

## **SENATE BANKING COMMITTEE APPROVES FINANCIAL MODERNIZATION: IMPLICATIONS FOR INSURANCE AND INVESTMENT PRODUCTS AND SERVICES**

**(March 23, 2010)**

### **INTRODUCTION**

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

Yesterday, the Senate Committee on Banking, Housing and Urban Affairs (the "Senate Committee") approved on a party-line vote the Restoring American Financial Stability Act of 2009 ("RAFSA").<sup>1</sup> RAFSA would make a wide variety of far-reaching and comprehensive regulatory reforms that are in many respects similar to those included in H.R. 4173, which was passed in the House of Representatives on December 11, 2009.

The Senate Committee yesterday considered only relatively limited changes, which were contained in a "manager's amendment" that was also approved by party-line vote. Now it will be up to the full Senate to consider the many additional amendments that are expected to be put forward.

This Bulletin discusses certain features of RAFSA, as reported out of the Senate Committee yesterday, that would be important for some of Jordan Burt's core client groups, including insurance companies, investment advisers, and distributors of investment and insurance products. Consistent with our prior client Bulletins, however, we generally are not addressing here the regulatory changes that RAFSA proposes for banks and bank holding companies.

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<sup>1</sup> The text of RAFSA as released last week by Senate Committee Chairman Christopher Dodd is available at: [http://banking.senate.gov/public/\\_files/ChairmansMark31510AYO10306\\_xmlFinancialReformLegislationBill.pdf](http://banking.senate.gov/public/_files/ChairmansMark31510AYO10306_xmlFinancialReformLegislationBill.pdf) In connection with its approval of RAFSA yesterday, the Senate Committee also made some further amendments in the version released last week, which amendments are available at: [http://banking.senate.gov/public/\\_files/032310MangersAmendmentAYO10627.pdf](http://banking.senate.gov/public/_files/032310MangersAmendmentAYO10627.pdf) The foregoing documents, taken together, comprise the bill as reported out of the Senate Committee yesterday.

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## ANALYSIS

### I. MEASURES TO DIRECTLY CONTROL SYSTEMIC RISKS

RAFSA is conceptually similar to H.R. 4173 in that it provides for direct macro analysis and management of risks that threaten the stability of the United States financial system or economy. First, it would establish a structure for the identification and management of such

“systemic” risks, with broad powers and resources for gathering and analyzing information and for exerting prudential regulation over companies that pose identified levels of risk. Second, it would provide for intervention to fundamentally restructure or liquidate companies that pose unacceptable risks. RAFSA also contains a series of provisions covering specific industries or types of activities, the relevant portions of which are discussed in this Bulletin, with a focus on assessing and attempting to manage risks with respect to those industries and activities. The ways in which RAFSA and H.R. 4173 would implement these policies are similar, but differ in significant respects.

A. Financial Stability Oversight Council (the “Council”)

RAFSA would establish systemic risk and prudential risk regulation primarily through a Financial Stability Oversight Council. The Council would be composed of nine voting and one nonvoting member. The voting members would be:

- Secretary of the Treasury (Chairperson of the Council);
- Chairman of the Board of Governors of the Federal Reserve System;
- Comptroller of the Currency;
- Director of the Bureau of Consumer Financial Protection (discussed in part V. below):
- Chairperson of the SEC;
- Chairperson of the FDIC;
- Chairperson of the CFTC;
- Director of Federal Housing Finance Agency; and
- a person appointed by the President (and confirmed by the Senate) who has insurance expertise.

The Director of the Office of Financial Research (another new entity that RAFSA would establish) would be the only nonvoting member of the Council. Unlike H.R. 4173, RAFSA would not include participation on the Council by the Director of the Office of National Insurance (discussed in part II. below) or state banking, insurance or securities regulators.

The Council would have four broad purposes: (i) to identify risks to the financial stability of the United States that could arise from the material financial distress or failure of large, interconnected bank holding companies or nonbank financial companies; (ii) to promote market discipline by eliminating expectations that the government will shield shareholders, creditors and counterparties from losses in the event of failure; (iii) to respond to emerging threats to the stability of the United States financial markets; and (iv) to determine whether and when nonbank financial companies should be subjected to prudential supervision by the Board of Governors of the Federal Reserve System (the “Fed”).

To accomplish these purposes, the Council would be charged with a large number of tasks, including:

- collecting information from federal and state agencies and regulators and, through the Office of Financial Research, from bank holding companies and nonbank financial companies, and assessing risks to the United States financial system;
- monitoring the financial services marketplace to identify potential threats to the financial stability of the United States;
- providing direction to the Office of Financial Research. That office, in turn, would (i) gather information through inter-agency cooperation, required disclosures by companies, and examination of nonbank financial companies by the Fed and (ii) prepare analyses based on such information;
- facilitating information sharing and coordination among federal and state agencies regarding domestic financial services policy development, rulemaking, examinations, reporting requirements, and enforcement actions;
- recommending to the member agencies general supervisory priorities and principles;
- identifying regulatory gaps that could pose risks to the financial stability of the United States;
- requiring supervision by the Fed of nonbank financial companies that may pose risks to the financial stability of the United States in the event of their material financial distress or failure;
- making recommendations to the Fed concerning the establishment of prudential standards for risk-based financial management and disclosure for companies supervised by the Fed;
- identifying systematically important financial market utilities and payment, clearing and settlement activities, and requiring that these be subject to standards established by the Fed;
- making recommendations to the various primary financial regulatory agencies to apply new or heightened standards and safeguards for financial activities or practices that could create or increase risks of significant liquidity, credit, or other problems spreading among bank holding companies, nonbank financial companies, and United States financial markets;
- providing a forum for the discussion of emerging market developments and financial regulatory issues and the resolution of jurisdictional disputes among members of the Council; and
- reporting annually to Congress on the activities of the Council.

## B. Enhanced Prudential Regulation

### 1. *Fed Supervision of Certain Nonbank Financial Companies*

By a vote of two thirds of its voting members, including an affirmative vote by the Chairperson, the Council could determine that a United States nonbank financial company (or, in certain cases, a foreign nonbank financial company) shall be subject to prudential supervision by the Fed, on the grounds that financial distress at such company would pose a threat to the financial stability of the United States.

“Nonbank financial companies” would be defined as being companies that are substantially engaged in activities in the United States that are financial in nature as defined in

Section 4(k) of the Bank Holding Company Act of 1956. This definition is very broad, potentially encompassing the following types of activities: (i) lending, exchanging, transferring, investing for others, or safeguarding money or securities; (ii) insuring, guaranteeing, or indemnifying against loss, harm, damage, illness, disability, or death, or providing or issuing annuities, and acting as principal, agent or broker for such activities; (iii) providing financial, investment, or economic advisory services, including advising an investment company; and (iv) underwriting, dealing in, or making a market in securities. RAFSA contains a list of factors that should be considered by the Council in determining whether a nonbank financial company should be subject to Fed supervision, and provides for notice and a “hearing” before the Council to contest such a determination. The “hearing,” however, may be limited to the submission of written materials by the company.

The Fed would be charged with establishing and implementing prudential standards and reporting and disclosure requirements that are applicable to companies it supervises under these provisions. RAFSA would require that those standards and requirements be “more stringent” than those applicable to companies that are not under the Fed’s prudential supervision. The Fed’s more stringent standards would be based, in part, upon recommendations from the Council and would likely concern the following matters:

- risk-based capital requirements;
- leverage limits;
- liquidity requirements;
- resolution plan and credit exposure report requirements;
- concentration limits;
- credit exposure concentration limits (limiting the credit exposure of the company to any unaffiliated company to no more than 25 percent of its capital stock and surplus);
- contingent capital requirements (requiring long-term hybrid debt that could be converted into equity in times of financial distress);
- contingent capital requirements;
- enhanced public disclosures and reporting to the Fed; and
- overall risk management requirements.

## 2. Enhanced Prudential Regulation Recommendations to Primary Regulators

RAFSA also would provide the Council itself with authority to indirectly regulate certain activities and practices by providing “recommendations” to the “primary financial regulatory agencies” to apply new or heightened standards and safeguards for an identified financial activity or practice conducted by a bank holding company or nonbank financial company. Such “recommendations” must be based upon a determination by the Council that the conduct of such activity or practice could create or increase the risk of significant liquidity, credit, or other problems spreading among bank holding companies and nonbank financial companies or the financial markets of the United States. The primary “financial regulatory agency” may be a federal regulatory agency or a state agency, such as a state insurance department.

It is not clear (i) why this authority was not given to the Fed as an adjunct to its prudential supervision responsibilities or (ii) how the exercise of such authority would occur if

the company is already under prudential supervision by the Fed. It is probably less likely that such a recommendation would be ignored if it were made to a federal regulatory agency that is represented on the Council, than if it were made to a federal or particularly a state regulatory agency that is not represented on the Council. If the primary regulatory authority does not implement the recommendation, there is a 60 day window during which the Fed may implement the recommendation.

### *3. Extraordinary Fed Intervention in Certain Cases*

Finally, the Bill would authorize the Fed, upon a vote of two thirds of the voting members of the Council, to take certain actions to “mitigate” risks to financial stability posed by bank holding companies with more than \$50 billion of consolidated assets or nonbank financial companies supervised by the Fed, if it determines that such companies pose a “grave threat to the financial stability of the United States.” Such actions may include (i) requiring the company to terminate one or more activities, (ii) imposing conditions on the manner in which the company conducts one or more activities, or (iii) requiring that the company sell or otherwise transfer assets or off-balance-sheet items to unaffiliated entities. These provisions address the issues of companies which, although financially healthy, may be “too big to fail” under some analysis because of their relationship to the economy as a whole. Providing this authority to the Council, instead of to the Fed, creates another area of potential jurisdictional conflict.

#### C. Resolution Authority

The various proposals for the “modernization” of financial regulation all provide some method for “resolving” (*e.g.*, liquidating) financially troubled companies that are deemed to be inappropriate for established bankruptcy processes. While both the RAFSA and H.R. 4173 provide that the FDIC would be appointed as the receiver/liquidator in such cases, they differ as to how the determination would be made that such an appointment is appropriate and necessary. Among other things, H.R. 4173 contains a provision providing a strong presumption that the existing available bankruptcy processes remain the primary means of resolving financial companies and that the new resolution procedures should be used only in “the most exigent circumstances.” RAFSA contains no such presumption, however, although it does require consideration of why the otherwise available bankruptcy process would not be an appropriate alternative.

#### *1. Initiating Liquidation Process*

Under RAFSA, the process of deciding to seek the liquidation of a company would start with a written recommendation of liquidation that would be based upon a vote of two thirds of the members of the Fed Board of Governors and two thirds of the members of the Board of Directors of the FDIC. Such a written recommendation must contain:

- an evaluation of whether the company is in default or in danger of default;
- a description of the effect that the default would have on the financial stability of the United States;

- a recommendation regarding the nature and extent of actions to be taken regarding the company;
- an evaluation of the likelihood of a private sector alternative to prevent the default of the company;
- an evaluation of why a case under the Bankruptcy Code is not appropriate for the company; and
- an evaluation of the effects on creditors, counterparties, and shareholders of the company and other market participants.

The Secretary of the Treasury (the “Secretary”) must file a petition (the “Petition”) with an Orderly Liquidation Authority Panel (discussed below) if, considering the written recommendation, and after consulting with the President, the Secretary determines that:

- the company is in default or in danger of default;
- the failure of the company and its resolution would have serious adverse effects on the financial stability of the United States;
- no viable private sector alternative is available to prevent the default of the company;
- any effect on the interests of creditors, counterparties, shareholders, and others is appropriate given the impact that resolution would have on the financial stability of the United States;
- resolution would mitigate such adverse effects; and
- a federal regulatory agency has ordered the company to convert into equity all of its convertible debt instruments that are subject to a regulatory order.

Written notice of such a determination by the Secretary must be provided to Congress within 48 hours.

For purposes of this process, a company would be considered to be in default or in danger of default if:

- a case has been, or likely will promptly be, commenced with respect to the company under the Bankruptcy Code;
- the company has incurred, or is likely to incur, losses that will deplete all or substantially all of its capital, and there is no reasonable prospect for the company to avoid such depletion;
- the assets of the company are, or are likely to be, less than its obligations to creditors and others; or
- the company is, or is likely to be, unable to pay its undisputed obligations in the normal course of business.

RAFSA would establish an Orderly Liquidation Authority Panel (the “Panel”), which would be composed of the Chief Judge of the United States Bankruptcy Court for the District of Delaware and two other judges of that Court appointed by the Chief Judge of that court. If the Secretary makes the above-described determination that a company should be subjected to RAFSA’s liquidation authority, the Secretary would be required to present a Petition to the Panel seeking authorization to appoint the FDIC as receiver for the company. The Petition would be

filed under seal, and the company would have notice and an opportunity to be heard at a hearing. However, within 24 hours of the filing of the Petition, the Panel would hold any hearing and determine, without any prior public disclosure, whether the determination by the Secretary is supported by substantial evidence. If the Panel finds that the Petition is supported by substantial evidence, RAFSA would require the Panel to authorize the Secretary to appoint the FDIC as receiver for the company. If the Panel finds that the Petition is not supported by substantial evidence, the Panel would be required to provide a written statement of each reason supporting its determination, and afford the Secretary an immediate opportunity to amend and re-file the Petition.

Under RAFSA, final decisions of the Panel would be appealable to the United States Court of Appeals for the Third Circuit, and would be considered by that court on an expedited basis. However, RAFSA states that final decisions of the Panel “shall not be subject to any stay or injunction pending appeal,” and are confidential, with criminal penalties for disclosure of the determination of the Secretary. Given the speed at which this process might move, it is quite likely that there would be little or no effective appellate review of decisions to liquidate companies under the RAFSA. The short notice, limited due process and subjective nature of the standards for liquidating a company are troubling, given the draconian and irreversible nature of the actions being contemplated.

## *2. Administering Liquidation Process*

RAFSA contains extensive provisions providing the FDIC with broad authority in the management and liquidation of companies for which it is appointed receiver. In particular, RAFSA provides that the liquidation or rehabilitation of insurance companies would be conducted as provided under state law and contains special provisions regarding the liquidation of securities broker-dealers. RAFSA requires that the FDIC liquidate companies for which it is appointed receiver.

In carrying out its duties as a receiver, the FDIC would be required to: (i) preserve the financial stability of the United States, rather than to preserve any company; (ii) ensure that unsecured creditors of the company bear losses in accordance with claim priorities set out in RAFSA; (iii) ensure that the company’s shareholders do not receive payment until after all other claims and liquidation expenses have been paid; (iv) ensure that management responsible for the failed condition of the company is removed; and (v) take no equity interest in the company.

RAFSA also would establish an orderly liquidation fund (the “Fund”), which could be used by the FDIC to pay the expenses of the liquidation of companies as to which it is appointed receiver under RAFSA. The initial target balance for the Fund would be \$50 billion, to be funded by risk-based assessments on (i) bank holding companies with total consolidated assets of \$50 billion or more and (ii) any nonbank financial companies with respect to which the Fed is exercising prudential supervision responsibilities.

## II. INSURANCE REGULATION

### A. Office of National Insurance

RAFSA would establish an Office of National Insurance (“ONI”) within the Department of the Treasury, headed by a career service Director appointed by the Secretary. The functions of the ONI would be the same as those proposed in the Obama Administration’s Office of National Insurance Act of 2009 (which was discussed in our Task Force’s August 4, 2009 Bulletin<sup>2</sup>), namely:

- to monitor all aspects of the insurance industry, including identifying issues or gaps in the regulation of insurers that could contribute to a systemic crisis in the insurance industry or the United States financial system;
- to recommend to the Fed when it should designate an insurer, including its affiliates, as an entity subject to regulation as a nonbank financial company subject to prudential regulation by the Fed;
- to assist the Secretary 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 United States 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 B. 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 would have no authority with respect to health insurance or crop insurance as established by the Federal Crop Insurance Act, which is a broader exclusion for those types of insurance than previously proposed by the Obama Administration.

### B. International Agreements and Preemption of State Insurance Measures

RAFSA would authorize the Secretary to negotiate and enter into international insurance agreements on prudential measures on behalf of the United States, and would authorize the ONI’s Director to determine that a state insurance measure is preempted by federal law upon a determination by the Director that the state measure (i) treats an insurer that is domiciled outside the United States and subject to an international agreement on prudential measures less favorably than it treats a United States-domiciled insurer and (ii) is inconsistent with such international agreement. Prior to making such a determination, the Director would be required to notify and consult with the appropriate state, publish notice in the Federal Register regarding the potential inconsistency or preemption, and provide a period for written comments by interested parties.

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<sup>2</sup> That Bulletin is available at:  
<http://www.jordenburt.com/attach/3280/080409+Financial+Modernization+Bulletin.pdf>

The preemption provisions of RAFSA are specifically limited, moreover, so as not to preempt (i) any state insurance measure that governs any insurer's rates, premiums, underwriting or sales practices; (ii) any state coverage requirements for insurance; (iii) the application of the antitrust laws of any state to the business of insurance; or (iv) any state insurance measure governing the capital or solvency of an insurer, except to the extent that such state insurance measure results in less favorable treatment of a non-United States insurer than a United States insurer. The preemption of any state insurance measure as being inconsistent with and preempted by federal law other than the provisions relating to the ONI would not be affected by RAFSA.

RAFSA expressly provides that it would not give the ONI or the Department of the Treasury "general supervisory or regulatory authority over the business of insurance." It appears to be the intention of RAFSA not to preempt the regulation of the business of insurance by the states other than in the context of establishing and implementing federal policy with respect to the prudential regulation of insurance on an international scale.<sup>3</sup>

### C. Information Gathering, Studies, and Reporting

RAFSA would provide the ONI with the authority to gather and analyze information to support its activities, through cooperative information sharing arrangements with state insurance regulators, requests to insurers or their affiliates (if such information is not available from state insurance regulators), and by subpoena.

RAFSA would require that the ONI's Director provide reports as follows:

- an annual report to the President and to specified committees of Congress on any preemption of state insurance measures implemented by the ONI, or any other information deemed relevant by the Director, or as requested by the Congressional committees; and
- a report resulting from a special one-time study on how to modernize and improve the system of insurance regulation in the United States. This report would contain any appropriate legislative and regulatory recommendations, and would be provided to Congress not later than 18 months after the enactment of RAFSA. In conducting the study, the ONI would be required to consult with the NAIC, consumer organizations and representatives of the insurance industry, and policyholders. In this connection, the ONI would be required to consider the following factors:
  - systemic risk regulation;
  - capital standards;
  - consumer protection for insurance products and practices;
  - the degree of national uniformity of state insurance regulation;
  - the regulation of insurance companies and affiliates on a consolidated basis;

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<sup>3</sup> This is consistent with the portion of RAFSA that comprises the Consumer Financial Protection Act of 2010, as discussed in part VI.D.2. below.

- international coordination of insurance regulation;
- the costs and benefits of potential federal regulation across various lines of insurance;
- the feasibility of regulating only certain lines of insurance at the federal level;
- the ability of any potential federal regulation or regulator to eliminate or minimize regulatory arbitrage;
- the impact that developments in the regulation of insurance in foreign jurisdictions might have on the potential federal regulation of insurance;
- the ability of any potential federal regulation or regulator to provide robust consumer protection for policyholders; and
- the potential impact of subjecting insurance companies to a federal resolution authority on (i) the operation of state insurance guaranty funds, (ii) policyholder protection, (iii) separate account issues, and (iv) international competitiveness.

#### D. Nonadmitted and Reinsurance Reform Act

RAFSA also contains a version of proposed legislation that has been introduced in Congress as separate bills at least since 2006. This proposed legislation, known as the Nonadmitted and Reinsurance Reform Act, is also included in similar form in H.R. 4173. This portion of RAFSA would do the following:

- regulate premium taxes for nonadmitted insurance;
- provide that the placement of nonadmitted insurance shall be subject to regulation solely by the insured's home state;
- limit the ability of a state to establish eligibility requirements for United States-domiciled nonadmitted insurers that vary from the Non-Admitted Insurance Model Act;
- require a GAO study of the nonadmitted insurance market;
- regulate the extent to which a state may not recognize credit for reinsurance for an insurer's ceded risk;
- partially pre-empt the extraterritorial application of the law of a state to a ceding insurer not domiciled in that state; and
- provide that in most circumstances a state that is the domicile of a reinsurer shall be solely responsible for regulating its financial solvency.

#### E. Senior Protection

Unlike H.R. 4173, RAFSA does not contain specific suitability requirements for the sale of annuities. It does, instead, provide for grants to States or to State securities, insurance, or consumer protection departments for certain activities which enhance the protection of seniors from being misled by false designations or misleading and fraudulent marketing of financial products to seniors.

### **III. MAJOR CHANGES IN HOW SEC FUNCTIONS**

RAFSA would make numerous changes in the functioning of the SEC that will probably have significant consequences for those who provide products and services that are subject to the SEC's jurisdiction.

#### **A. Increased Focus on Investor Protection**

Historically, the SEC has viewed the protection of investors as its primary mission and has striven mightily to fulfill that mission. RAFSA aims to further enhance this pro-investor orientation.

##### *1. Investor Advocate*

RAFSA would establish within the SEC an Office of the Investor Advocate, whose function would be generally to look out for the interests of investors and to propose changes to promote those interests.

The Investor Advocate would have considerable power and influence, having authority to employ such "independent counsel, research staff, and service staff as the Investor Advocate deems necessary." The Investor Advocate also would have access to all documents of the Commission and any self-regulatory organization, as necessary to carry out the functions of the office. The SEC would be required to formally respond within three months to any recommendations (including changes in SEC rules and orders) it receives from the Investor Advocate.

The Investor Advocate also would be specifically required to propose to Congress any "legislative, administrative, or personnel changes that may be appropriate" to enhance investor protection. Moreover, the Investor Advocate would be required to make certain periodic reports to Congress each year concerning, among other things, what investor protection problems exist and how quickly the SEC is addressing those problems. The Investor Advocate would be required to submit such reports directly to Congress and would be prohibited from obtaining any prior review or comment on such reports by the SEC, any SEC Commissioner, or any member of the SEC staff. Finally, the Investor Advocate must be a person who has not recently worked at the SEC in another position and must not work at the SEC for five years after ceasing to be the Investor Advocate.

All of this suggests the Investor Advocate would have substantial influence and would function to a considerable extent as the Congress's "eyes and ears" on many oversight issues.

##### *2. Investor Advisory Committee*

RAFSA also would establish an Investor Advisory Committee composed of:

- the Investor Advocate (discussed immediately above);
- a representative of state securities commissions;

- a representative of the interests of senior citizens; and
- a number of other persons representing the interests of individual equity and debt investors, registered investment companies, pension funds, and other institutional investors.

The Investor Advisory Committee would be charged generally with advising, consulting with, and making recommendations to the SEC concerning such things as:

- the regulation of securities products, trading strategies and fee structures, and the effectiveness of disclosure;
- other initiatives to protect investors' interests; and
- initiatives to promote investor confidence and the integrity of the securities marketplace.

While the Investor Advisory Committee's role would be purely advisory and consultative, the Investor Advocate, who would be a member of the committee, could be expected also to adopt many of the Advisory Committee's recommendations. For that and other reasons, it is foreseeable that the Investor Advisory Committee would have considerable influence on investor protection issues.

### 3. *Other Significant Investor Protection Aspects*

RAFSA also would include:

- Clarification of the SEC's authority to gather information from investors or other members of the public in connection with developing rules or programs under any law the SEC administers and
- Clarification of the SEC's authority to implement temporary pilot programs with respect to such rules and programs.

#### B. Mandatory Monetary Awards to "Whistleblowers"

RAFSA provides that, if original information voluntarily provided to the SEC by a "whistleblower" results in monetary sanctions exceeding \$1 million, the SEC must, if certain conditions are met, award the whistleblower between 10% and 30% of the sanctions. H.R. 4173 would provide for similar rewards, except that H.R. 4173 does not provide for a 10% minimum award amount.

Awards of this type have considerable possibility to increase the number of proceedings for securities law violations, particularly because the 10% minimum leaves the SEC relatively little discretion as to whether an award will be granted. These whistleblowing awards may result in many firms or individuals being unjustly charged with legal violations and may result in many other undesirable consequences. Such whistleblowing proposals have not received nearly the

public attention that they deserve. You can find more information about the adverse unintended effects of such proposals in our Task Force's October 9, 2009 client alert on that subject.<sup>4</sup>

## C. New Funding Sources for SEC

Under RAFSA, the SEC would generally meet the expenses of its operations out of fees that the SEC collects at rates specified by it. This "self funding" arrangement contrasts with the historical procedure under which the SEC has been able to expend only such amounts as have been specifically appropriated to it by Congress.

Thus, under RAFSA, the SEC would, as a practical matter, have access to far greater resources to hire staff and meet its other operating expenses. Over time, this reduction in practical financial constraints could greatly increase the risk of "overregulation" by the agency. On the other hand, although the SEC would have more resources, RAFSA also would impose so many new responsibilities and functions on the SEC that, over the short to intermediate term, the agency would in all probability continue to find it challenging to discharge them all.

## IV. CERTAIN INVESTMENT ADVISERS ACT REFORMS, INCLUDING "PRIVATE FUNDS"

### A. Repeal of "15 Client" Exemption

RAFSA generally would eliminate the exemption in the Investment Advisers Act of 1940 (the "Advisers Act") that currently enables advisers with fewer than 15 clients to avoid registering under that act (the "15 Client Exemption"). The 15 Client Exemption, however, would be preserved for certain foreign advisers whose assets under management attributable to United States clients are relatively modest.

Although the repeal of the 15 Client Exemption has been motivated largely by a desire to enhance regulation with respect to hedge funds, it also would require numerous other types of advisers to register under the Advisers Act. However, the impact of this would be partially offset by the effect of certain new exemptions discussed in subparts C.-E. below.

### B. Repeal of Intrastate Exemption for Private Fund Advisers

An adviser to a "private fund" would no longer be able to rely on the current provision that exempts from Advisers Act registration persons who conduct an advisory business solely within a single state. (RAFSA defines a "private fund" to be a company that would be subject to the Investment Company Act of 1940 (the "1940 Act"), but for the exemptions for private investment companies provided in Sections 3(c)(1) or 3(c)(7) of that act.)

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<sup>4</sup> That client alert is available at: <http://www.jordenburt.com/attachments/3319.pdf>

## C. New Exemptions for Advisers to Venture Capital or Private Equity Funds

RAFSA would provide an Advisers Act registration exemption for the provision of advice to venture capital funds or private equity funds. This is widely regarded as reasonable, insofar as these types of funds have not to date been identified as having contributed to the problems in the financial markets. On the other hand, the SEC and others have pointed out the difficulty of precisely defining these types of funds to sufficiently distinguish them from, for example, hedge funds. RAFSA simply puts this ball back in the SEC's court by requiring the SEC to prescribe appropriate definitions. Also, RAFSA would require that exempt advisers to private equity funds maintain such records and file such reports with the SEC as the agency may prescribe.

H.R. 4173 differs significantly from RAFSA in that, while H.R. 4173 contains an Advisers Act exemption for venture capital funds, it contains no such exemption for private equity funds.

## D. New Exemption for Certain Small Business Investment Company Advisers

RAFSA would exempt from Advisers Act registration any person (i) who advises only small business investment companies who are licensees (or, in certain cases, applicants) under the Small Business Investment Act of 1958, and (ii) who is not regulated as a business development company under the 1940 Act.

## E. New Exclusion for "Family Offices"

RAFSA would exclude from the Advisers Act definition of an investment adviser any "family office," as the SEC may define that term.

## F. Registered Adviser Records for Private Funds

RAFSA would make clear that advisers who are registered under the Advisers Act must maintain such records and file such reports regarding private funds they advise as the SEC may deem necessary or appropriate for the protection of investors or the assessment of systemic risks. Moreover all records of the private funds would be deemed to be records of the adviser for this purpose. Accordingly, as a practical matter, the SEC would have access to practically any information that is in the possession of a private fund or its adviser.

RAFSA does specify various types of records that private fund advisers would be required to maintain, including a description of "side arrangements or side letters, whereby certain investors in a fund obtain more favorable rights or entitlements than other investors." Such arrangements are, of course, common practice, and this language in RAFSA may evidence particular Congressional concerns over the propriety thereof. Accordingly, it is foreseeable that this may become an area of increased regulatory pressure.

## G. Potential Future Regulatory Developments for Private Funds

### 1. *GAO Studies*

RAFSA would require the Comptroller General of the United States to conduct studies and report to Congress on the following subjects:

- the appropriate criteria for determining “accredited investor” status and eligibility to invest in private funds and
- the feasibility of forming a self-regulatory organization to oversee private funds.<sup>5</sup>

The ultimate follow-on to any such studies, naturally, could be quite significant for private funds.

### 2. *Short Selling Study*

The SEC would be required to conduct a study and report to Congress on short selling and related matters. The SEC, of course, already has been deeply involved in this subject in recent years. Congress’ request for this report, however, could herald a greater Congressional role, over time. This would be of considerable interest to the hedge fund industry, as many hedge funds are prolific short sellers.

## H. \$100 Million Minimum Assets Under Management for Advisers Act Registrants

Section 203A(a)(1)(A) of the Advisers Act currently provides that an investment adviser with less than \$25 million in assets under management cannot be registered under the Advisers Act if such adviser is regulated as an investment adviser in the state in which it maintains its principal office and place of business. The SEC by rule has increased that dollar threshold to \$35 million, and RAFSA would increase it to \$100 million.<sup>6</sup> This would substantially reduce the number of Investment Advisers that are subject to SEC regulation, and increase the role for state (“Blue Sky”) regulation of many investment advisers.

## V. **DEVELOPMENTS IN SEC’S REGULATION OF CERTAIN OTHER PRODUCTS OR ACTIVITIES**

### A. Reconciling Certain Aspects of Broker-Dealer/Investment Adviser Regulation

#### 1. *RAFSA Requirements*

RAFSA requires the SEC to conduct a major study to evaluate the current regulatory requirements that are applicable when broker-dealers and investment advisers provide

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<sup>5</sup> This study would somewhat overlap the aspect of a mandated SEC study that is referred to in the text accompanying footnote 7 below.

<sup>6</sup> RAFSA, however, would also amend Section 203A(a)(1)(A) to specify that no adviser to a company registered as a business development company with the SEC could rely on that provision to avoid registration as an investment adviser with the SEC.

personalized investment advice and recommendations about securities to retail customers. This would include regulatory requirements imposed by the SEC and FINRA, as well as other federal and state legal and regulatory standards.

RAFSA specifies that the study should evaluate whether there are legal or regulatory gaps or overlaps and should consider, among other things, the following:

- the regulatory, examination, and enforcement resources devoted to, and the activities of, the SEC and FINRA in enforcing the relevant standards of care for broker-dealers and investment advisers;
- the specific instances in which customers of investment advisers are afforded greater protections than customers of broker-dealers and *vice-versa*;
- how various types of broker-dealer customers would be affected if broker-dealers were subjected to the standard of care that applies under the Advisers Act;
- the consequences of (i) requiring investment advisers to observe the standard of care applied by the SEC and FINRA to broker-dealers and (ii) authorizing the SEC to designate one or more self-regulatory organizations<sup>7</sup> to augment the SEC's oversight of investment advisers; and
- certain potential consequences of eliminating the current Advisers Act provision that excludes certain broker-dealers from the definition of an investment adviser.

The SEC's study would be closely related to a major study that RAFSA would require the United States Comptroller General to make concerning (i) the current state and federal oversight structure and regulation for financial planners and (ii) any gaps in the regulation of financial planners and other individuals who provide or offer to provide financial planning services to consumers. Within 180 days after RAFSA's enactment, the Comptroller General would be required to submit to Congress a report, including recommendations, arising out of its study.

Within one year after RAFSA's enactment, the SEC would be required to submit to Congress a report on its study of the regulation of broker-dealers and investment advisers in providing personalized advice or recommendations about securities to retail customers. The SEC's report would also take into consideration public input, comments, and data that the SEC would solicit and would set forth the SEC's findings, conclusions, and recommendations. For example, the SEC would report as to whether the SEC requires additional statutory authority to address any gaps or overlap in the legal or regulatory standards for the protection of retail investors when they receive personalized investment advice about securities from broker-dealers or investment advisers.

To the extent that the SEC has identified any such gaps or overlap that can be addressed pursuant to the SEC's existing rulemaking authority, RAFSA would require the SEC to commence a rulemaking proceeding within two years after its enactment.

## *2. Relationship to CFTC Regulation of Investment Advice*

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<sup>7</sup> See footnote 5 above.

Persons regulated by the CFTC, of course, also render investment advice, and much consideration has recently been given to the advisability of reconciling the CFTC's regulatory approach to the standards that apply to broker-dealers and investment advisers. Indeed, considerable impetus for such reconciliation has come from Congress. In part as a result of such Congressional interest, there was issued in October 2009 a Joint Report of the SEC and the CFTC on Harmonization of Regulation. A major subject of that Joint Report was the possibility of reconciling the differing standards and regulatory requirements that apply depending upon whether a person rendering investment advice is regulated by the SEC (and/or FINRA) or by the CFTC. Please refer to our Task Force's client alert dated October 22, 2009<sup>8</sup> for more information on this and other aspects of the Joint Report.

Accordingly, it would make some sense also to include CFTC regulation, if the above-described RAFSA study and report requirements are enacted into law. Query, however, whether the SEC would take upon itself to expand its study mandate in that way, given the absence from RAFSA of any such requirement.

### *3. Contrast with H.R. 4173*

As indicated by the above discussion, RAFSA seems relatively neutral about what the conclusions of the SEC's study and report should be. This is in distinct contrast to H.R. 4173, which would require that the SEC adopt rules that make broker-dealers and investment advisers subject to a uniform requirement to act in the customer's best interest when providing personalized investment advice to retail, and possibly certain other types of, customers. H.R. 4173 also would also provide that, in this context:

- commission-based and fee-based compensation structures would be preserved;
- broker-dealers would have no general continuing duty of care and loyalty to their customers;
- a broker-dealer's offering of a limited range of products (such as products proprietary to that firm) would not be prohibited, but would require notice to and acknowledgement from the customer;
- customers could consent to disclosed material conflicts; and
- SEC enforcement of all of the above-described requirements would have to be uniform as between broker-dealers and investment advisers.

#### B. Improving Investor Understanding of Investment Products and Services

The SEC would be required to conduct a study and report to Congress, within two years after RAFSA's enactment, concerning the following matters, among others:

- the degree of "financial literacy" that is characteristic of different subgroups of investors;

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<sup>8</sup> That client alert is available at: <http://www.jordenburt.com/attachments/3324.pdf>

- what strategy might be developed to increase investors' financial literacy; and
- how to improve the timing, content, and format of disclosures to investors with respect to financial intermediaries, investment products, and investment services. This would involve improving the transparency of expenses and conflicts of interest in connection with, *inter alia*, mutual funds.

## C. Mutual Fund Advertising

RAFSA directs the United States Comptroller General to conduct a study of mutual fund advertising, including:

- the currently-applicable regulatory requirements;
- current marketing practices, including use of past performance data, funds that have merged, and what are sometimes referred to as "incubator" funds; and
- recommendations for ensuring that investors have the information necessary to enable informed decisions when purchasing mutual fund shares.

The Comptroller General would be required to make its report to Congress within one year after RAFSA's enactment.

## D. Disclosure by Broker-Dealers Prior to Retail Customer Purchases

RAFSA would provide that the SEC has general authority to require that a broker-dealer provide documents or information to a retail customer prior to that customer's purchase of an investment product or service. Any such disclosure would be required (i) to be "in summary format" and (ii) to contain "clear and concise" disclosure about investment objectives, strategies, costs and risks, as well as compensation and other financial incentives to a broker-dealer or intermediary in connection with the purchase of a retail investment product.

## E. Pre-Dispute Agreements to Arbitrate

Disagreement has been brewing for a while over the extent to which investment advisers and broker-dealers ought to be able to require their customers to bind themselves in advance to resolve disputes by arbitration. RAFSA would simply grant clear authority to the SEC to resolve this issue by rule and does not in any way pre-judge what the answer should be. Nor does RAFSA mandate that the SEC in fact take any action at all (or even consider the matter).

# VI. BUREAU OF CONSUMER FINANCIAL PROTECTION

## A. The Bureau and its Director

RAFSA includes the "Consumer Financial Protection Act of 2010 (the "CFPA"), would establish a new Bureau of Financial Protection (the "Bureau") within the Federal Reserve System. The Bureau would be headed by a Director, who would be appointed by the President with the advice and consent of the Senate. The Director would be appointed for a five year term

and could be removed only by the President and only for cause (which would include “inefficiency”).

The Bureau would function in most ways like a separate agency, and the Bureau and its Director would have a very large degree of autonomy from the Fed.

## B. Potentially Comprehensive Nature of CFPA Regulation

The CFPA would give the Bureau authority to regulate with considerable thoroughness certain “Consumer Financial Products or Services” and certain persons (“Covered Persons”) who provide such products and services. For example being regulated as a Covered Person under the CFPA would carry with it obligations (depending upon the circumstances) such as:

- registering with the Bureau;
- making disclosures to consumers as prescribed by the Bureau;
- maintaining records prescribed by, and making periodic reports to, the Bureau;
- submitting to examinations by, and information requests from, the Bureau;
- complying with any requirements imposed by the Bureau to ensure that consumers are protected from abuse, unfairness, deception, and discrimination; and
- being subject to extensive enforcement and remediation powers that would be vested in the Bureau.

Different Covered Persons would be subject to different levels of regulation. For example, many aspects of CFPA regulation would generally apply to a Covered Person only if the Bureau, in consultation with the FTC, has by rule defined that person as a “larger participant” in a market for Consumer Financial Products or Services. (The Bureau would be required to adopt such a rule within a prescribed period of time.)

## C. Persons and Activities Subject to Bureau’s Jurisdiction--General

### 1. *Overview*

The general touchstone of whether a product or service would be subject to the CFPA is whether it is a “Consumer Financial Product or Service.” Persons who offer or provide Consumer Financial Products or Services also would be subject to regulation under the CFPA as Covered Persons.

Moreover, certain related persons of a Covered Person would themselves generally be deemed to be Covered Persons and potentially subject to many of the same regulatory requirements as other Covered Persons. Such related persons would include:

- any director, officer, employee charged with managerial responsibility, or controlling stockholder of, or agent for, the Covered Person;
- any shareholder, consultant, joint venture partner, and any other person as determined by the Bureau who materially participates in the conduct of the Covered Person’s affairs; and

- any independent contractor (including any attorney, appraiser, or accountant) with respect to the Covered Person who knowingly participates in a violation of any law or regulation or in any breach of fiduciary duty.

In addition, certain service providers to Covered Persons, would be subject to various regulatory requirements under the CFPA, though they may not themselves be Covered Persons. The concept of a “service provider” would be broadly defined, to include, generally, any person that provides a material service to a Covered Person in connection with offering or providing a Consumer Financial Product or Service; except that a provider of support services of a type provided to business generally (or a similar ministerial service) would not result in “service provider” status.

Finally, the CFPA contains a general provision making it unlawful for “any person” to offer or attempt to enforce any agreement in connection with a Consumer Financial Product or Service that is not in conformity with the CFPA or any rules thereunder or to engage in any unfair, deceptive, or abusive act or practice. This provision applies to any person in connection with a Consumer Financial Product or Service, regardless of whether that person is otherwise within any of the categories of persons that the CFPA specifically defines as being regulated.

## 2. *Definition of a Consumer Financial Product or Service*

As discussed immediately above, the basic scheme of the Bureau’s jurisdiction would depend, ultimately, on identifying what is a Consumer Financial Product or Service. That, however, would be determined by a complicated set of interrelated and not entirely clear definitions that are set forth in the CFPA. The products and services that have been the main motivation for developing the CFPA have typically been developed and offered primarily by persons other than insurance companies, investment funds, and investment advisers. This has included, among many others, the following:

- deposit taking by banking and similar institutions;
- debt collection services;
- real estate settlement services; and
- issuing or servicing mortgages and other loans.

On the other hand, some of the language in the CFPA is broad enough to include certain activities in which insurance and securities firms do normally engage. For example, Consumer Financial Products and Services would generally include “providing financial advisory services to consumers on individual financial matters or relating to proprietary financial products or services.” Moreover, in addition to the numerous Consumer Financial Products or Services that are specifically listed in the CFPA, the definition has a “catch all” provision that gives the Bureau considerable latitude to define other “financial products” as coming within its jurisdiction.

Accordingly, insurance and securities firms would need to carefully evaluate all of their activities to determine whether any of them would fall within the definition of Consumer

Financial Products or Services. If so, those activities would generally be subject to regulation by the Bureau, unless a specific exclusion were available. Some potentially applicable exclusions are discussed in D. and E. below.

D. Applicability to Insurance Firms

1. *Exclusion for Business of Insurance*

No insurance products are included among those that the CFPA lists as being within the definition of Consumer Financial Products or Services. On the contrary, the CFPA would in effect provide that said definition does “not include the business of insurance” and that the Bureau may not exercise its power to define terms in such a way that “engaging in the business of insurance” would come within the definition. For these purposes, the “business of insurance” would be defined to mean:

[T]he writing of insurance or the reinsuring of risks by an insurer, including all acts necessary to such writing or reinsuring and the activities relating to the writing of insurance or the reinsuring of risks conducted by persons who act as, or are, officers, directors, agents, or employees of insurers or who are other persons authorized to act on behalf of such persons.

This definition, and the related exclusions in the CFPA, now provides significantly broader and clearer relief for insurance firms than did a previous version of the CFPA, which Senator Dodd released in November of last year. In this respect, the CFPA now is essentially the same as H.R. 4173. Still, it remains foreseeable that disagreements may arise over the extent to which various activities of insurance firms in fact fall within the exclusion.

2. *Preservation of State Insurance Regulation*

The CFPA contains provisions that would specifically preserve state insurance regulators’ authority with respect to any person subject to such regulators’ jurisdiction. Another provision states that the CFPA would not affect any provisions of state laws and regulations, except to the extent that any such provision is inconsistent with the CFPA, and then only to the extent of the inconsistency. For this purpose, state law would not be deemed inconsistent with the CFPA if it affords consumers greater protection than is afforded under the CFPA.

The intention and effect of these provisions, together with the “business of insurance” exclusions discussed above, appears to be to preserve generally intact the current state regulation of the business of insurance.<sup>9</sup>

E. Applicability to Securities Firms

1. *Exclusion for Persons Regulated by SEC*

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<sup>9</sup> This is consistent with the portion of RAFSA that concerns the ONI as discussed in the text accompanying footnote 3, above.

The CFPA contains a provision that would specifically preserve the SEC’s sole jurisdiction over, *inter alia*, (i) broker-dealers registered under the Securities Exchange Act of 1934, (ii) advisers registered under the Advisers Act, (iii) funds registered under the 1940 Act, and (iv) any employee, agent, or contractor acting on behalf of, registered with, or providing services to, any such person. This provision, however, would be applicable only to the extent that any such person is acting “in a regulated capacity.”

It is foreseeable that questions would arise whether, for this purpose, a given activity of a person who is regulated by the SEC is being performed in that person’s “regulated capacity.” The CFPA provides no guidance as to how such questions should be resolved.

## *2. Preservation of Exclusive State Securities Regulation*

As noted above, the CFPA contains a provision that generally preserves the effect of state laws and regulations (to the extent not inconsistent with the CFPA), and this would include state securities regulatory provisions. Moreover, the CFPA also contains language that would preserve, more specifically, state securities regulators’ jurisdiction over any person that they regulate; and that jurisdiction would be exclusive, to the extent the state-regulated person is acting in such regulated capacity. Again, however, questions would foreseeably arise whether, with respect to a given activity, a regulated person is acting in its regulated capacity.

## **VII. POSSIBLE LOSS OF “BLUE SKY” EXEMPTION FOR CERTAIN PRIVATE OFFERINGS**

Currently, “Regulation D” offerings are exempted by Section 18 of the Securities Act of 1933 from state Blue Sky registration. RAFSA, however, would authorize the SEC to prescribe types of offerings that, because of their modest size or scope, would not have the benefit of Section 18’s exemption. It is entirely unclear what offerings might be subject to any such rule.

Even in the absence of any such rule, moreover, RAFSA would appear to require that the SEC review Form D filings made with respect to Regulation D offerings within 120 days after the filing thereof; and, if the SEC failed to review the filing within that period of time, the Section 18 exemption could automatically be lost. This provision of RAFSA is troubling because, among other things, (i) it is obscurely drafted, so that its purpose and effects are not entirely clear and (ii) it could give rise to significant regulatory exposures from loss of the Section 18 exemption due to a matter that is solely within the SEC’s control: *i.e.*, whether the SEC reviews a Form D filing within 120 days.

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For additional information:

Jorden Burt has formed a special Task Force to monitor these and similar 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](mailto: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](mailto:tcl@jordenusa.com) or (202) 965-8156). Or you may contact any of Jorden Burt's other regulatory attorneys.

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