financial reform matters

ROPES & GRAY

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The Impact of Financial Reform: Effects on Investment Companies and Investment Advisers of the *Dodd-Frank Wall Street Reform and Consumer Protection Act*

Earlier today, President Obama signed into law the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (the "Act"). The Act restructures the U.S. financial regulatory system by providing for more extensive regulation of banks and other financial institutions, derivatives markets, consumer financial products and services, investment advisers, credit rating agencies, short sales, and mortgage lending. Although the Act is not specifically intended to restructure the regulatory scheme applicable to investment companies and investment advisers, a number of its provisions will have a significant effect on investment companies, private investment funds, such as hedge funds and private equity funds, and registered and unregistered investment advisers. A summary of the provisions of the Act most relevant to funds and advisers appears below.

Maintaining Financial Stability – Provisions Applicable to Nonbank Financial Companies

The Act provides authority for additional oversight of financial companies. The Act divides "financial companies" into bank holding companies and nonbank financial companies (including foreign nonbank financial companies). The Act defines "nonbank financial companies" as those companies "predominantly engaged in financial activities." A company is "predominantly engaged in financial activities" if its annual gross revenues from activities (or consolidated assets related to activities) that are "financial in nature" (as defined in Section 4(k) of the Bank Holding Company Act of 1956) and, if applicable, from owning/controlling one or more insured depository institutions, represent 85% or more of the company's consolidated annual gross revenues (or consolidated assets). Although acting as a registered investment adviser clearly qualifies as an activity that is "financial in nature," various provisions in the Act suggest that pooled investment vehicles (such as investment companies, business development companies ("BDCs") and hedge funds) also could be deemed to be engaging in activities "financial in nature" for these purposes. In any event, if an investment adviser or its parent company were affected by these provisions, they could have indirect implications on any pooled investment vehicles advised by the adviser.

A. Financial Stability Oversight Council

The Act creates a Financial Stability Oversight Council (the "Council") tasked with identifying risks to financial stability, promoting market discipline, and responding to emerging threats to financial stability. If the Council determines that material financial distress at a particular nonbank financial company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the company's activities, could pose a threat to the financial stability of the United States, the Council is authorized to require that the company register with, and be supervised by, the Federal Reserve Board of Governors (the "Board"), and be subject to the "prudential standards" described below. The Act also requires that other regulatory agencies overseeing the applicable entity enforce heightened standards and safeguards recommended by the Council on such nonbank financial company (or provide an explanation as to why the agency is not following the Council's recommendations). In addition, the Council may recommend to a regulatory agency that financial activities and practices that could create or increase risks of significant liquidity, credit or other problems spreading among nonbank financial companies and U.S. financial markets be subject to new or heightened standards and safeguards and require the applicable regulatory agency to impose such standards and safeguards (or provide an explanation as to why the agency has not followed the Council's recommendation).

B. Board Supervision

In determining whether a nonbank financial company should be subject to the Board's supervision and prudential standards, the Council will consider, among other factors, leverage; off-balance-sheet exposures; transactions and relationships with other significant nonbank financial companies; the importance of the company as a source of credit for households, businesses and local and state governments and as a source of liquidity for the U.S. financial system; the extent to which assets are managed rather than owned by the company and the extent to which ownership of assets under management is diffuse; the nature, scope, size, scale, concentration, interconnectedness, and mix of the activities of the company; the degree to which the company is already regulated by a financial regulatory agency; the amount and nature of financial assets; the amount and types of liabilities, including the degree of reliance on short-term funding; and other risk-related factors that the Council deems appropriate. If the Council determines that a nonbank financial company should be subject to the Board's supervision, it will provide such company written notice, including an explanation of the basis of the decision. The company may then request an opportunity for a written or oral hearing before the Council to contest the determination. The Act also requires the Board to mandate that publicly-traded nonbank financial companies supervised by the Board establish a risk committee, which will be responsible for the oversight of the enterprise-wide risk management practices of the nonbank financial company.

C. Prudential Standards Defined

Prudential standards, as defined by the Act, will include risk-based capital requirements and leverage limits,[1] liquidity requirements, overall risk management requirements, resolution plan and credit exposure report requirements,[2] and concentration limits.[3] The Act includes a carve-out from risk-based capital requirements and leverage limits if the Board determines that such requirements are not appropriate for a company subject to stricter standards because of such company's activities (such as "investment company activities" or assets under management) or structure, in which case the Board will apply other standards that result in similarly stringent risk controls. Prudential standards also may include a contingent capital requirement (*e.g.,* requiring a nonbank financial company to maintain a minimum amount of contingent capital that is convertible to equity in times of financial

[1] Leverage limits could include the requirement to maintain a debt-to-equity ratio of no more than 15 to 1 if the Council determines that the company poses a grave threat to financial stability. In addition, the Act mandates minimum leverage and risk-based capital requirements for financial companies supervised by the Board to be imposed by federal banking agencies. Such capital requirements would address risks arising from significant volumes of activity in derivatives, securitized products, financial guarantees, securities borrowing and lending, and repurchase and reverse repurchase agreements; concentrations in assets for which values in financial reports are based on models (not historical costs) or prices deriving from deep and liquid two-way markets; and from concentrations in market share for activities that would substantially disrupt financial markets if the entity ceases the activity.

[2] These include a report regarding the financial company's plan for rapid and orderly resolution in the event of material financial distress or failure, which must include information regarding the manner and extent to which any insured depository institution affiliated with the financial company is adequately protected from risks arising from the activities of any nonbank subsidiaries of the company; a full description of the ownership structure, assets, liabilities, and contractual obligations of the company; identification of cross-guarantees tied to different securities, identification of major counterparties and a process for determining to whom the collateral of the company is pledged; and any other information the Board and the Federal Deposit Insurance Corporation (the "FDIC") require. The financial company must also report its credit exposure to significant financial companies and the credit exposure that other significant financial companies have to that company. If the Board and the FDIC determine that the resolution plan is not credible, then the company must resubmit the plan. If the company fails to timely resubmit a resolution plan with appropriate revisions, the Board and the FDIC may impose more stringent requirements or restrictions on the growth, activities or operations of the company and may direct the company to divest certain assets or operations identified by the Board and the FDIC to facilitate an orderly resolution in the event of the failure of the company.

[3] For example, credit exposure (through transactions such as repurchase agreements, securities loans and certain derivative transactions) to an unaffiliated company may not exceed 25% of capital stock and surplus, or a lower amount determined by the Board.

stress); enhanced public disclosures (to support market evaluation of the risk profile, capital adequacy, and risk management capabilities of a company); limits on the issuance of short-term debt; and such other prudential standards the Board, either on its own or pursuant to a recommendation by the Council, determines are appropriate. In prescribing prudential standards, the Board will tailor prudential standards to each individual company or category of companies, taking into account differences among nonbank financial companies under its supervision, non-financial activities and affiliations of the company, and other risk-related factors the Board determines appropriate, and adapting the required standards as appropriate in light of the company's predominant line of business, including activities for which particular standards may not be appropriate.[4]

D. Limits on Activities for Entities that Pose a "Grave Threat" to Financial Stability

If the Board determines that a nonbank financial company supervised by the Board poses a "grave threat to the financial stability of the United States," the Board may limit the company's ability to merge with, acquire, consolidate with or otherwise become affiliated with another company; restrict its ability to offer financial products; require the company to terminate one or more activities; impose conditions on the manner in which the company conducts one or more activities; or, if the Board determines that such actions are inadequate to mitigate a threat to financial stability, it may require the company to sell or otherwise transfer assets or off-balance-sheet items to unaffiliated entities. Prior to such action, the nonbank financial company will be provided notice and the opportunity for a hearing.

E. Potential Fees and Funding for the Council

Two years after enactment of the Act, the Secretary of the Treasury will establish (with approval of the Council) an assessment schedule applicable to bank holding companies with total consolidated assets of $50 billion or more and nonbank financial companies supervised by the Board (regardless of whether their total assets are $50 billion or more) to fund the Office of Financial Research, which will support the Council. The assessment rates will take into account differences among the companies based on the considerations for establishing the aforementioned prudential standards.

F. Orderly Liquidation of Covered Financial Companies

The Act establishes the authority to liquidate failing financial companies that pose a significant risk to the financial stability of the United States by appointing the FDIC as a receiver. The Act includes provisions that could impact recovery by an investor and derivatives and other counterparties in the event of an insolvency of a financial company that is placed in FDIC receivership. Please see The Impact of Financial Reform: Framework Established for Liquidating Failed Financial Companies for further information.

The Act also creates an orderly liquidation fund (the "Liquidation Fund") to facilitate the liquidation of covered financial companies (which could include a nonbank financial company under the supervision of the Board).[5] The Liquidation Fund is not pre-funded; instead, the FDIC, when necessary, will borrow from the U.S. Treasury, with the borrowings to be repaid through income from the liquidated assets of covered financial companies; by imposing assessments on certain claimants of financial companies that received amounts from the Liquidation Fund; and, if those are insufficient, by imposing asset- and risk-based assessments on bank holding companies with at least $50 billion in assets, any nonbank financial companies supervised by the Board (regardless of whether their total assets are $50 billion or more) and any other financial companies with at least $50 billion in assets.

Registration and Reporting Requirements Under the Advisers Act

[4] Prior to imposing prudential standards that are likely to have a significant impact on a functionally regulated subsidiary or depository institution subsidiary of a nonbank financial company supervised by the Board, the Board will consult with the Council member that primarily supervises such subsidiary (*i.e.,* the Securities and Exchange Commission (the "SEC") in the case of investment advisers, investment companies and private funds).

[5] Covered financial companies are those financial companies for which it has been determined that the FDIC should be appointed as a receiver.

The Act substantially alters the registration and reporting schemes under the Investment Advisers Act of 1940 (the "Advisers Act") by requiring most hedge fund managers and private equity advisers to register with the SEC as investment advisers. The Act also creates new recordkeeping and reporting obligations with respect to "private funds," which are expected to include most hedge funds and private equity funds.[6] Please see The Impact of Financial Reform: Private Fund Investment Adviser Registration for further information on these new requirements.

Regulation of Over-the-Counter Derivatives Markets

The Act imposes new requirements on participants in the over-the-counter derivatives markets and subjects many over-the-counter derivative transactions to federal regulation. The Act creates new clearing and exchange trading requirements, capital and margin requirements, reporting requirements and position limits. Sponsors of funds, as well as investment advisers of clients, which use certain non-securities based swaps (*e.g.,* interest rate swaps), will be subject to registration and regulation under the Commodity Exchange Act (or will need to find an exemption therefrom). Please see The Impact of Financial Reform: The Federal Regulation of OTC Derivatives for further information on these new requirements.

Credit Ratings and Nationally Recognized Statistical Ratings Organizations

A. Elimination of Statutory and Regulatory References to Credit Ratings

The Act eliminates references to credit ratings in certain federal securities laws, including the Investment Company Act of 1940 (the "1940 Act"), and generally replaces them with references to "standards of credit-worthiness" to be established by the SEC. The Act makes similar changes to other federal laws, such as the Federal Deposit Insurance Act. Moreover, each federal agency is required to review any of its regulations that require an assessment of the credit-worthiness of a security by reference to credit ratings (*e.g.,* Rule 2a-7 under the 1940 Act) and replace the references to credit ratings in such regulations with standards of credit-worthiness determined by the agency.

B. Regulations for Nationally Recognized Statistical Ratings Organizations

Under the Act, Nationally Recognized Statistical Ratings Organizations ("NRSROs") must establish internal controls governing the methodologies for determining credit ratings, taking into consideration factors prescribed by the SEC. The Act requires the SEC to prescribe rules that require annual reports from NRSROs describing and assessing their internal control structure and public disclosure on the initial credit ratings determined by an NRSRO for each type of obligor, security and money market instrument, as well as for any subsequent changes to such ratings. In addition, each NRSRO must ensure that credit ratings are determined using procedures and methodologies approved by the board of the NRSRO and are in line with the NRSRO's policies and procedures aimed at eliminating conflicts of interest; and that any material changes to procedures and methodologies are applied consistently, disclosed to the public and applied to then-current ratings within a reasonable time period. Furthermore, each NRSRO must ensure that users of credit ratings are aware of the version of a procedure or methodology being used with respect to a particular credit rating, any material changes thereto, and any significant errors identified in such methodologies. The SEC also may suspend or revoke the registration of a NRSRO with respect to a particular class of securities if the SEC finds (after notice and opportunity for a hearing) that the NRSRO does not have adequate financial and managerial resources to consistently produce credit ratings with integrity.

[6] In addition, it is possible these adviser registration provisions could result in BDCs and other registered investment companies that currently own unregistered advisers divesting themselves of those advisers or seeking exemptive relief.

C. Studies of Credit Ratings for Structured Finance Products and NRSROs

The Act also provides for a study to be conducted by the SEC of the credit rating process for structured finance products and the conflicts of interest associated with the "issuer-pay" and "subscriber-pay" models, the feasibility of creating a public/private utility or a self-regulatory organization ("SRO") that assigns NRSROs to determine the credit ratings of structured finance products, the metrics that could be used to determine the accuracy of credit ratings and alternative means for compensating NRSROs that create incentives for accurate ratings.

Credit Risk Retention

The Act requires the adoption of regulations that require any securitizer[7] of an asset-backed security generally to retain at least 5% of the credit risk for any asset that the securitizer, through the issuance of any asset-backed security, transfers, sells, or conveys. The portion of credit risk retained may be lower if certain underwriting standards, to be clarified by rule, are met by the originator of the assets.[8] Also, the credit risk may be shared between the securitizer and the originator in the case of a securitizer that purchases assets from an originator. The Act includes an exemption for asset-backed securities collateralized only by residential mortgages that meet standards (also to be clarified by rule) relating to a lower risk of default. Investment companies, BDCs and hedge funds that make or invest in asset-backed securities (or could be considered originators of asset-based securities) will be affected by this provision.

Short Sale Reforms and Studies

A. Reforms in Short Sale Disclosures and Prohibition of Manipulative Short Selling

Expanding on recent rules promulgated by the SEC curbing short sales, the Act further regulates short selling of securities by amending the Securities Exchange Act of 1934 (the "Exchange Act") and requiring that the SEC prescribe rules requiring the monthly public disclosure of, at a minimum, the issuer name, title, class CUSIP number, aggregate amount of the number of short sales of each security and any additional information determined by the SEC. The Act also outlaws "a manipulative short sale of any security." A manipulative short sale is not defined; rather, the SEC will issue rules necessary to enforce this ban. Finally, the Act requires brokers and dealers to inform their customers that the customers may forbid a broker/dealer from lending fully paid securities held in their accounts in connection with short sales.

B. Studies on Short Selling

The Act calls for a study regarding short selling on national securities exchanges and in over-the-counter markets. The study, to be conducted by the SEC's Division of Risk, Strategy, and Financial Innovation, will pay particular attention to the impact of the SEC's recent rule changes and the incidence of (1) the failure to deliver shares sold short or (2) the delivery of shares on the fourth day following the short sale transaction. The SEC also will conduct a study on the feasibility, costs and benefits of (1) more transparent and frequent reporting of short sales and (2) a voluntary pilot program in which public companies agree to have their trades publicly marked and reported as "short," "long" and other designations.

Standards for Brokers and Dealers

The Act requires the SEC to study, among other things, the effectiveness of legal/regulatory standards of care

[7] A "securitizer" is either an issuer of an asset-backed security or a person who organizes and initiates an asset-backed securities transaction by selling or transferring assets to the issuer.

[8] An "originator" is a person who through the extension of credit or otherwise creates a financial asset that collateralizes an asset-backed security and who sells an asset, directly or indirectly, to a securitizer.

for broker-dealers to determine whether there are legal/regulatory gaps in the protection of retail investors and, in particular, whether retail investors understand the different standards of care applicable to broker-dealers and investment advisers and whether the exclusion of broker-dealers from the definition of "investment adviser" should be eliminated. The Act gives the SEC rulemaking authority to provide that brokers, dealers and investment advisers, when providing personalized investment advice about securities to certain retail customers, act in the best interest of the customer without regard to the financial or other interest of the entity providing the advice. The SEC is also granted authority to adopt rules providing that broker-dealers providing personalized investment advice about securities to certain retail customers will be subject to the same standard of conduct applicable to investment advisers. Additionally, the Act requires the SEC to adopt rules establishing a duty for security-based swap dealers or major security-based swap participants to communicate in a fair and balanced manner based on principles of fair dealing and good faith. The Act also permits the SEC to require that security-based swap dealers who act as advisers to a government entity, employee benefit plan, governmental plan or endowment act in the best interests of that entity. Security-based swap dealers and major security-based swap participants who act as counterparties to such entities also must comply with duties to be established by the CFTC under the Commodity Exchange Act.

Corporate Governance

A. Compensation Committee

The Act requires the SEC to establish rules to direct the national securities exchanges and associations to prohibit the listing of any equity security of an issuer that does not have an independent compensation committee. Although open-end mutual funds are specifically excepted from this requirement, closed-end funds are not, even though, like open-end mutual funds, the compensation committees of closed-end funds typically only consider their directors' compensation because the officers of the funds are usually compensated by fund service providers and not the funds themselves.

B. Proxy Solicitation, Broker Discretionary Voting and Executive Compensation

The SEC may promulgate rules requiring an issuer to include in proxy solicitation materials any nominee to the board of directors submitted by a shareholder. Moreover, the SEC must issue rules that require an issuer to disclose in the annual proxy sent to shareholders why the issuer has chosen either the same person to serve as chair of the board of directors and CEO or different individuals to serve as the chair of the board and CEO. These rules, when adopted, may apply to investment companies.

The Act also amends the Exchange Act to require national securities exchanges to adopt rules prohibiting brokers from voting shares without shareholder instructions on proxy proposals relating to director elections, executive compensation, or any other significant matter (as determined by SEC rule), except for proposals relating to uncontested elections of investment company board members.[9] In addition, the Act provides that institutional investment managers subject to Section 13(f) of the Exchange Act must report at least annually how they voted on proposals relating to compensation of executives and golden parachute compensation (unless the vote has already been publicly reported).

The Act also creates additional disclosure requirements relating to executive compensation. These requirements will not be applicable to registered investment companies but will apply to BDCs. Please see [The Impact of Financial Reform: Banking, the Volcker Rule, Executive Compensation, and Corporate Governance] for further information on these requirements and other requirements relating to executive compensation, director nominees and proxy

[9] New York Stock Exchange Rule 452 was recently amended to similarly limit broker discretionary voting in director elections; however, Rule 452 does not apply to elections of investment company board members. The Act will require a modification to Rule 452 such that brokers will no longer be able to vote in contested elections of investment company board members without obtaining shareholder instructions.

disclosures.

Enhancement of SEC Enforcement Powers

The Act enhances the SEC's enforcement powers. The following are some of the changes made by the Act:

- The SEC will be permitted to prosecute for aiding and abetting under the Securities Act of 1933 (the "Securities Act"), the 1940 Act and the Advisers Act.

- The standard of intent for aiding and abetting liability may be satisfied by recklessness.

- The SEC will have authority to impose civil penalties in administrative cease-and-desist proceedings and obtain penalties in aiding and abetting cases under the Advisers Act.

- The Act grants the SEC extraterritorial jurisdiction over violations of the antifraud provisions of the Securities Act, Exchange Act and Advisers Act, where (i) conduct within the United States constitutes significant steps in furtherance of the violation, even if the securities transactions occur outside the United States and only involve foreign investors, and (ii) conduct outside the United States has a foreseeable substantial effect within the United States. The Act also permits nationwide service of process of subpoenas in SEC civil actions, which will make it easier for the SEC to compel witnesses to attend trials.

- Control person liability under Section 20(a) of the Exchange Act will apply in SEC enforcement actions, not only in private actions.

- The Act amends the Exchange Act by imposing a 180-day deadline after the service of a "Wells notice" in SEC enforcement investigations for the SEC staff to either file an action against the recipient or to notify the Director of the Division of Enforcement of its intent not to file an action. However, the Director of the Division of Enforcement may, with notice to and approval of the SEC Commissioners, extend the deadline indefinitely for multiple 180-day periods for complex enforcement investigations. The Act also imposes a 180-day deadline in SEC compliance examinations and inspections for the SEC staff to either notify an entity that it has concluded a compliance examination or inspection with or without findings, or that the SEC staff requests corrective action. In this case, however, the Act allows only one additional 180-day extension.

Miscellaneous Provisions

- *Permanent Increase in Deposit Insurance.* The Act makes permanent the temporary increase of the FDIC standard maximum deposit insurance amount from $100,000 to $250,000 and makes the increase retroactive to January 1, 2008. This permanent increase could have an impact on investments in money market funds by encouraging individual investors to keep more money in bank money market savings accounts.

- *Exemption of Annuities from SEC Jurisdiction.* The Act generally removes annuities, including indexed annuities, from SEC jurisdiction by broadly defining exempt "annuity contracts" in Section 3(a)(8) of the Securities Act.

- *Former Director & Officer Liability.* The Act allows the SEC to bring an action for breach of fiduciary duty against a former officer, director, member of an advisory board, investment adviser, depositor or principal underwriter of an investment company who served at the time of the alleged misconduct, in addition to persons or entities currently serving in those capacities.

- *Volcker Rule - Prohibitions on Proprietary Trading and Sponsorships and Investments in Hedge Funds/Private Equity Funds by Banking Entities.* The Act requires the adoption of rules by the appropriate federal banking agencies, the Board, the SEC and the CFTC to prohibit, subject to certain exceptions, insured depository institutions, their control companies, bank holding companies and their affiliates and subsidiaries ("banking entities") from engaging in proprietary trading, or acquiring or retaining ownership interests, in hedge funds and private equity funds or from sponsoring such funds, subject to limited exceptions.[10] In addition, banking entities and their affiliates that serve (directly or indirectly) as an investment adviser or a sponsor to a hedge fund or private equity fund are prohibited from entering into a "covered transaction" (as defined in Section 23A of the Federal Reserve Act, which would include, for example, a loan or extension of credit to an affiliate or a purchase of, or an investment in, securities issued by an affiliate) with the fund (or entities that it controls), with limited exceptions for prime brokerage transactions. Any nonbank financial companies supervised by the Board that engage in proprietary trading or sponsor and invest in hedge funds and private equity funds shall be subject to additional capital requirements and quantitative limits. Please see The Impact of Financial Reform: Banking, the Volcker Rule, Executive Compensation, and Corporate Governance for further information on the Volcker Rule.

- *Broker-Dealer Disclosure to Retail Investors Prior to Purchase.* The Act amends the Exchange Act to permit the SEC to issue rules designating documents or information that a broker or dealer will be required to provide to a retail investor prior to the purchase of an investment product (including investment company shares) or service. Any documents or information must be in summary form and contain information about investment objectives, strategies, costs and risks, and any compensation or other financial incentive received by a broker or dealer in connection with the purchase of retail investment products.

- *Adviser Safeguards of Client Assets.* The Act amends the Advisers Act by providing that an investment adviser registered under the 1940 Act shall take steps to safeguard client assets over which the adviser has custody, including verification of such assets by an independent accountant, as the SEC may prescribe by rule. Because the SEC has recently promulgated rules addressing such safeguards, it is unclear whether the Act will prompt the SEC to revise those rules or whether additional rules would be required by the Act. Please see SEC Adopts Final Amendments to the Custody Rule under the Advisers Act (January 12, 2010) for further information on the recent SEC action.

- S*tudy on Enhancing Investment Adviser Examinations.* The Act requires the SEC to conduct a study that will review and analyze the need for enhanced examination and enforcement resources for investment advisers. In particular, the study will examine the frequency of examinations of investment advisers, the extent to which having Congress authorize the SEC to designate one or more SROs to augment the SEC's efforts in overseeing investment advisers would improve the frequency of examinations of investment advisers, and current and potential approaches to examining investment advisory activities of dually-registered broker-dealers and investment advisers or affiliated broker-dealers and investment advisers.

- *Study on Mutual Fund Advertising.* The Act requires a study on mutual fund advertising by the Comptroller General that will identify existing and proposed regulatory requirements for open-end mutual fund advertisements; current marketing practices for sales of open-end mutual fund shares, including the use of past performance data, funds that have merged and incubator funds; and impacts of such advertising on consumers. The study will be required to identify recommendations intended to improve investor protections.

[10] Investments in obligations of the United States and certain government-sponsored enterprises, obligations of any state, risk-mitigating hedging activities, certain trading activities done in connection with underwriting or market-making, investments in small business investment companies, and certain trading that occurs solely outside of the United States are generally excepted. "*De minimis*" investments include the banking entity's seed investment and other investments in the fund, provided that the banking entity reduces its investments in the fund to 3% or less of the fund's total ownership interest and the aggregate of all the banking entity's *de minimis* investments does not exceed 3% of its core capital, among other restrictions.

A report detailing the results of the study is due to the Senate Committee on Banking, Housing, and Urban Affairs and to the House Committee on Financial Services within 18 months after enactment of the Act.

- *Limits on Securities Lending.* The Act amends the Exchange Act to make it illegal to engage in securities lending in contravention of SEC rules. The Act, however, does not limit the authority of certain federal departments and agencies, including federal banking agencies and the National Credit Unit Administration, to continue to promulgate regulations restricting the lending and borrowing of securities. The Act also requires the SEC to promulgate rules intended to increase the transparency of information available to brokers, dealers and investors relating to securities lending and borrowing.

- *Custodian Recordkeeping and Examination Requirements.* The Act expands recordkeeping and examination requirements for persons, such as investment company custodians and investment advisers, with custody of securities, deposits or credits of registered investment companies or advisory clients.

- *Regulations of Municipal Securities.* Under the Act, municipal advisers are required to register with the SEC and will be subject to rules enforced by the SEC. The Act also requires that investor and public representatives serve on the Municipal Securities Rulemaking Board. Additionally, the Act imposes a fiduciary duty on municipal advisers with respect to municipal entities they advise.

- *Establishment of Risk Management Standards.* The Act requires the Board, in consultation with the Council and supervisory agencies, to prescribe (and permits the SEC and CFTC to prescribe) regulations regarding risk management standards governing payment, clearing and settlement activities[11] of "designated financial market utilities"[12] and the conduct of payment, clearing or settlement activities by financial institutions (which include investment companies, broker-dealers and investment advisers) deemed by the Council to be systemically important.

- *Possible SEC Reform.* The Act requires the SEC to hire an independent consultant to examine the internal operations, structure, funding and need for comprehensive reform of the SEC, as well as the SEC's relationship with and reliance on SROs and other entities relevant to securities regulation and investor protection. In particular, the study will focus on the possible elimination of unnecessary or redundant units at the SEC; improving communications between SEC offices and divisions; the need for a clear chain-of-command structure; the effect of high-frequency trading on the market and methods the SEC uses to monitor such trading; the SEC's hiring authorities, workplace policies and personnel practices; whether the SEC's oversight and reliance on SROs promotes efficient and effective governance for the securities markets; and whether adjusting the SEC's reliance on SROs is necessary to promote more efficient and effective governance for the securities markets.

- *Accredited Investor and Qualified Client Standard.* The Act directs the SEC to adjust the "accredited investor" standard under Regulation D under the Securities Act so that the individual net worth requirement (currently $1,000,000) excludes the value of a primary residence and is adjusted periodically by SEC rule. Currently, there is no requirement for periodic adjustment and the net worth threshold does not exclude the value of a primary residence. The Act also requires the SEC to periodically review the definition of "accredited investor" to determine whether the definition should be revised. In addition, the Act amends the Advisers Act to provide that any dollar amount test used in determining "qualified clients" for purposes of charging a performance-based fee will be adjusted for the effects of inflation. Please see The Impact of Financial Reform: Private Fund Investment Adviser Registration for further information.

[11] The offer or sale of a security under the Securities Act, or any quotation, order entry, negotiation, or other pre-trade activity or execution activity are not considered payment, clearing or settlement activities.

[12] "Designated financial market utilities" means any person that manages or operates a multilateral system for purposes of transferring, clearing or settling payments, securities or other financial transactions among financial institutions or between financial institutions and the person that the Council has designated as systematically important and generally do not include brokers, dealers, transfer agents or investment companies.

- *Restrictions on Mandatory Pre-Dispute Arbitration and Waiver Clauses.* The Exchange Act and Advisers Act are amended to provide that the SEC may promulgate rules prohibiting (or limiting) the use of agreements that require investment adviser and broker-dealer customers or clients to arbitrate any future dispute arising under federal securities laws and regulations or SRO rules. The Act also amends the Exchange Act to invalidate any contractual provision requiring persons to waive compliance with any SRO rules.

- *State Powers.* The Act contains provisions preserving the enforcement powers of states, although it restricts the ability of state attorneys general to bring civil actions against national banks or federal savings associations. The Act also contains provisions relating to federal preemption for national banks and certain subsidiaries.

- *Office of the Investor Advocate.* The Act establishes the Office of the Investor Advocate within the SEC to assist retail investors in resolving significant problems they may have with the SEC or SROs; identify areas in which investors would benefit from changes in the regulations of the SEC or SROs; identify problems that investors have with financial service providers and investment products; analyze the potential impact on investors of proposed regulations of the SEC and proposed rules of SROs; and, to the extent practicable, propose to the SEC changes in the regulations or orders of the SEC and propose to Congress any legislative, administrative or personnel changes that may be appropriate to mitigate problems identified and to promote the interests of investors.

- *Beneficial Ownership and Short-Swing Profit Reporting.* The Act amends the Exchange Act to give the SEC the authority to shorten, by rule, the 10-day reporting period for 5% beneficial owners under Section 13(d) of the Exchange Act and the 10-day reporting period for initial reports filed by beneficial owners, officers and directors under Section 16(a)(2)(B) of the Exchange Act.

- *Whistleblower Incentives and Protections.* When whistleblowers voluntarily provide original information to the SEC that leads to a successful administrative or judicial action brought by the SEC resulting in sanctions of more than $1 million, or a related action, the Act provides an award of 10% to 30% of the monetary sanctions imposed in the action, with certain limitations and with the amount subject to the discretion of the SEC. The Act also provides protections to the whistleblower against retaliatory action by the whistleblower's employer and for the treatment of confidential information, subject to certain limitations. The SEC's Inspector General is required to conduct a study on the whistleblower protection program.

- *Protecting Confidentiality of Materials Submitted to the SEC.* The Act modifies the 1940 Act and the Advisers Act to protect records or information submitted to the SEC in connection with an examination or other request from a member of the SEC staff from disclosure under the Freedom of Information Act. However, under the Advisers Act, similar to the current provisions of the 1940 Act, the SEC is obligated to provide such information to Congress, any federal department or agency, or a United States court pursuant to a court order in an action brought by the United States or the SEC.

- *Study Regarding Financial Literacy Among Investors.* The Act requires the SEC to conduct a study on the existing level of financial literacy among retail investors; methods to improve disclosures to investors with respect to financial intermediaries, investment products and investment services; useful and relevant information that retail investors need to make informed decisions before engaging a financial intermediary or purchasing an investment product (including shares of open-end mutual funds); methods to increase transparency of expenses and conflicts of interests in transactions involving investment services and products (including shares of open-end mutual funds); and effective private/public efforts to educate investors and strategies to increase investors' financial literacy.

We continue to evaluate the impact of financial reform legislation, especially those changes that may affect the investment management, banking, hedge and private investment fund, private equity, and derivatives businesses. If you have questions concerning *Financial Reform Matters*, please contact any of the attorneys listed below or the Ropes & Gray attorneys with whom you regularly work:

Michael G. Doherty	Jason E. Brown	Alexandra Oprescu	Marian G. Fowler