness of a financial institution or to protect the financial system from systemic risk.

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Successful implementation of the Act will be largely dependant on the rulemaking and interpretation positions of the SEC, CFTC, banking regulators and other agencies. We will continue to keep you informed as we enter the next stage of financial reform.

A full copy of the Act is available online at:
http://docs.house.gov/rules/finserv/111_hr4173_finsrvcr.pdf
Investment Management Group

For more information about the matters discussed in this Alert, please contact your regular Drinker Biddle lawyer or any member of our Investment Management Group.

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