

LATEST PROPOSALS TO MODERNIZE FINANCIAL SERVICES REGULATION: IMPACT ON INSURANCE COMPANIES, INVESTMENT ADVISERS AND FUNDS

(August 4, 2009)

INTRODUCTION

This Bulletin is one of a continuing series of analyses prepared by Jordan Burt LLP's Task Force on Modernizing Financial Services Regulation.

In one of our previous Bulletins,¹ we reported on the June 17, 2009 "White Paper" in which the Obama administration proposed numerous measures to address perceived inadequacies in regulation of the financial services industry.² The intent of these administration proposals was generally to modernize such regulation and address problems that are perceived to have contributed to the current economic situation. The White Paper, however, did not propose specific statutory language for enactment.

In the past few weeks, matters have progressed to the point where the administration has put forward several pieces of legislation to implement the recommendations of the White Paper. Other parties also have continued to put forward specific federal legislative and rule proposals for modernizing financial services regulation. Clearly, the legislative/regulatory train has now pulled out of the station, although it is still too early to know what the fate of most of these proposals ultimately will be.

This Bulletin discusses important ways in which certain of the more recent proposals would affect some of Jordan Burt's core client groups.

CONTENTS

- I. Insurance
 - A. Regulation of Financial Companies that Present Systemic Risks
 1. Tier 1 Financial Holding Company Designation
 2. Prudential Regulation Standards
 3. FDIC "Back-Up" Examination Authority
 4. Regulatory Actions Against Functionally-Regulated Subsidiaries
 5. Segregating Financial Activities into a New Intermediate Holding Company
 6. Remedial Action
 7. Disagreement over Federal Reserve Board Role

¹ The previous Bulletin may be found at: <http://www.jordenusa.com/attachments/3233.pdf>

² The White Paper, issued by the Treasury Department, may be found at: http://www.financialstability.gov/docs/regs/FinalReport_web.pdf

- B. Financial Services Oversight Council
 - C. Office of National Insurance
 1. Functions of ONI
 2. International Agreements and Preemption of State Law
 3. H.R. 2609—An Alternative Proposal
 - D. Federal “Resolution” Authority as to Financial Companies that Have Systemic Importance
 1. Obama Administration Proposal
 2. Implementing the Proposed Statutory Authority
 3. Impact on Subsidiaries
 - E. Regulation by Consumer Financial Protection Agency
- II. Investment Advisers
- A. Impact of Tier 1 Financial Holding Company Regulation
 - B. Impact of New Resolution Authority
 - C. Repeal of “15 Client” Exclusion
 - D. Additional Benefit of Being an SEC-Regulated Adviser
 - E. Regulation by Consumer Financial Protection Agency
- III. Money Market Funds
- A. Background: September 18, 2009 Termination Date for Treasury Temporary Guarantee Program
 - B. SEC Proposals to Enhance Money Market Fund Resilience
 - C. Other Possibilities the SEC Has Raised for Money Market Funds
 - D. Next Steps
- IV. Hedge Funds and Other Private Funds
- A. Regulation Likely
 - B. Private Fund Investment Advisers Registration Act of 2009
 1. Repeal of “15 Client” Exclusion
 2. Providing Additional Information to Regulators
 3. Repeal of Exemption for Intrastate Advisers and Commodity Trading Advisers
 4. Potential Additional Disclosures to Investors, Counterparties, and Creditors
 - C. Other Pending Bills
 - D. European Union’s Proposed Alternative Investment Funds Directive

- V. Proposed Consumer Financial Protection Agency
 - A. Potentially Comprehensive Nature of CFPB Regulation
 - B. The CFPB's Primary Areas of Concern
 - C. Relevance to Insurance Industry
 - D. Exclusion for Certain persons Regulated by the SEC or CFTC
 - F. Investment and Financial Advisory Activities
 - G. Certain Industry Communications with Congress

- VI. Other Legislative Proposals
 - A. Investor Protection Act of 2009
 - B. Bank Holding Company and Depository Institution and Regulatory Improvements Act of 2009
 - C. Payment, Clearing, and Settlement Supervision Act of 2009
 - D. Consumer Protection and Regulatory Enhancement Act

ANALYSIS

I. INSURANCE

As discussed further below, portions of several pieces of proposed legislation published by the Obama administration to implement various portions of the White Paper relate to (or could be interpreted to relate to) the insurance sector. Although not explicit in the proposed legislation and related findings, Representative Barney Frank, who is the influential chair of the House Financial Services Committee, stated in a recent interview that he did not view the insurance sector as being a contributor to the current financial crisis. This view may result in further revisions to the language of the proposed legislation (or interpretations of the existing language) that, in some respects, limit the impact upon insurance and reinsurance companies. This, however, remains to be seen, as the proposed legislation progresses through Congress.

A. Regulation of Financial Companies that Present Systemic Risks

On July 22, 2009, the administration published proposed legislation that generally implements the White Paper's recommendations concerning the regulation of financial companies that present systemic risks. The proposed legislation, entitled the Bank Holding Company Modernization Act of 2009 (the "2009 Holding Company Act"),³ has many aspects that are of considerable potential significance.

³ The text of this proposed legislation may be found at:
<http://www.ustreas.gov/press/releases/reports/title%20ii%20tier%201%20fhcs%20%207222009%20fnl.pdf>

1. *Tier 1 Financial Holding Company Designation*

The 2009 Holding Company Act would provide for designation by the Federal Reserve Board of domestic or foreign companies as Tier 1 financial holding companies (“Tier 1 Financial Holding Companies”) and for the “comprehensive and robust prudential supervision and regulation” of such companies and their subsidiaries. Absent an emergency situation, companies that the Board proposes be so designated would receive notice of that proposal and an opportunity to be heard either through written or oral submissions. It is anticipated that such companies would be limited to those of the following minimum size: (1) \$10 billion or more in assets; (2) \$100 billion or more in assets under management; or (3) \$2 billion or more in gross annual revenue. The Board could require the submission of reports and conduct an examination to assist it in deciding whether to designate particular companies as Tier 1 Financial Holding Companies.

We believe it possible that under this legislation one or more insurance company holding companies could be accorded Tier 1 Financial Holding Company status. This could have very significant ramifications for insurance company subsidiaries of such a company.

2. *Prudential Regulation Standards*

The Board would prescribe prudential standards for Tier 1 Financial Holding Companies covering the following areas: (1) risk-based capital requirements; (2) leverage limits; (3) liquidity requirements; and (4) overall risk management requirements. Also, the Board would:

- have authority to compel reports from and conduct examinations of Tier 1 Financial Holding Companies and any of their subsidiaries;
- require such companies to provide in advance a plan for their rapid and orderly resolution in the event they should, at some future time, experience severe financial distress;
- require Tier 1 Financial Holding Companies to make unspecified “enhanced public disclosures”; and
- impose limits on a Tier 1 Financial Holding Company’s exposure to the credit of any other company.

Also, Tier 1 Financial Holdings Companies automatically would be deemed to be bank holding companies and be subject to regulation as such.

3. *FDIC “Back-Up” Examination Authority*

The proposed legislation also would provide the FDIC with “back-up” examination authority. If the FDIC believes that a Tier 1 Financial Holding Company is not complying with applicable laws or otherwise poses a material risk, the FDIC may recommend that the Federal Reserve Board conduct an examination, and if the Board fails to do so, the FDIC may conduct an examination of the company.

4. *Regulatory Actions Against Functionally-Regulated Subsidiaries*

The 2009 Holding Company Act also would provide that, if the Board believes that the activities of a “functionally regulated subsidiary” of a Tier 1 Financial Holding Company pose unacceptable risk, the Board may recommend “to the primary Federal regulatory agency for the subsidiary” the commencement of supervisory action or an enforcement proceeding. There is no mention of similar action or indirect regulation with respect to subsidiaries that are functionally regulated by a *state*, which would be the case if a subsidiary were an insurance company. The proposal does state that with respect to examinations, the Board would, to the extent appropriate, obtain and consider examination reports from relevant federal *and* state regulators before conducting its own examination. This at least recognizes that state regulators may have regulatory authority with respect to some of these companies, although it does not evidence much deference to such state regulators.

5. *Segregating Financial Activities into a New Intermediate Holding Company*

The proposal further would require that any Tier 1 Financial Holding Company that is engaged predominantly in activities that are not financial in nature, establish and conduct its activities that *are* financial in nature through a new “intermediate holding company,” in accordance with regulations prescribed by the Board. This would enable the Board to regulate the intermediate holding company in the same manner as a Tier 1 Financial Holding Company.

6. *Remedial Action*

The 2009 Holding Company Act contains strong provisions for the Board to take remedial action with respect to Tier 1 Financial Holding Companies that are or become undercapitalized. Depending on the circumstances, such remedial action could include, for example, one or more of the following: implementing a capital restoration plan; requiring a bankruptcy filing; restricting senior executive officer compensation (including the elimination of bonuses); and replacing senior executives officers.

7. *Disagreement over Federal Reserve Board Role*

There is considerable disagreement about whether the Federal Reserve Board should play as prominent a role in systemic risk regulation as is contemplated by the 2009 Holding Company Act. SEC head Mary Schapiro and FDIC head Sheila Bair have testified before Congress that they believe that some of the Board’s proposed functions should instead be performed by a council of regulators. For example, the functions, capabilities, and independence of the Financial Stability Oversight Counsel discussed in part B. below could be enhanced for this purpose. Some influential members of Congress have expressed similar views.

B. Financial Services Oversight Council

On July 22, 2009, the administration published proposed legislation to implement the portion of the White Paper that recommended the creation of a Financial Services Oversight Council. Under this proposed legislation, which is entitled the Financial Services Oversight Council Act of 2009,⁴ the Council would be chaired by the Secretary of the Treasury. The Council would be composed of nine officials from federal agencies and regulatory offices and would be charged with:

- advising Congress on financial regulation and making recommendations that will enhance the integrity, efficiency, orderliness, competitiveness and stability of the financial markets and maintain investor confidence;
- monitoring the financial services marketplace to identify potential threats to the stability of the financial system;
- facilitating information sharing and coordination among Council members regarding policy and enforcement issues relating to financial services;
- advising the Federal Reserve Board with respect to the designation of Tier 1 Financial Holding Companies, the designation of systematically important financial market utilities, payment, clearing, and settlement activities and the standards for such companies and activities; and
- providing a forum for the discussion and analysis of emerging market developments and financial regulatory issues and for resolution of jurisdictional disputes among Council members.

As framed in this proposed legislation, the Council would be largely a consultative body, with various reporting obligations.

C. Office of National Insurance

On July 22, 2009, the Obama administration published proposed legislation entitled the Office of National Insurance Act of 2009 (“the ONI Act”).⁵ The ONI Act would generally implement the recommendations in the White Paper concerning a proposed Office of National Insurance (“ONI”).

1. *Functions of ONI*

The ONI Act provides that the “functions” of the ONI would be:

- to monitor all aspects of the insurance industry (other than health insurance), including identifying issues or gaps in the regulation of insurers that could contribute to a systemic crisis in the insurance industry or the U.S. financial system;

⁴ The text of this proposed legislation may be found at:
<http://www.ustreas.gov/press/releases/reports/title%20i%20soc%207222009%20fnl.pdf>

⁵ The text of this proposed legislation may be found at:
<http://www.ustreas.gov/press/releases/reports/title%20v%20ofc%20natl%20ins%207222009%20fnl.pdf>

- to recommend to the Federal Reserve Board when it should designate an insurer, including its affiliates, as an entity subject to regulation as a Tier 1 Financial Holding Company;
- to assist the Secretary of the Treasury in administering the Terrorism Insurance Program under the Terrorism Risk Insurance Act of 2002;
- to coordinate federal efforts and establish federal policy on prudential aspects of international insurance matters, including representing the U.S. in the International Association of Insurance Supervisors and assisting the Secretary in negotiating international agreements regarding prudential measures applicable to the business of insurance or reinsurance;
- to determine (as discussed in subpart 2. below) whether state insurance measures are preempted by such international agreements; and
- to consult with the states regarding insurance matters of national importance and prudential insurance matters of international importance.

The ONI Act would provide broad authority for gathering information from insurance companies and their affiliates, with the presumption that, if the desired information is already being gathered by a state regulator, the information will be obtained from that regulator.

2. *International Agreements and Preemption of State Law*

The proposed legislation authorizes the Secretary of the Treasury to negotiate and enter into international agreements on prudential matters relating to insurance or reinsurance, and provides that a state insurance “measure” will be preempted if and to the extent that: (1) the Director of the ONI determines that the measure treats a non-U.S. domiciled insurer that is subject to an international agreement on prudential measures less favorably than it treats a U.S.-domiciled insurer; and (2) the measure is inconsistent with such an international agreement. Any determination that a state measure is preempted is limited to situations involving international agreements on prudential measures, making it clear that the scope of the activities of the ONI are far more restricted than those of the federal insurance regulator that the administration had previously proposed.

These preemption provisions in the ONI Act are specifically limited, moreover, so as not to preempt “any State measure that governs any insurer’s rates, premiums, underwriting or sales practices, or State coverage requirements for insurance, or to [*sic*] the application of the antitrust laws of any State to the business of insurance.”

3. *H.R. 2609—An Alternative Proposal*

The ONI Act is similar to, but somewhat broader than, H.R. 2609,⁶ which was introduced on May 21, 2009, prior to the issuance of the White Paper. H.R. 2609, the Insurance Information Act of 2009, provides for the establishment of the Office of Insurance Information (“OII”). The proposed OII would have responsibilities for monitoring the insurance industry, gathering and distributing information, coordinating federal policy and efforts on international insurance

⁶ This bill may be found at: <http://thomas.loc.gov/cgi-bin/query/z?c111:H.R.2609>:

matters, providing liaison with non-U.S. insurance regulators and determining when federal policy has preempted State law relating to the insurance industry. Like the proposed ONI, the proposed OII would not have responsibilities with respect to health insurance.

D. Federal “Resolution” Authority as to Financial Companies that Have Systemic Importance

1. *Obama Administration Proposal*

Implementing the recommendations of the White Paper, the Obama administration published on July 23, 2009 proposed legislation entitled the Resolution Authority for Large, Interconnected Financial Companies Act of 2009 (the “Resolution Authority Act”).⁷ This legislation would provide new federal authority, modeled on the existing authority of the FDIC, which is designed to allow the government to address the potential failure of certain companies, when the stability of the financial system is at risk. The following types of companies (which we refer below to as “Resolution Companies”) would be potentially subject to this new authority:

- Tier 1 Financial Holding Companies,
- Other Bank Holding Companies, and
- Any subsidiary of a Tier 1 Financial Holding Company or other Bank Holding Company, *unless* the subsidiary is (a) an insured depository institution, (b) an SEC-registered broker-dealer that is a member of the Securities Investor Protection Corporation or (c) an insurance company.

The goal of the new resolution authority is to avoid the disorderly resolution of failing Resolution Companies, if a disorderly resolution would have serious adverse effects on the financial system or the economy.⁸

2. *Implementing the Proposed Statutory Authority*

In order for the resolution authority to be exercised in a particular case, the Secretary of the Treasury, after consultation with the President, must make certain determinations prescribed in the Act. The Secretary may make these determinations only upon a recommendation approved by at least a two-thirds vote of the FDIC Board. An exception exists, however, if the largest subsidiary of the Resolution Company is an SEC-registered broker-dealer, in which case, generally, a two-thirds vote of the SEC Commissioners (rather than the FDIC Board) must approve the recommendation. Interestingly, there is no analogous exception where the largest subsidiary is an insurance company. In that case, the ONI could presumably provide consultation on insurance matters, although state insurance authorities apparently would have no direct voice at all.

⁷ The text of this proposed legislation may be found at:

<http://www.ustreas.gov/press/releases/reports/title%20xii%20resolution%20authority%207232009finala.pdf>

⁸ On July 30, 2009, Senators Bob Corker and Mark Warner introduced legislation that covers part of the same subject matter as the Resolution Authority Act. Specifically, they introduced the Resolution Reform Act of 2009 (S. 1540), which would give the FDIC the authority to “resolve” or “wind down” bank holding companies.

Once the special resolution authority is invoked, the Resolution Authority Act would vest in the Secretary of the Treasury (or in the FDIC, with the Secretary's approval) the power to decide what steps should be taken pursuant to that authority. If the Secretary decides for a receivership or conservatorship, the Secretary would generally appoint the FDIC as the conservator or receiver. However, the Secretary would have discretion to appoint the SEC as conservator or receiver where the predominant subsidiary is a broker-dealer. However, there is no analogous provision to the effect that, if the predominant subsidiary is an insurance company, an insurance regulator may be appointed the conservator or receiver. This is perhaps ironic in view of the considerable experience that state insurance regulators have in connection with insurance company conservatorships/receiverships under a model act that is substantially uniform across the U.S.

The scope of federal discretion that could be exercised pursuant to the resolution authority proposed in the Resolution Authority Act is very broad, including the right to repudiate or renegotiate contracts (including employment contracts), loans by the government to the entity, purchasing assets from the entity, guaranteeing the liabilities of the entity, and making equity investments in the entity.

3. *Impact on Subsidiaries*

Some of the powers granted by the Resolution Authority Act, by their terms, could be exercised only as to the Resolution Company and any of its subsidiaries that are "covered subsidiaries." "Covered subsidiaries" would be defined to include all subsidiaries that are not (a) insured depository institutions; (b) broker-dealer firms that are members of the Securities Investor Protection Corporation ("SIPC"); or (c) insurance companies.

Thus, the Resolution Authority Act seems to recognize that there should be some limits on the remedial actions that it authorizes with respect to certain subsidiaries that are not themselves Resolution Companies and that are regulated by other entities such as bank regulators, the SIPC/SEC, or state insurance regulators. Nevertheless, even with respect to such "non-covered" subsidiaries, the impact could be profound if resolution procedures were implemented for their parent company. Among other things, for example, the Resolution Authority Act would give any conservator or receiver appointed under the Act "all rights titles, powers, and privileges of the [Resolution Company] and of any stockholder, member, officer, or director of such institution with respect to the [Resolution Company] and the assets of the [Resolution Company]." Any conservator or receiver, of course, could exercise such powers in ways that significantly affect any subsidiary (such as an insurance company) and such subsidiary's operations, notwithstanding that the subsidiary is not a "covered subsidiary."

E. Regulation by Consumer Financial Protection Agency ("CFPA")

As discussed in part V. below, the new CFPA, as currently proposed, would have regulatory jurisdiction with respect to credit insurance, mortgage insurance, and title insurance. It may also have regulatory jurisdiction with respect to certain other activities that insurance firms may conduct, unless those activities are deemed to be "engaging in the business of insurance."

II. INVESTMENT ADVISERS

A. Impact of Tier 1 Financial Holding Company Regulation

An investment adviser may be part of a Tier 1 Financial Holding Company that would be subject to regulation as discussed in part I.A. above. Such regulation of its parent holding company could have very important consequences for an investment adviser subsidiary. This could include substantial new reporting burdens and operational constraints.

B. Impact of New Resolution Authority

An investment adviser may be part of a holding company that would be subject to the new federal “resolution” authority discussed in part I.D. above. This proposed resolution authority would provide federal authorities with exceedingly broad powers to take all actions they deem necessary to address any perceived financial stress on a financial firm that is subject to such authority. This would be, in effect, a new form of federal regulation to which investment advisers would be potentially subject, to the extent that they are (or are members of) sizable bank holding companies or Tier 1 Financial Holding Companies.

C. Repeal of “15 Client” Exclusion

As discussed in part IV. below, proposals are moving forward that would eliminate the exclusion from registration under the Investment Advisers Act of 1940 for investment advisers that have fewer than 15 clients. Although the primary motivation for this change is to provide more regulatory oversight with respect to hedge funds, this change would have other far-reaching consequences. For example, under the proposed legislation, even an adviser whose clients are limited to three or four natural persons could be required to register as an adviser with the SEC.⁹

D. Additional Benefit of Being an SEC-Regulated Adviser

As discussed in part V.D. below, an investment adviser that is not registered with the SEC may be subject to the jurisdiction of the proposed new Consumer Financial Protection Agency (“CFPA”). On the other hand, SEC-registered investment advisers generally would not be subject to the CFPA’s jurisdiction, so long as they are acting in their registered capacity.

This could be an important collateral benefit of registering with the SEC as an investment adviser. It is entirely unclear what sort of regulation the CFPA would ultimately exert over investment advisers that fall within its jurisdiction. Accordingly, if given the choice, some advisers may prefer to be subject to a regulator that is more of a known commodity (*i.e.*, the SEC).

⁹ As is currently the case, however, an adviser still would be prohibited from registering with the SEC, if it is regulated by the securities regulator in its state and has assets under management of less than \$30 million.

E. Regulation by Consumer Financial Protection Agency

As discussed in part V. below, many activities conducted by investment advisers and financial planners may be subject to regulation by the proposed new CFPA, if such activities are not conducted in the firm's capacity as an SEC registrant. However, many thousands of investment advisers and financial planners are not registered with the SEC. For example, advisers that have less than \$30 million under management generally are registered only with the securities regulator in the state where the adviser is located. Many financial planners, likewise, are not registered with the SEC.

A Treasury official has been reported in the press as having confirmed that, as to a state-regulated adviser, the CFPA would have jurisdiction and would at least "monitor" the adviser's activities. The official stated, however, that the primary regulation of the adviser would continue to be provided by the state regulator in those circumstances. Nevertheless, the relative roles of the CFPA and the state securities regulators are not defined in the proposed legislation to establish the CFPA, and this has caused considerable concerns about possible regulatory "turf wars" and possibly inconsistent or duplicative regulation by different regulators.

For example, William Galvin, Secretary of the Commonwealth of Massachusetts, has expressed opposition to any preemption of state law in this area. The North American Securities Administrators Association Inc. also has been considering the matter, as have trade associations whose members include investment advisory and financial planning firms.

Also, any investment advisers and financial planners that are not subject to either SEC or state regulation may find that they become subject to substantial regulation by the CFPA.

III. MONEY MARKET FUNDS

A. Background: September 18, 2009 Termination Date for Treasury Temporary Guarantee Program

September 18, 2009 marks the expiration of Treasury's temporary program for guaranteeing certain investments in money market funds, and it does not currently appear that the program will be extended beyond that date. Although the temporary guarantee program was subject to significant limitations and conditions, the administration's White Paper made clear the administration's view that the program, together with various other governmental programs, has been instrumental in stabilizing the money market fund industry against the threat of massive and disorderly redemptions such as rocked the industry last autumn.

The White Paper, moreover, evidenced clear concern that the money market funds may be unable to stand on their own, once the temporary guarantee program terminates (and other programs of direct and indirect governmental assistance wind down).

B. SEC Proposals to Enhance Money Market Fund Resilience

Consistent with the White Paper's recommendations, the SEC on June 30, 2009 proposed for comment numerous steps to strengthen money market fund resilience.¹⁰ The SEC's proposals include rule changes that would:

- reduce money market funds' maximum permitted weighted average portfolio maturity;
- impose a new maturity test that would limit the portion of a fund's portfolio that could be held in longer term variable or floating-rate securities;
- make certain government securities subject, for the first time, to the same maturity limits as other portfolio securities;
- impose extensive new requirements to ensure that money market funds' portfolio investments are sufficiently liquid. These requirements would vary, depending on the nature of the investors in the fund (*i.e.*, more rigorous liquidity standards would apply to "institutional funds" than to "retail" funds);
- require periodic "stress testing" of a money market fund's ability to maintain a stable net asset value per share in the face of various hypothetical scenarios of adverse developments;
- modify the requirements that money market funds must satisfy with respect to their investments in repurchase agreements, to reduce certain risks to the funds;
- require money market funds to make more frequent public disclosure of their portfolio holdings;
- require money market funds to file monthly with the SEC detailed information bearing on the investment and risk characteristics of each of their portfolio holdings, which detailed information would be made available to the public after a two week delay;
- require that money market funds' administrative systems be capable of processing transactions in the funds' shares at prices other than \$1 per share, should it ever become necessary or appropriate for the fund to "break the buck";
- modify the terms of and conditions under which an affiliate of a money market fund can purchase securities from the fund without obtaining SEC approval; and
- permit a money market fund to suspend redemptions of its shares in order to facilitate a liquidation of the fund, if the fund's share price has broken a buck.

Some of the SEC's proposed changes are similar to some changes that had previously been recommended by the Investment Company Institute ("ICI").¹¹ But the SEC's proposed rule changes go considerably beyond the ICI proposals.

¹⁰ The SEC's proposals may be found at: <http://www.sec.gov/rules/proposed/2009/ic-28807.pdf>

¹¹ See Report of the Money Market Fund Working Group of the Investment Company Institute (March 17, 2009), which may be found at: http://www.ici.org/pdf/ppr_09_mmwg.pdf

The SEC's proposed changes probably would somewhat enhance the stability of money market funds, while slightly increasing fund operating expenses and decreasing returns to investors. Moreover, some of the SEC's proposals may presage a significantly different relationship between money market funds and the SEC, with the SEC performing a much more active ongoing role of reviewing detailed current information about a fund's portfolio securities in an effort to identify any untoward risks to which the fund is exposed.

In any event, the ever-expanding regulatory requirements will continue to make it more and more difficult for smaller money market funds to remain economically viable.

C. Other Possibilities the SEC Has Raised for Money Market Funds

In its release proposing the above-discussed rule changes, the SEC also solicited comments from the public on numerous other ideas that the SEC did not specifically propose. These include:

- eliminating the use of NRSRO ratings in the SEC's rule requirements governing permissible money market fund investments;
- permitting a money market fund to suspend redemptions of its shares for up to five days if its net asset value is materially impaired, in order to give the fund an opportunity to remedy the impairment;
- requiring money market funds to value their shares at net asset value, rather than on an amortized cost basis; and
- requiring money market funds to pay the proceeds of redemptions above a certain size "in kind," rather than in cash.

Some of such changes would, of course, change the nature of money market funds in ways that clearly would significantly shrink the market for such products. A move away from a constant net asset value per share, for example, would surely have that result. The extensive rule proposals that the SEC has made, however, seem to reflect an attempt by the SEC to address the perceived problems in ways that avoid such a draconian result.

D. Next Steps

Money market funds already have voluntarily been taking many steps to enhance their resilience. To the extent that they can implement the SEC's most recent proposals prior to the SEC's adoption of rules, many money market funds will probably at least give consideration to doing so. The industry has a general interest not only in *being* as strong as possible by the time the Treasury's temporary guarantee program terminates on September 18, but also in being *perceived* by investors as being as strong as possible.

The deadline for public comments on the SEC's rule proposals is September 8, 2009. It is not clear when thereafter the SEC may take final action on any of the proposals. Even if the impending termination of the Treasury's temporary guarantee program impels the SEC to act

promptly, the September 8 comment date ensures that, in doing so, the SEC will have the benefit of considerable public input.

IV. HEDGE FUNDS AND OTHER PRIVATE FUNDS¹²

A. Regulation Likely

It seems increasingly likely that hedge funds, as well as at least some other forms of private funds, will come under increased SEC regulation. While several bills for this purpose have been introduced that would accomplish this in different ways, the Obama administration's position on the matter is becoming increasingly clear, as discussed further below. In any case, it seems likely that more private fund advisers (if not the funds themselves) will have to register with the SEC; more information about private funds will have to be provided to federal regulators; and, in some cases, the SEC may examine more frequently and with somewhat different objectives in mind than in the case of other types of advisory clients.

B. Private Fund Investment Advisers Registration Act of 2009

Consistent with a recommendation in the administration White Paper, the administration on July 15, 2009 published proposed legislation that would require the advisers to most hedge funds and other private investment funds to be registered with the SEC as investment advisers. This proposed legislation, the Private Fund Investment Advisers Registration Act of 2009 ("PFIARA 2009"),¹³ generally incorporates the substance of S. 1276 (the Private Fund Transparency Act of 2009),¹⁴ which was introduced by Senator Jack Reed on June 16, 2009. (Senator Reed's bill itself was introduced at about the time the White Paper was published and was reportedly designed to implement the provisions thereof.)

1. *Repeal of "15 Client" Exclusion*

Like S. 1276, PFIARA 2009 would eliminate the provision in the Investment Advisers Act of 1940 that enables advisers with fewer than 15 clients to avoid registering under that Act (except that this exclusion would be retained for certain foreign investment advisers). This change would affect not only advisers to hedge funds, but also advisers to other private funds, such as venture capital and private equity funds. This is controversial, in that private equity funds and venture capital funds typically have not been identified as a cause of any of the recent financial market difficulties.

¹² Regulation in this area may be of interest to insurance and reinsurance companies because of the role of hedge funds in prior years in providing significant liquidity to the reinsurance and alternative risk transfer sectors.

¹³ The text of this proposed legislation may be found at:

<http://www.ustreas.gov/press/releases/reports/title%20iv%20reg%20advisers%20priv%20funds%207%2015%2009%20fnl.pdf>

¹⁴ This bill may be found at: [http://www.thomas.gov/cgi-bin/query/z?c111:S.1276:](http://www.thomas.gov/cgi-bin/query/z?c111:S.1276)

2. *Providing Additional Information to Regulators*

PFIARA 2009 also would specifically require registered investment advisers to maintain and make available to federal regulators such information as the SEC may require concerning the private funds they advise as may be necessary for the regulators' supervision of systemic risk. This could include, but not be limited to, records of or information about the identity, investments or affairs of the private funds. In this regard, PFIARA 2009 seems narrower than S. 1276, in that S. 1276 would require the adviser to make available this type of information as to *any* client, and not merely those clients who are private funds.

3. *Repeal of Exemptions for Intrastate Advisers and Commodity Trading Advisers*

On the other hand PFIARA 2009 contains certain provisions not found in S. 1276. In this regard, certain investment advisers currently are excluded from registration with the SEC as such if they conduct business solely within a single state or who are registered with the CFTC as commodity trading advisers. PFIARA 2009 would eliminate these exclusions for any adviser to a private fund.

4. *Potential Additional Disclosures to Investors, Counterparties, and Creditors*

Also, PFIARA 2009 empowers the SEC to require that advisers to hedge funds and other private funds provide investors, prospective investors, counterparties, and creditors with such reports, records and other documents concerning a fund as the SEC may prescribe as necessary or appropriate in the public interest and for the protection of investors or for the assessment of systemic risk. This is a remarkably broad provision, in that it seems to authorize the SEC to impose disclosure obligations on private funds that might, in theory at least, approach and in some respects even exceed the disclosure obligations of fully-registered mutual funds.

C. Other Pending Bills

H.R. 711 (the Hedge Fund Advisor Registration Act of 2009)¹⁵ is similar in general concept to PFIARA 2009, in that both would repeal the exclusion from SEC registration for investment advisers with fewer than 15 clients. S. 344 (the Hedge Fund Transparency Act)¹⁶ is different in concept, in that it would leave intact the 15 client exclusion from investment adviser regulation and, instead, impose certain filing, reporting and other conditions on the availability of the exemption on which private funds customarily rely in order to avoid registration under the Investment Company Act of 1940. Speaking broadly, however, the practical effect of S. 344 would be not dissimilar to that of PFIARA 2009 or H.R. 711.

H.R. 713 (the Hedge Fund Study Act)¹⁷ has also been introduced. That bill would require the President's Working Group on Financial Markets to conduct a broad study of hedge funds,

¹⁵ This bill may be found at: <http://www.thomas.gov/cgi-bin/query/z?c111:H.R.711>:

¹⁶ This bill may be found at: <http://www.thomas.gov/cgi-bin/query/z?c111:S.344>:

¹⁷ This bill may be found at: <http://www.thomas.gov/cgi-bin/query/z?c111:H.R.713>:

including potential risks that such funds pose to investors and to financial markets. The recommendations of any such study could potentially be wide-ranging.

D. European Union's Proposed Alternative Investment Funds Directive

The European Union is considering a proposed Alternative Investment Funds Directive, which would place more substantive requirements on private investment funds than would the U.S. legislative initiatives discussed above. This would include, for example, leverage limitations. Because U.S. private funds historically have not been subject to such limitations, the European Union proposal threatens to make it impossible for U.S. funds to raise cash in Europe. The preponderance of hedge funds and private equity funds are based in the U.S. and the U.K. Accordingly, the U.S. and the U.K. are lobbying for removal of some of the more burdensome provisions in the proposed Directive that they believe are unnecessary. Some fund managers and their associations are doing the same.

V. PROPOSED CONSUMER FINANCIAL PROTECTION AGENCY

Consistent with the White Paper's recommendations, the Obama administration published proposed legislation on June 30, 2009 that would establish a Consumer Financial Protection Agency ("CFPA"). On July 8, 2009, almost identical legislation (the Consumer Financial Protection Agency Act of 2009) was introduced by Barney Frank as H.R. 3126.¹⁸

A. Potentially Comprehensive Nature of CFPA Regulation

The CFPA Act would give the CFPA authority to regulate with extraordinary thoroughness any "Consumer Financial Product or Service" and any persons who provide such products and services ("Covered Persons"). We previously published an Alert concerning the proposed CFPA, which summarizes how numerous and varied are the forms of regulation that could apply.¹⁹ Accordingly, H.R. 3126 is potentially of utmost consequence to any product, service or person that falls within its purview.

B. The CFPA's Primary Areas of Concern

H.R. 3126 is not entirely clear to what extent the CFPA would have jurisdiction over insurance and securities firms. It is clear that H.R. 3126 is primarily concerned with consumer activities such as:

- taking deposits by banks, savings and loans, credit unions, and the like;
- providing money transfer, check guarantee, and bill payment services;
- issuing and servicing mortgages and consumer loans; issuing and servicing credit cards and debit cards;
- providing real estate settlement services;

¹⁸ This bill may be found at: <http://www.thomas.gov/cgi-bin/query/z?c111:H.R.3126>:

¹⁹ Our Alert may be found at: <http://www.jordenusa.com/attachments/3243.pdf>

- tax planning and tax preparation;
- providing leasing services for personal or real property;
- credit reporting;
- debt collection and negotiation and mortgage modification; and
- debt counseling and credit repair.

C. Relevance to Insurance Industry

Various provisions in H.R. 3126 clearly evidence a specific intent for the CFPA to have jurisdiction over credit insurance, mortgage insurance, and title insurance. This, of course, sets up a tension (which the proposed legislation leaves largely unaddressed) between the new scheme of federal regulation and currently existing state regulatory regimes for those products.

H.R. 3126 contains language that suggests that (except for credit, mortgage, and title insurance) the CFPA is not to assert jurisdiction over any activity that constitutes “engaging in the business of insurance.” The scope of this exclusion is unclear. However, the mere fact that a company may engage in the business of insurance would not seem necessarily to preclude CFPA jurisdiction if that company also engages in activities with which the CFPA is primarily concerned. Rather, in order to escape CFPA jurisdiction with respect to any activity that otherwise would be within the CFPA’s jurisdiction, it might be necessary for that activity actually to comprise part of the business of insurance.

D. Exclusion for Certain Persons Regulated by the SEC or CFTC

H.R. 3126 specifically preserves the SEC’s sole jurisdiction over any person required to be registered under the Securities Exchange Act of 1934, the Investment Advisers Act of 1940 or the Investment Company Act of 1940; and there is a similar provision for persons who are registered with the CFTC. In each case, however, the exclusion from CFPA jurisdiction applies only to the extent that the person in question acts in a “registered capacity.”

Does this mean that the exclusion could be relied upon only for activities that could not be conducted without SEC/CFTC registration? Or might the exclusion be established if the activity in question is subject to some SEC/CFTC (or perhaps FINRA) requirements, even though the activity would not by itself require SEC/CFTC registration? It is unclear whether these or some other interpretations would apply.

E. Investment and Financial Advisory Activities

H.R. 3126 would specifically include within its jurisdiction certain investment advisory and financial advisory activities, including:

- acting as investment adviser to any consumer and
- acting as financial adviser to any consumer, including the provision of (i) financial and other related advisory services, (ii) educational courses and instructional materials on individual financial management matters, or (iii) credit counseling, tax planning, or tax preparation services.

Large numbers of insurance and securities firms provide services that could constitute these types of investment and financial advisory activities. It would appear, therefore that these firms would be subject to regulation by the CFPA, except to the extent that these activities were deemed (a) to be “engaging in the business of insurance” (as discussed in part V.C. above) or (b) to be conducted in the firm’s SEC/CFTC-registered capacity (as discussed in part V.D. above).

Clearly, should H.R. 3126 become law in its current form, difficult interpretive questions will arise.

F. Certain Industry Communications with Congress

Insurance industry associations have been communicating with Congress in an effort to remove credit, mortgage and title insurance from the CFPA’s jurisdiction (*see* part V.C. above) and, more generally, to remedy other ambiguities that might give the CFPA jurisdiction over issuers and other persons involved in the insurance industry under circumstances where such jurisdiction would not be advisable.

VI. OTHER LEGISLATIVE PROPOSALS

Listed below are other recent legislative proposals that are relevant to the insurance and investment adviser/fund industries but that are not otherwise covered in this Bulletin.

A. Investor Protection Act of 2009

The provisions of this proposed legislation, which was published by the Obama administration on July 10, 2009,²⁰ include:

- authorization for the SEC to establish a fiduciary standard of conduct for all investment advisers and broker-dealers when they provide investment advice to customers about securities;
- authorization for the SEC to prohibit sales practices, conflicts of interest, and compensation schemes for investment advisers and broker-dealers that the SEC deems contrary to the public interest and the interests of investors;
- authorization for the SEC to specify information that must precede a sale to a purchaser of securities issued by a registered investment company;
- authorization for the SEC to prohibit or restrict mandatory arbitration provisions in customer agreements used by broker-dealers and investment advisers.
- authorization for the SEC to set up a program under which substantial monetary awards could be paid to “whistleblowers” who provide information to the SEC that leads to monetary recoveries in SEC enforcement actions; and
- enhancement of the SEC’s ability to seek remedies against aiders, abettors and controlling persons of those who violate federal securities laws.

²⁰ The text of this proposed legislation may be found at: <http://www.treas.gov/press/releases/docs/tg205071009.pdf>

B. Bank Holding Company and Depository Institution and Regulatory Improvements Act of 2009

This proposed legislation was published by the Obama administration on July 22, 2009.²¹ Consistent with recommendations in the White Paper, this legislation would amend the Bank Holding Company Act so that certain companies that own specific types of institutions (such as federally-insured thrift institutions, industrial loan companies or credit card banks) would no longer be excluded from the Act's coverage.

C. Payment, Clearing, and Settlement Supervision Act of 2009

This proposed legislation was published by the Obama administration on July 23, 2009.²² Consistent with recommendations in the White Paper, this legislation authorizes the Federal Reserve to prescribe uniform standards for the management of risks by systemically important financial market utilities and for the conduct of systemically important payment, clearing and settlement activities by financial institutions.

D. Consumer Protection and Regulatory Enhancement Act

The Consumer Protection and Regulatory Enhancement Act (H.R. 3310)²³ was introduced by House Republicans on July 23, 2009. H.R. 3310 would cover many of the subjects that are addressed in the administration's proposals, but naturally, with very different substance and emphasis. Among other things, H.R. 3310 would:

- Provide mechanisms for the resolution of non-bank financial institutions;
- Establish a Market Stability and Capital Adequacy Board, which would seek to identify risks that could endanger the stability and soundness of the financial system and to make reports thereon to Congress and appropriate regulatory authorities;
- Establish a federal Financial Institutions Regulator, which would absorb many of the functions of the several current federal bank regulatory bodies;
- Establish an Office of Consumer Protection within the Federal Institutions Regulator, which office which would be responsible for carrying out the Federal Institutions Regulator's consumer protection functions;
- Impose restrictions on the emergency powers of the Federal Reserve Board; and
- Eliminate or require relevant federal regulators to eliminate many references to credit ratings in federal laws and regulations.

²¹ The text of this proposed legislation may be found at:
<http://www.ustreas.gov/press/releases/reports/title%20vi%20bhca%20amndts%20%200722%20fnl.pdf>

²² The text of this proposed legislation may be found at:
http://www.ustreas.gov/press/releases/reports/titleviii_payments_072209.pdf

²³ This bill may be found at: <http://www.thomas.gov/cgi-bin/query/z?c111:H.R.3310>:

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For additional information:

Jorden Burt has formed a special Task Force to monitor these proposals. To obtain additional information about particular proposals that might have an impact on the insurance or reinsurance industries, you may contact Roland Goss (rcg@jordenusa.com or (202) 965-8148). To obtain additional information about particular proposals that might have an impact on the investment adviser and fund industries you may contact Tom Lauerman (tcl@jordenusa.com or (202) 965-8156). Or you may contact any of Jorden Burt's other regulatory attorneys.