JORDEN BURT

IMPLICATIONS OF FINANCIAL REGULATORY REFORM LEGISLATION FOR INSURANCE AND INVESTMENT PRODUCTS AND SERVICES

(July 21, 2010)

INTRODUCTION

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

Today, the President signed the Dodd-Frank Wall Street Reform and Consumer Protection Act ("DFA").[1] This legislation was passed by the House of Representatives in late June and by the Senate earlier this month, in each case by a largely party line vote.

DFA makes a wide variety of far-reaching and comprehensive reforms in the regulation of financial products and services. As passed by the House, DFA is the product of a conference committee that during June considered similar bills that had been passed by the House in December of last year (the "House Bill"[2]) and by the Senate in May of this year (the "Senate Bill"[3]).

The conference committee used the Senate Bill as the basis for its deliberations, with both the House and Senate conferees proposing changes to that base text. A substantial number of changes were made, including inclusion of certain provisions from the House Bill (in many cases with further revisions) that had not previously been contained in the Senate Bill.

This Bulletin discusses features of DFA that are important for some of Jorden 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 do not address here the regulatory changes that DFA entails for banks and bank holding companies.

CONTENTS

I. Measures to Directly Control Systemic Risks

A. Financial Stability Oversight Council

B. Enhanced Prudential Regulation

1. Fed Supervision of Certain Nonbank Financial Companies

---

[1] The text of DFA is available at: http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h4173enr.txt.pdf

[2] The text of the House Bill is available at: http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h4173eh.txt.pdf

[3] The text of the Senate Bill is available at: http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h4173pp.txt.pdf

2. Enhanced Prudential Regulation Recommendations to Primary Regulators
3. Extraordinary Fed Intervention in Certain Cases
4. Study Regarding Systemic Risks

C. Resolution Authority
1. Initiating Liquidation Process
2. Administering Liquidation Process
3. Inapplicability to Certain Insurance Companies and Broker-Dealers
4. Continuing Role for Bankruptcy Code

II. Insurance Regulation

A. Federal Insurance Office

B. International Agreements and Preemption of State Insurance Measures

C. Information Gathering, Studies, and Reporting

D. Nonadmitted and Reinsurance Reform Act of 2010

E. Certain Other Insurance-Related Matters
1. Application of Section 3(a)(8) Exemption for Certain Insurance Products
2. Senior Protection from Misleading Professional Designations

III. Major Changes in How SEC Functions

A. Increased Focus on Investor Protection
1. Investor Advocate
2. Investor Advisory Committee
3. SEC Ombudsman
4. Other Significant Investor Protection Aspects

B. Mandatory Monetary Awards to "Whistleblowers"
1. Program Features
2. SEC Inspector General Study
3. SEC Whistleblower Office

C. Enhanced Remedies Against Aiding and Abetting

D. Other Enhancements to SEC Enforcement Tools

E. "Streamlined" Procedures for Filing and Approval of SRO Regulations

F. Additional Funding for SEC

G. Deadline for Completing Investigations and Compliance Examinations
1. Wells Notices
2. Compliance Examinations and Inspections

H. Certain Studies
1. Overall Evaluation of SEC
2. Revolving Door Study
3. Reports on SEC Oversight of SROs

I. Mandatory Responses to Inspector General Findings

J. Compliance Examiners for SEC Regulatory Divisions

IV. Certain Investment Advisers Act Reforms, Including "Private Funds"

A. Repeal of "15 Client" Exemption

B. Repeal of Intrastate Exemption for Private Fund Advisers

C. New Exemption for Advisers to Small Private Funds

D. New Exemption for Advisers to Venture Capital Funds

E. New Exemption for Certain Small Business Investment Company Advisers

F. New Exclusion for "Family Offices"

G. Registered Adviser Records for Private Funds
1. General
2. Certain Mandated Records

H. Adjustment to Certain SEC-Prescribed Standards for Investors
1. "Accredited Investor" Standard
2. "Qualified Clients" for Performance Fees

I. Other Potential Regulatory Developments for Private Funds
1. GAO Studies
2. Short Selling Study

J. $100 Million Minimum Assets Under Management for Certain Advisers Act Registrants

K. Studies Relating to Investment Advisers
1. Investment Adviser Examination/Enforcement Study
2. Investment Adviser Custody Study

V. Developments in SEC's Regulation of Certain Other Products or Activities

A. Reconciling Certain Aspects of Broker-Dealer/Investment Adviser Regulation
1. SEC Study
2. GAO Financial Planner Study
3. SEC Report to Congress
4. Relationship to CFTC Regulation of Investment Advice
5. Possible SEC Rulemaking
6. Harmonizing Enforcement Efforts
7. Other SEC Mandates

B. Improving Investor Understanding of Investment Products and Services

C. Mutual Fund Advertising

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

E. Pre-Dispute Agreements to Arbitrate

F. Investor Access to Information on Investment Advisers and Broker-Dealers

G. Disqualifying "Bad Actors" from Making Certain Regulation D Offerings

H. Enhanced Recordkeeping Requirements for Certain Custodians

I. Other Changes

VI. Bureau of Consumer Financial Protection

A. The Bureau and its Director

B. Potentially Comprehensive Nature of CFPA Regulation

C. Persons and Activities Subject to Bureau's Jurisdiction—General
1. Overview
2. Definition of a Consumer Financial Product or Service

D. Applicability to Insurance Firms
1. Exclusion for Business of Insurance
2. Preservation of State Insurance Regulation

E. Applicability to Securities Firms
1. Certain Financial Advisory Services
2. General Preservation of Exclusive SEC Regulation
3. General Preservation of State Securities Regulation

F. Coordination Between Bureau and Other Regulators

VII. SIPC Reforms

VIII. Application of Section 3(a)(8) Exemption For Certain Insurance Products

IX. Certain Potential Legal Exposure

A. Study of Private Right of Action Against Aiders and Abettors

B. Longer Statute of Limitations for Securities Violations

C. Review of Financial Fraud Sentencing Guidelines

D. Extraterritorial Jurisdiction for Securities Antifraud Actions

X. Credit Ratings

XI. Derivatives Regulation

A. Need for New Arrangements for Derivatives Trading

B. Bank Spin-Off of Certain Derivatives Trading Operations

C. Possible Status as "Major Swap Participant"

D. Status of Stable Value Contracts

E. Preemption of Insurance Regulation for Swaps

XII. The Volcker Rule

A. Basic Requirements

B. Council Study and Coordinated Rulemaking

C. Key Definitions

1. Proprietary Trading
2. Hedge Funds and Private Equity Funds

D. Exclusions from Volcker Rule

XIII. Senior Protection From Misleading Professional Designations

ANALYSIS

I. MEASURES TO DIRECTLY CONTROL SYSTEMIC RISKS

DFA, like both the House and Senate Bills, provides for direct macro analysis and management of risks that threaten the stability of the United States financial system or economy. First, it establishes 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 provides for intervention to fundamentally restructure or liquidate companies that pose unacceptable risks. DFA also contains a series of provisions covering specific industries or types of activities, 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.

A. Financial Stability Oversight Council (the "Council")

DFA establishes systemic risk and prudential risk regulation primarily through a Financial Stability Oversight Council. The Council will be composed of ten voting and five nonvoting members. The voting members will be:

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

The following persons will be nonvoting members of the Council:

- Director of the Office of Financial Research (another new entity that DFA will establish);
- Director of the Federal Insurance Office (discussed in part II.A. below);
- a state insurance commissioner, selected in a manner determined by all such commissioners;
- a state banking supervisor, selected in a manner determined by all such banking supervisors; and
- a state securities commissioner, selected in a manner determined by all such commissioners.

The DFA envisions three broad purposes for the Council: (i) to identify risks to the financial stability of the United States that could arise from the material financial distress, failure or ongoing activities of large, interconnected bank holding companies or nonbank financial companies, or that could arise outside the financial services marketplace; (ii) to promote market discipline by eliminating expectations that the government will shield shareholders, creditors and counterparties from losses in the event of failure; and (iii) to respond to emerging threats to the stability of the United States financial markets.

To accomplish these purposes, the DFA will assign a large number of tasks to the Council, including:

- collecting information necessary for assessing risks to the United States financial system. The Council could obtain such information from federal and state agencies and regulators and, through the Office of Financial Research, from bank holding companies and nonbank financial companies;
- monitoring the financial services marketplace to identify potential threats to the financial stability of the United States;
- providing direction to and requesting data and analyses from the Office of Financial Research;
- monitoring domestic and international financial regulatory proposals and developments, including insurance and accounting issues, and advising Congress and making recommendations in such areas that will enhance the integrity, efficiency, competitiveness, and stability of the United States financial markets;
- 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 capital, leverage, liquidity, contingent capital, resolution plans, credit exposure reports, concentration limits, enhanced public disclosures, and overall risk management for companies supervised by the Fed;
- identifying systemically important financial market utilities and payment, clearing and settlement activities;
- making recommendations to the various primary financial regulatory agencies (defined to include both federal and state 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;
- reviewing and submitting comments to the SEC and any standard-setting body with respect to any existing or proposed accounting principle, standard, or procedure;

- 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 and testifying before Congress on:
    - the activities of the Council;
    - significant financial market and regulatory developments, including insurance and accounting regulations and standards, with an assessment of those developments on the stability of the financial system;
    - potential emerging threats to the financial stability of the United States;
    - determinations by the Council that companies should be subject to enhanced prudential regulation;
    - the resolution by the Council of jurisdictional disputes among agencies; and
    - the Council's recommendations to enhance the integrity, efficiency, competitiveness, and stability of United States financial markets, to promote market discipline, and to maintain investor confidence.

The Council will have broad powers to request, collect, and analyze data, itself and through the Office of Financial Research. If the data or information is available through federal or state regulatory agencies, DFA contemplates that it should be obtained from such agencies to mitigate the reporting burden on companies. If necessary, the Fed could conduct an examination of a United States nonbank financial company for the sole purpose of determining whether that company should be subjected to enhanced prudential regulation.

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 may determine that a United States nonbank financial company (or, in certain cases, a foreign nonbank financial company) will be subject to prudential supervision by the Fed, on the grounds that financial distress at such company will pose a threat to the financial stability of the United States.

DFA defines "Nonbank financial companies" as 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 extremely broad definition potentially encompasses 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. Thus, for example, insurance companies, investment companies, investment advisers, and broker-dealers can easily fall within the definition of nonbank financial companies.

DFA 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, including:

- the extent of leverage of the company;
- the extent and nature of the off-balance-sheet exposures of the company;
- the extent and nature of the transactions and relationships of the company with other significant nonbank financial companies and significant bank holding companies;
- the importance of the company as a source of credit for households, businesses, and state and local governments and as a source of liquidity for the United States financial system;
- the importance of the company as a source of credit for low-income, minority, or underserved communities, and the impact that the failure of the company would have on the availability of credit in such communities;
- the extent to which assets are managed rather than owned by the company, and the extent to which ownership of assets under management is diffuse;
- the nature, scope, size, scale, concentration, interconnectedness, and mix of the activities of the company;
- the degree to which the company is already regulated by one or more primary financial regulatory agencies (defined to include state insurance regulators and the SEC);
- the amount and nature of the financial assets of the company;
- the amount and types of the liabilities of the company, including the degree of reliance on short-term funding; and
- any other risk-related factors that the Council deems appropriate.

The Council must consult with any primary financial regulatory agency of such a company before making a final determination that a nonbank financial company should be subject to enhanced prudential regulation by the Fed. If the company is an insurance company, this consultation would occur with a state insurance regulator, presumably the insurance commissioner of the company's domiciliary state.

The Council must provide written notice to a nonbank financial company of any proposed determination that prudential regulation of its financial activities be undertaken. Within 30 days after such notice, the company could request 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 requirement for notice could be waived by the Council in an emergency.

A company also will have the right to obtain judicial review of the Council's final determination. The review would occur in the United States District Court where the company's home office is located, or in the District of Columbia, upon the company's filing an action within 30 days after the receipt of the final determination. However, the judicial review would be limited to a determination of whether the Council's final determination was arbitrary and capricious.

DFA charges the Fed with establishing and implementing prudential standards and reporting and disclosure requirements applicable to companies it supervises under these provisions. Moreover, those standards and requirements must be "more stringent" than those applicable to companies that are not under the Fed's prudential supervision. The Fed's more stringent standards will be based, in part, upon recommendations from the Council and likely will concern the following matters:

- risk-based capital requirements;
- leverage limits;
- liquidity requirements;
- resolution plan and credit exposure report requirements;
- credit exposure concentration limits;
- contingent capital requirements;
- enhanced public disclosures;
- short-term debt limits; and
- overall risk management requirements.

Once a nonbank financial company is subjected to such regulation, the Fed would have extensive authority to require reporting by the company and to manage directly and indirectly, or restrict, many facets of the operation and management of the company. The Fed essentially will have the authority to fundamentally restructure companies and alter their business and financial plans such that the resulting company might have only a limited resemblance to the company that was placed under the Fed's control. In addition, the Fed must require that every nonbank financial company under its supervision have a plan for the rapid and orderly "resolution" of its operations in the event of material financial distress or failure, so that it could move directly and quickly toward the resolution (*i.e.,* liquidation) of the company, if necessary.

To avoid evasion, the Fed could require that the company move its financial activities to a special intermediate holding company, to facilitate the prudential regulation of only the financial activities of the company.

In what DFA describes as a "safe harbor" provision, the Fed will promulgate regulations, in consultation with the Council, setting forth criteria for exempting certain types or classes of United States nonbank financial companies from supervision by the Fed. While the ultimate scope of this provision remains unclear, DFA directs that the Council, in developing the safe harbor regulations, take account of the same types of factors as listed above for determining whether a nonbank financial company should be subject to Fed supervision. It is to be hoped that many categories of insurance companies, investment companies, investment advisers, and broker-dealers could be exempted based on, among other considerations, their regulation by state insurance departments or the SEC.

2. *Enhanced Prudential Regulation Recommendations to Primary Regulators*

DFA authorizes the Council to regulate indirectly certain activities and practices by making "recommendations" to the "primary financial regulatory agencies" that they 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, such as the SEC, or a state agency, such as a state insurance department.

The primary financial regulatory agency must either: (i) implement the Council's recommendations or similar standards that the Council deems acceptable; or (ii) explain in writing to the Council, not later than 90 days after the date on which the Council issues the recommendation, why the agency has determined not to follow the Council's recommendation. If the primary regulatory authority does not implement the recommendation, there is a 60 day window during which the Fed could implement the recommendation.

3. *Extraordinary Fed Intervention in Certain Cases*

DFA empowers 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) limiting the ability of the company to merge with, acquire, consolidate with, or otherwise become affiliated with another company; (ii) restricting the ability of the company to offer a financial product or products; (iii) requiring the company to terminate one or more activities; (iv) imposing conditions on the manner in which the company conducts one or more activities; or (v) requiring that the company sell or otherwise transfer assets or off-balance-sheet items to unaffiliated entities. There are provisions for notice of such a decision to the company, and an opportunity for a "hearing," which again may consist only of the submission of written materials. There is no provision for the judicial review of this action.

4. *Study Regarding Systemic Risks*

DFA requires the Chairman of the Council to carry out a study of the economic impact of possible financial services regulatory limitations intended to reduce systemic risk. The study will estimate such limitations' cost/benefit impact on the efficiency of capital markets, on the financial sector, and on national economic growth. The potential limitations to be studied include:

- explicit or implicit limits on the maximum size of banks, bank holding companies, and other large financial institutions;
- limits on the organizational complexity and diversification of large financial institutions;
- requirements for operational separation between business units of large financial institutions in order to expedite resolution in case of failure;
- limits on risk transfer between business units of large financial institutions;
- requirements that such institutions carry contingent capital or similar mechanisms;

- limits on commingling of commercial and financial activities by large financial institutions;
- segregation requirements between traditional financial activities and trading or other high-risk operations in large financial institutions; and
- other limitations on the activities or structure of large financial institutions that may be useful to limit systemic risk.

The study will include recommendations for the optimal structure of any limits outlined above, in order to maximize their effectiveness and minimize any adverse economic impact. This will be an ongoing study, with an initial report to Congress due not later than 180 days after the enactment of DFA and a further report due not later than every 5 years thereafter.

C. Resolution Authority

In addition to the broad powers of the Fed and the Council to impose enhanced prudential regulation as set forth above, DFA provides the ultimate remedy as well: the authority to "resolve" or liquidate financial companies in specified circumstances in a process separate and apart from the established bankruptcy process.

1. *Initiating Liquidation Process*

The resolution process starts with a written recommendation to the Secretary of the Treasury (the "Secretary") by the Fed and the FDIC that the FDIC be appointed as receiver for a financial company. The recommendation must be approved by 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. However, if the company is an SEC-registered broker-dealer, or the largest United States subsidiary of the company is an SEC-registered broker-dealer, the recommendation must come instead from the Fed and the SEC. If the company is an insurance company, or the largest United States subsidiary of the company is an insurance company, the recommendation must come from the Fed and the Director of the Federal Insurance Office (discussed in part II.A. below).

The recommendation to the Secretary 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 description of the effect that the default of the company would have on economic conditions or financial stability for low income, minority, or underserved communities;
- 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;

- an evaluation of the effects on creditors, counterparties, and shareholders of the company and other market participants; and
- an evaluation of whether the company satisfies the definition of a financial company.

The Secretary must file the petition described below (the "Petition") if, upon the written recommendation described above, the Secretary (in consultation with the President) 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 that resolution would have on the claims or interests of creditors, counterparties, shareholders, and others is appropriate, given the impact that resolution would have on the financial stability of the United States;
- any liquidation under these provisions would avoid or mitigate the adverse impact on third parties;
- 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; and
- the company satisfies the definition of a financial company.

Subsequent to a determination by the Secretary that a company satisfies the requirements for resolution, the Secretary must give notice to the FDIC and the company of the determination. If the board of directors of the company consents to the appointment of the FDIC as receiver, the Secretary will make the appointment. If the board does not consent, the Secretary must file a Petition, under seal, with the United States District Court for the District of Columbia for an order authorizing the Secretary to appoint the FDIC as receiver. As discussed in subpart 3. below, however, DFA generally contemplates that, rather than being liquidated by the FDIC, (i) an insurance company would be liquidated or rehabilitated pursuant to the applicable state law providing for such processes; and (ii) an SEC-registered broker-dealer that is subject to a determination by the Secretary would be liquidated under the terms of the Securities Investor Protection Act of 1970.

Without making any public disclosure, the District Court must provide notice and an opportunity for a hearing to the company, and must determine whether the Secretary's determination that the company is in default or in danger of default is arbitrary and capricious. If the District Court sustains the Secretary's determination, it must enter an order appointing the FDIC as receiver. If the court finds that the Secretary's determination was arbitrary and capricious, it must issue a written statement supporting its determination and afford the Secretary an immediate opportunity to amend the Petition. The Petition will be deemed granted by operation of law if the District Court does not make a determination within 24 hours of the receipt of the Petition. The District Court's decision will be subject to expedited appeals to the United States Court of Appeals for the District of Columbia Circuit and the Supreme Court, with review limited to whether the Secretary's determination is arbitrary and capricious. The District Court's decision will not be subject to any stay or injunction pending appeal.

The Secretary must provide written notice to Congress within 24 hours of the appointment of any receiver.

For purposes of this process, a company will 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.

2. *Administering Liquidation Process*

DFA contains extensive provisions granting the FDIC broad authority in the management and liquidation of companies for which it is appointed receiver. In carrying out its duties as a receiver, the FDIC would be required to act so that: (i) creditors and shareholders bear the losses of the financial company; (ii) management responsible for the condition of the financial company are not retained; and (iii) the FDIC and other appropriate agencies take all steps necessary and appropriate to assure that all parties (including management and third parties) having responsibility for the condition of the financial company bear losses consistent with their responsibility. The FDIC and other appropriate agencies are authorized to file actions for damages, restitution, and recoupment of compensation and other gains that are not compatible with the responsibilities outlined above.

Although early versions of the House and Senate Bills provided for an orderly liquidation fund, which would have been used by the FDIC to pay the expenses of the liquidation of companies as to which it is appointed receiver, there is no such provision or fund under DFA. Instead, the statute provides various guidance to the FDIC as to how it should fund its liquidation activities as the receiver under DFA.

3. *Inapplicability to Certain Insurance Companies and Broker-Dealers*

Rather than being subject to the foregoing liquidation process, if the company that is the subject of a recommendation to the Secretary and a determination by the Secretary is an insurance company, or has an insurance company parent or subsidiary or affiliate, the liquidation or rehabilitation of any such insurance company will be conducted as provided under state law (*i.e.*, the state-based insurance company rehabilitation and liquidation process). If, however, the appropriate state regulatory agency does not initiate the insolvency process within 60 days of the determination by the Secretary, the FDIC has the authority to stand in the place of the state insurance department and initiate the state law-based liquidation process.

If the company that is the subject of the Secretary's determination is an SEC-registered broker-dealer, the FDIC must appoint the Securities Investor Protection Corporation ("SIPC") to act as trustee for the liquidation of the broker or dealer under the terms of the Securities Investor Protection Act of 1970. DFA provides for certain filings and administration by the SIPC.

4. *Continuing Role for Bankruptcy Code*

The provisions of the Bankruptcy Code will continue to apply (to the same extent as currently) to financial companies not liquidated pursuant to these provisions. DFA requires, however, that the Administrative Office of the United States Courts and the United States Comptroller General conduct separate studies regarding the effectiveness of the Bankruptcy Code in facilitating the orderly liquidation or reorganization of financial companies, ways to make that process more effective and ways to increase the efficiency and effectiveness of DFA's liquidation process for financial companies. DFA also requires studies of international coordination relating to the bankruptcy process for financial companies and the implementation of prompt corrective action by federal banking agencies.

II. INSURANCE REGULATION

A. Federal Insurance Office

DFA includes the Federal Insurance Office Act of 2010 (the "FIOA"), which establishes a Federal Insurance Office ("FIO") within the Department of the Treasury, headed by a Director appointed by the Secretary. The functions of the FIO will be:

- 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 monitor the extent to which traditionally underserved communities and consumers, minorities, and low- and moderate-income persons have access to affordable insurance products (all lines except health insurance);
- to recommend to the Financial Stability Oversight Council (as discussed in part I.A. above) 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 with respect 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 FIO or its Director will have two advisory functions: (i) the FIO will advise the Secretary on major domestic and prudential international insurance policy issues; and (ii) the Director will serve in an advisory capacity on the Council.

The FIO will have no authority with respect to: (i) health insurance; (ii) long-term care insurance, except long-term care insurance that is included as part of a life insurance or annuity policy; or (iii) crop insurance, as established by the Federal Crop Insurance Act. These are broader exclusions than those previously proposed by the Obama administration.

The FIOA basically preserves the primacy of the state regulation of insurance, provides for a federal role only with respect to international insurance and reinsurance matters, and provides limited regulation with respect to surplus lines and reinsurance (as discussed in subpart D. below). The National Association of Insurance Commissioners ("NAIC") has managed to secure a limited role in this process with a requirement that the FIO consult with the states regarding insurance matters of national importance and prudential insurance matters of international importance. The extent to which the NAIC will remain active with the International Association of Insurance Supervisors is unclear, given the fact that the FIO has been tasked with representing the United States in that organization.

The FIOA also requires that the Secretary consult with state insurance regulators, individually or collectively, to the extent determined appropriate by the Director in carrying out the functions of the FIO. However, the FIOA expressly limits the authority of the FIO in all of its activities such that the FIOA will not:

- preempt any state insurance measures that govern an insurer's rates, premiums, underwriting or sales practices;
- preempt any state coverage requirements for insurance;
- preempt the application of the antitrust laws of any state to the business of insurance;
- preempt any state insurance measure governing the capital or solvency of an insurer, except as described in subpart B. below;
- alter, amend, or limit any provision of the Consumer Financial Protection Act of 2010 (discussed in part IV. below);
- establish or provide the FIO or the Department of the Treasury with general supervisory or regulatory authority over the business of insurance;
- limit the authority of any federal financial regulatory agency;
- limit the authority of the United States Trade Representative; or
- affect the preemption of state insurance measures preempted by other federal law.

B. International Agreements and Preemption of State Insurance Measures

The FIOA authorizes the Secretary and the United States Trade Representative jointly to negotiate and enter into international insurance agreements on prudential measures on behalf of the United States. The FIOA further authorizes the FIO'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 insurer domiciled, licensed or otherwise admitted in that state; and (ii) is inconsistent with such international agreement. Prior to making such a determination, the Director must notify and consult with the appropriate state and the United States Trade Representative, publish notice in the Federal Register regarding the potential inconsistency or preemption, provide a period for written comments by interested parties, and consider any comments received. A preemption determination will not be effective earlier than 30 days after the notification to the affected state of the determination. Once such a determination is final, and notice of the finality is published in the Federal Register, no state may enforce a state insurance measure to the extent that the measure has been preempted.

Before initiating negotiations of any such international agreement, the Secretary and United States Trade Representative must jointly consult with Congress as to the nature of the proposed agreement, how and the extent to which the agreement would achieve the applicable purposes, policies, priorities and objectives of the applicable section of the FIOA, and the implementation of the agreement, including the general effect of the agreement on existing state laws. The final text of any such agreement must be submitted to Congress at least 90 calendar days prior to its effectiveness.

The preemption provisions of the FIOA are specifically limited to the subject matter of the international agreement and the need to achieve a level of protection for insurance and reinsurance consumers that is substantially equivalent to the level of protection achieved under state insurance or reinsurance regulation. Such preemption also is subject to the limitations set forth in the list at the end of subpart A. above.

The FIOA expressly provides that it does not give the FIO or the Department of the Treasury "general supervisory or regulatory authority over the business of insurance." In sum, it is the clear intention of the FIOA 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.[4]

C. Information Gathering, Studies, and Reporting

The FIOA provides the FIO with authority to gather and analyze information reasonably required in carrying out its functions, 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. However, information could not be

[4] This is consistent with the Consumer Financial Protection Act of 2010, as discussed in part VI.D.2. below.

gathered directly from an insurer or affiliate that falls below a minimum size threshold established by the FIO by rule. To further reduce the burden on insurers, information could be obtained from an insurer only if the information is not available from federal or state regulatory agencies or other publicly-available sources. The provision of non-public information by insurance companies will not constitute a waiver of any privilege available under federal or state law, and will not affect any existing confidentiality laws or agreements. The FIO could establish an information sharing agreement to share information it has with state insurance regulators. Subpoenas could be issued only for information not otherwise available, and only after coordination with state regulatory authorities.

The FIOA requires the FIO's Director to provide reports as follows:

- annual reports to the President and Congress regarding: (i) any preemption of state insurance measures implemented by the FIO; and (ii) the insurance industry and any other information deemed relevant by the Director, or as requested by Congress;
- a report to Congress no later than September 30, 2012 describing the breadth and scope of the global reinsurance market and the critical role such market plays in supporting insurance in the United States;
- a report to Congress no later than January 1, 2013 (and updated not later than January 1, 2015), describing the impact of the Nonadmitted and Reinsurance Reform Act of 2010 (discussed in subpart D. below) on the ability of state regulators to access reinsurance information for regulated companies in their jurisdictions;
- 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 will contain any appropriate legislative and regulatory recommendations, and must be provided to Congress not later than 18 months after the enactment of the FIOA. In conducting the study, the FIO must consult with the NAIC, consumer organizations, representatives of the insurance industry, and policyholders. In this connection, the FIO must 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;
  - international coordination of insurance regulation;
  - the costs and benefits of potential federal regulation across various lines of insurance (except health 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 of 2010 (the "NRRA")

DFA also contains a version of proposed legislation that has been introduced in Congress as separate bills at least since 2006. This portion of DFA (the NRRA) has not been controversial, with the language having been the same in both the House Bill and the Senate Bill. No significant changes were made to this portion of the bills in the conference committee.

With respect to nonadmitted insurance, the NRRA:

- establishes a "home state" for insureds for purposes of the NRRA, namely the state in which the insured maintains its principal place of business; except that, if 100% of the insured risk is located in other states, the home state will be the state to which the greatest percentage of the insured's taxable premium for a particular insurance contract is allocated;
- with respect to nonadmitted premium taxes:
  - provides that no state other than the home state of an insured may require the payment of any premium tax for nonadmitted insurance;
  - provides that states may enter into a compact or other procedures for the allocation of nonadmitted premium tax revenues among the states;
  - requires that the NAIC submit a report to Congress identifying and describing any such interstate compact or other procedures for allocating premium taxes among the states; and
  - encourages the adoption by each state of nationwide uniform requirements, forms, and procedures for reporting, payment, collection, and allocation of such taxes;
- provides that the placement of nonadmitted insurance will be subject to regulation solely by the insured's home state;
- after a two-year exemption period, prohibits the collection by states of fees relating to the licensing of an individual or entity as a surplus lines broker unless the state participates in a national insurance producer database (whether under the sponsorship of the NAIC or otherwise);
- limits the ability of a state to establish eligibility requirements for United States-domiciled nonadmitted insurers that vary from the NAIC's Non-admitted Insurance Model Act;
- restricts the ability of states to require surplus lines brokers seeking to procure or place nonadmitted insurance for an exempt commercial purchaser (a term subject to a multi-part definition) to make a due diligence search to determine whether the full amount or type of insurance sought by such exempt commercial purchaser can be obtained from admitted insurers, under specified circumstances; and
- requires a GAO study of the nonadmitted insurance market, in consultation with the NAIC, covering:

  - the change in the size and market share of the nonadmitted insurance market and in the number of insurance companies and insurance holding companies providing such business over an 18 month period of time;
  - the extent to which insurance coverage typically provided by the admitted insurance market has shifted to the nonadmitted insurance market;
  - the consequences of any change in the size and market share of the nonadmitted insurance market, including differences in the price and availability of coverage available in both the admitted and nonadmitted insurance markets;
  - the extent to which insurance companies and insurance holding companies that provide both admitted and nonadmitted insurance have experienced shifts in the volume of business between admitted and nonadmitted markets; and
  - the extent to which there has been a change in the number of individuals who have nonadmitted insurance policies, the type of coverage provided under such policies, and whether such coverage is available in the admitted insurance market.

With respect to reinsurance, the NRRA:

- provides that, if the state of domicile of a ceding insurer (so long as the state is NAIC accredited) recognizes credit for reinsurance for the insurer's ceded risk, no other state may deny such credit for reinsurance;
- preempts the extraterritorial application of the law of a state to a ceding insurer not domiciled in that state (except those with respect to taxes and assessments on insurance companies and insurance income), to the extent that such application would:
  - restrict or eliminate the rights of the ceding insurer or the assuming insurer to resolve disputes pursuant to contractual arbitration consistent with the provisions of Title 9 of the United States Code;
  - require that a certain state's law govern the reinsurance contract, disputes arising from the reinsurance contract, or requirements of the reinsurance contract;
  - attempt to enforce a reinsurance contract on terms different from those set forth in the reinsurance contract, to the extent that the contractual terms are not inconsistent with the NRRA; or
  - otherwise apply to reinsurance agreements the laws of a state other than the domicile of the ceding insurer; and
- provides that, in most circumstances, a state that is the domicile of a reinsurer will be solely responsible for regulating its financial solvency.

These provisions could be significant for drafting reinsurance contracts, since they make the law of the ceding state control over the law of other states. While these provisions do not expressly prohibit the parties to a reinsurance contract from agreeing that a reinsurance contract will be governed by the law of a state other than the state of domicile of the ceding insurer, such an agreement may be challenged under these provisions.

E. Certain Other Insurance-Related Matters

1. *Application of Section 3(a)(8) Exemption for Certain Insurance Products*

This subject is addressed in part VIII. below.

2. *Senior Protection from Misleading Professional Designations*

This subject is addressed in part XIII. below.

III. MAJOR CHANGES IN HOW SEC FUNCTIONS

DFA makes 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. DFA aims to further enhance this pro-investor orientation.

1. *Investor Advocate*

DFA establishes within the SEC an Office of the Investor Advocate, whose function will be generally to advance the interests of investors and to propose changes to promote those interests. The Investor Advocate will be appointed by the Chairman of the SEC, in consultation with the other Commissioners and will report directly to the Chairman.

The Investor Advocate will have considerable power and influence, and will be authorized to employ (after consultation with the Chairman) such "independent counsel, research staff, and service staff as the Investor Advocate deems necessary." The Investor Advocate also will 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 must 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 is specifically required to propose to Congress any "legislative, administrative, or personnel changes that may be appropriate" to enhance investor protection. Moreover, DFA provides that the Investor Advocate must 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 must submit such reports directly to Congress and is 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 will have substantial influence and will function to a considerable extent as the Congress's "eyes and ears" on many oversight issues.

2. *Investor Advisory Committee*

DFA also establishes 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 (including investors in mutual funds), registered investment companies, pension funds, and other institutional investors.

The Investor Advisory Committee is 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 is purely advisory and consultative, the Investor Advocate, who will 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 will have considerable influence on investor protection issues.

3. *SEC Ombudsman*

DFA provides for the establishment of an Ombudsman within the SEC. The Ombudsman will report to the SEC's Investor Advocate and will act as a liaison with retail investors who have problems with the SEC or a self regulatory organization ("SRO"), such as FINRA.

4. *Other Significant Investor Protection Aspects*

DFA also includes:

- clarification of the SEC's authority to gather information from investors or other members of the public in connection with evaluating or 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"

1. *Program Features*

DFA provides that, if original information voluntarily provided to the SEC by one or more "whistleblowers" results in monetary sanctions exceeding $1 million, the SEC must, if certain conditions are met, award the whistleblowers between 10% and 30% of the sanctions.

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. DFA's whistleblowing provisions have not received nearly the public attention that they deserve. More information about the potential adverse unintended effects of such provisions is available in our Task Force's October 9, 2009 client alert on that subject.[5]

2. *SEC Inspector General Study*

DFA requires the SEC's Inspector General to conduct a study to evaluate, among other things, whether:

- the SEC has taken action to publicize widely the whistleblower program and to make the program "user friendly" from the whistleblower's standpoint;
- the minimum and maximum reward levels are adequate to motivate whistleblowers;
- the minimum and maximum reward levels are so high as to encourage illegitimate whistleblower claims; and
- whistleblowers who have attempted to pursue a case through the SEC should have a private right to bring suit based on the facts of the same case, on behalf of the government and themselves, against persons who have committed securities fraud. The prospect of such "privateering" whistleblowers is worrisome, to say the least.

The Inspector General must make its report to Congress within 30 months, and the report will be available to the public.

3. *SEC Whistleblower Office*

DFA requires the establishment of a separate office within the SEC to administer and enforce the whistleblower provisions. This office will be required to make annual reports to Congress.

---

[5] That client alert is available at: http://www.jordenburt.com/attachments/3319.pdf

C. Enhanced Remedies Against Aiding and Abetting

DFA authorizes the SEC to seek injunctive relief or civil penalties against persons who aid or abet violations of the Securities Act of 1933 (the "1933 Act"), the Investment Company Act of 1940 (the "1940 Act"), and the Investment Advisers Act of 1940 (the "Advisers Act"). Persons will be subject to these remedies if they "knowingly or recklessly" provide substantial assistance to another person in violation of a provision of the law in question (or a rule thereunder). These new aiding and abetting provisions are similar to a current provision covering aiding and abetting of violations under the Securities Exchange Act of 1934 (the "1934 Act"), except that the current 1934 Act standard is "knowingly" (rather than "knowingly or recklessly"). DFA also will change this 1934 Act standard for aiding and abetting to "knowingly or recklessly."

D. Other Enhancements to SEC Enforcement Tools

DFA also provides for various other new or enhanced SEC enforcement tools, including:

- authority for the SEC to seek civil penalties in "cease and desist" proceedings against any person (rather than only against registrants); and
- enhanced (nationwide) power to issue subpoenas.

Certain of the developments discussed in part IX. below also could potentially result in strengthened enforcement powers for the SEC.

E. "Streamlined" Procedures for Filing and Approval of SRO Regulations

DFA overhauls the procedures for FINRA and other SROs to file and obtain SEC approval of SRO regulations and amendments. DFA's intent is to promote more prompt and transparent review of SRO rule proposals by the SEC. As a practical matter, such streamlined procedures may make it more difficult for the SEC to hold up SRO proposals about which the SEC has questions. In this respect, therefore, DFA probably strengthens the position of SROs, relative to the SEC.

F. Additional Funding for SEC

DFA sets out very substantial increases in authorized appropriations for the SEC to fund its operations over the next few years. The Senate Bill would have allowed the SEC generally to meet the expenses of its operations out of fees that the SEC collects at rates specified by it. This "self funding" arrangement would have taken the SEC's budget largely outside the Congressional appropriations process and provided the SEC, as a practical matter, with access to far greater resources to hire staff and meet its other operating expenses.

DFA did not incorporate the Senate Bill's self funding arrangement. Nevertheless, as noted above, the SEC is still expected to experience a sharp increase in available resources. Some have expressed concern that such additional resources may increase the risk of "overregulation" by the agency. On the other hand, DFA also will impose so many new

responsibilities and functions on the SEC that, over the short to intermediate term, the agency will in all probability continue to find it challenging to discharge them all. It seems likely that, at least for the time being, any "overregulation" will reflect implementation of DFA's new regulatory requirements, more than overly-generous funding of the SEC.

G. Deadlines for Completing Investigations and Compliance Examinations

1. *Wells Notices*

DFA provides that, not later than 180 days after delivering any "Wells notification" to any person, the SEC staff must either file an action against such person or provide notice to the Director of the SEC's Division of Enforcement of its intent not to file an action. Provision is made, however, for the extension of this period if a particular enforcement investigation is "sufficiently complex such that a determination regarding the filing of an action against a person cannot be completed within the deadline."

2. *Compliance Examinations and Inspections*

Under DFA, when the SEC staff has conducted a compliance examination or inspection of any person, the staff must notify that person in writing that: (i) the examination or inspection has concluded; or (ii) the staff requests the person to undertake corrective action. This notice must be provided within 180 days after the staff completes its on-site inspection or receives all records requested from the person being examined or inspected, whichever is later. Provision is made, however, for one 180 day extension of this period if a particular compliance examination or inspection is "sufficiently complex" that the staff cannot make the determinations necessary to issue the notice by the initial deadline.

H. Certain Studies

1. *Overall Evaluation of SEC*

Within 90 days after DFA's enactment, the SEC must retain an independent consultant to evaluate the SEC's internal operations, structure, funding, and need for comprehensive reform, as well as the SEC's relationship with and reliance on FINRA and other SROs.[6] Within 150 days after being retained, the consultant must make a report to Congress and the SEC, including recommendations for legislative, administrative or regulatory action.

For a period of two years after the consultant's report, the SEC must issue reports (at six-month intervals) to Congress "describing the SEC's implementation of the regulatory and administrative recommendations contained in the consultant's report." The statutory language implies that the SEC will accept and act upon all of such recommendations, but this is not specifically mandated.

---

[6] To the extent it evaluates the SEC's use of SROs, this study will overlap certain other studies that relate to the use of SROs. *See* the studies or portions of studies referred to in the text accompanying footnotes 9 and 10 below.

2. *"Revolving Door" Study*

Also, DFA requires the Comptroller General of the United States to study issues surrounding employees who leave the SEC and become employed in the securities industry (*i.e.,* "revolving door" issues). The Comptroller General must report to Congress on these issues not later than one year after DFA's enactment.

3. *Reports on SEC Oversight of SROs*

DFA requires that, every three years, the Comptroller General of the United States make a report to Congress that evaluates the SEC's oversight of SROs, including FINRA. Although these reports will put pressure on the SEC to be thorough in its oversight, they also will indirectly put pressure on FINRA. Among other things, the statute indicates that the SEC's oversight should cover the following matters:

- the SROs' governance, including the identification and management of conflicts of interest and an analysis of the impact of conflicts on the SROs' enforcement or rulemaking activities;
- the SROs' executive compensation practices;
- the SROs' performance of their various regulatory functions;
- the SROs' policies regarding employment of their former personnel by entities that they regulate; and
- the transparency of the SROs' governance and other activities.

I. Mandatory Responses to Inspector General Findings

DFA requires the heads of certain federal regulatory bodies to respond to deficiencies that may be noted in any report or investigation by their respective inspectors general. Such heads include the Chairman of the SEC, the Chairman of the Fed, the Chairman of the CFTC, and the Chairman of the National Credit Union Administration. Specifically, the head of the regulatory body must either take action to address a deficiency identified by its inspector general or "certify to Congress that no such action is necessary or appropriate."

This could be viewed as giving a large amount of influence to inspectors general. That is because, even if the head of the regulatory body is of the opinion that no action is warranted, he or she may be reluctant to go on the record as "certifying" that to Congress. Government officials are not accustomed to certifying such matters, after all.

J. Compliance Examiners for SEC Regulatory Divisions

DFA provides that the SEC's Division of Trading and Markets and Division of Investment Management each must have a staff of examiners who will: (i) perform compliance inspections and examinations of entities under the jurisdiction of that division; and (ii) report to the Director of that division. This, of course, differs dramatically from the current arrangement under which examiners have been attached to the SEC's Office of Compliance Inspections and

Examinations. It is likely that this change will have noticeable consequences for SEC-regulated entities, over time, although we cannot yet reliably predict what those consequences will be.

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

A. Repeal of "15 Client" Exemption

DFA generally eliminates the exemption in the Advisers Act that currently enables advisers with fewer than 15 clients to avoid registering under that act (the "15 Client Exemption"). An exemption is, however, preserved for certain "foreign advisers" who advise "private funds" that have fewer than 15 United States investors and have a relatively modest amount of assets under management attributable to United States clients and investors. (DFA defines a "private fund" to be a company that would be subject to the 1940 Act, but for the exemptions for private investment companies provided in Sections 3(c)(1) or 3(c)(7) of that act.)

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 will require numerous other types of advisers to register under the Advisers Act. However, the impact of this will be partially offset by the effect of certain new exemptions discussed in subparts C.-F. below.

B. Repeal of Intrastate Exemption for Private Fund Advisers

An adviser to a private fund will no longer be able to rely on the provision that exempts from Advisers Act registration persons who conduct an advisory business solely within a single state.

C. New Exemption for Advisers to Small Private Funds

DFA requires the SEC to exempt from Advisers Act registration any person who: (i) advises only private funds, and (ii) has assets under management in the United States of less than $150 million. Such exempt advisers will still be required by the SEC to maintain certain records and file certain reports with the SEC, however.

D. New Exemption for Advisers to Venture Capital Funds

DFA provides an Advisers Act registration exemption for advising venture capital funds. This is widely regarded as reasonable, because venture capital funds have not 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 venture capital funds to sufficiently distinguish them from other types of private funds. DFA simply puts this ball back in the SEC's court by requiring the SEC to prescribe an appropriate definition. Also, DFA states that exempt advisers to venture capital funds must maintain such records and file such reports with the SEC as the agency may prescribe.

DFA contains no Advisers Act exemption for private equity funds. In this respect, DFA follows the approach of the House Bill, rather than the Senate Bill.

E. New Exemption for Certain Small Business Investment Company Advisers

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

F. New Exclusion for "Family Offices"

DFA excludes from the Advisers Act definition of an investment adviser any "family office." The SEC is to define the term "family office," within certain parameters set forth in the statute.

G. Registered Adviser Records for Private Funds

1. *General*

DFA makes 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 by the Council. Moreover all records of the private funds will be deemed to be records of the adviser. Accordingly, as a practical matter, the SEC and/or the Council will have access to practically any information concerning a private fund that is in the possession of the fund or its adviser.

An important exception to this general principle is that the SEC generally will not be authorized to require an investment adviser to disclose the identity, investments, or affairs of any client for whom the adviser provides investment supervisory services. Even this exception has its limitations, however. Specifically, the exception does not apply where such disclosure to the SEC is necessary or appropriate in a particular enforcement investigation or proceeding or for purposes of assessing potential systemic risk.

2. *Certain Mandated Records*

DFA specifies various types of records that private fund advisers must 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." Side arrangements and side letters, of course, have been common in the private fund context, and this language in DFA evidences particular Congressional concerns over the propriety thereof. This is consistent with recent statements by SEC officials that they are placing a high priority on scrutinizing instances where advisers and funds may treat some investors materially differently from other investors. Accordingly, it is foreseeable that this will be an area of increased regulatory pressure.

H. Adjustment of Certain SEC-Prescribed Standards for Investors

1. *"Accredited Investor" Standard*

DFA modifies the individual net worth standard prescribed for "accredited investors" in the SEC's rules under the 1933 Act to be $1,000,000, excluding the individual's primary residence. The SEC staff appears to be taking the position that this change is effective immediately, without delay or grace period, although it is not clear that this is a correct interpretation. The SEC also must consider further revisions to the accredited investor definition in the future.[7] These provisions in DFA pertaining to "accredited investors," although applicable to private funds, also apply to other types of private issuers for whom the "accredited investor" definition is relevant.

2. *"Qualified Clients" for Performance Fees*

DFA also addresses the SEC rule that defines "qualified clients" that are exempt from the Advisers Act's general prohibition on charging performance fees. Specifically, DFA requires that the SEC periodically make inflation adjustments in the dollar amount thresholds that the SEC has prescribed for purposes of this definition.

I. Other Potential Regulatory Developments for Private Funds

1. *GAO Studies*

DFA requires 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,[8] and
- the feasibility of forming an SRO to oversee private funds.[9]

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

2. *Short Selling Study*

The SEC must 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's request for this report, however, could herald a greater Congressional role, over time. This will be of considerable interest to the hedge fund industry, as many hedge funds are prolific short sellers.

---

[7] *See also* the GAO accredited investor study referred to in subpart I.1. below.
[8] *See also* subpart H.1. above concerning changes in the definition of an accredited investor.
[9] *See also* footnote 6 above and accompanying text.

J. $100 Million Minimum Assets Under Management for Certain Advisers Act Registrants

Section 203A(a)(1)(A) of the Advisers Act 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 the Advisers Act generally preempts state investment adviser regulation where the threshold is exceeded.

DFA, in effect, increases this threshold to $100 million for certain advisers ("Mid-Size Advisers"). However, certain advisers are excluded from the increased threshold, including those that: (i) although *regulated* as investment advisers by state securities regulators, are not subject to *examination* by those regulators; or (ii) would be required to register with 15 or more state securities regulators as a result of not being permitted to register with the SEC.

DFA's increase in the threshold for Mid-Size Advisers will substantially reduce the number of investment advisers that are subject to SEC regulation, and increase the role for state securities regulation of many investment advisers.

K. Studies Relating to Investment Advisers

1. *Investment Adviser Examination/Enforcement Study*

DFA requires that the SEC study the need for enhanced examination and enforcement resources for investment advisers, including:

- the number and frequency of SEC investment adviser examinations over the past five years;
- the extent to which having Congress authorize the SEC to designate one or more SROs to augment the SEC's efforts would increase the frequency of examinations of investment advisers;[10] and
- the current and potential approaches to examining the investment advisory activities of dually-registered (or affiliated) broker-dealers/investment advisers.

Within 180 days after DFA's enactment, the SEC must make a report to Congress, including a discussion of regulatory or legislative steps that are recommended to address concerns identified in the study. The SEC also is directed to use the findings in the report to revise its rules and regulations, as necessary.

The subject matter of this study and report is also to a considerable extent covered within the intended scope of the study and report discussed in part V.A.1. and 2. below.

[10] *See also* footnote 6 above and accompanying text.

2. *Investment Adviser Custody Study*

Under DFA, the Comptroller General of the United States is to study the costs of complying with the SEC's rules concerning the custody of assets of clients of investment advisers. The study is specifically required to consider (but not be limited to) what additional costs would result from elimination of a certain exclusion from the rules' requirements for independent verification of client assets. The Comptroller General must render a report to Congress within three years after DFA's enactment.

V. DEVELOPMENTS IN SEC's REGULATION OF CERTAIN OTHER PRODUCTS OR ACTIVITIES

Subparts A. through I. below discuss various SEC regulatory developments not covered in parts III. and IV. above. However, several other portions of this Bulletin also have substantial SEC regulatory implications. These include, for example, part VIII. (expanding the exemption for non-variable insurance products in Section 3(a)(8) of the 1933 Act) and part XIII. (protecting seniors from the use of misleading professional designations).

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

1. *SEC Study*

DFA directs the SEC to conduct a major study to evaluate the current legal or regulatory standards of care that are applicable when broker-dealers and investment advisers provide personalized investment advice and recommendations about securities to retail customers. This is to include regulatory requirements imposed by the SEC and FINRA, as well as other federal and state legal and regulatory standards. This could include, for example, CFTC requirements,[11] as well as state securities and insurance law requirements.

DFA specifies that the study should evaluate whether there are legal or regulatory gaps, shortcomings, or overlaps and should consider, among other things, the following:[12]

- whether retail customers understand that the standards of care for broker-dealers and their associated persons differ from those for investment advisers and their associated persons;
- whether the existence of different standards confuses retail customers;
- the regulatory, examination, and enforcement resources devoted to, and the activities of, the SEC, FINRA, and the states in enforcing the relevant standards of care for broker-dealers and investment advisers;
- the effectiveness of such examinations;

[11] *See* subpart 4. below.
[12] At least a fair amount of the subject matter of the study referred to in part IV.K.1. above would appear to overlap some of the subjects that this study is to cover.

- the existing legal or regulatory standards of state securities regulators or other regulators (which could include the CFTC and state insurance regulators) intended to protect retail customers;
- the substantive differences in the regulation of broker-dealers and investment advisers when providing personalized investment advice and recommendations about securities to retail customers;
- in this context, 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 and other requirements under the Advisers Act;
- certain potential consequences of eliminating the current Advisers Act provision that excludes certain broker-dealers from the definition of an investment adviser; and
- certain other potential consequences of changing the regulatory requirements or legal standards affecting brokers-dealers, investment advisers, and their associated persons and relating to their obligations, including duty of care, to retail customers.

2. *GAO Financial Planner Study*

The above-described SEC study is closely related to a major study that DFA directs 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 DFA's enactment, the Comptroller General must submit to Congress a report, including recommendations, arising out of its study.

Some financial planners may be subject to regulation by the new Bureau of Consumer Financial Protection that DFA creates, as discussed in part VI.E.1. below. Accordingly, the Comptroller General's study will presumably take that fact into account.

3. *SEC Report to Congress*

Within six months after DFA's enactment, the SEC must submit to Congress a report on its study (discussed in subpart 1. above) of the regulation of broker-dealers and investment advisers in providing personalized advice or recommendations about securities to retail customers. The SEC's report must also take into consideration input, comments, and data that the SEC solicits from the public. The report must set forth the SEC's findings, conclusions, and recommendations, as well as supporting analysis.

The six month deadline for the SEC's report (and related study, including public input) is remarkably tight, particularly in light of the number and complexity of the issues that the SEC is directed to consider and the fact that many of these issues are subject to divergent and strongly-held views within the industry.

4. *Relationship to CFTC Regulation of Investment Advice*

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[13] for more information on this and other aspects of the Joint Report.

Accordingly, it would make some logical sense also to include CFTC regulation in the SEC study and report described in subparts A.1. and 3. above. It is unclear, however, to what extent the SEC will move in that direction, particularly in view of the difficulty of meeting its six month deadline, even without considering CFTC regulation.

5. *Possible SEC Rulemaking*

DFA gives the SEC general authority, after considering the findings, conclusions and recommendations of the above study, to make rules concerning the standards of care for broker-dealers, investment advisers, and their associated persons for providing personalized investment advice about securities to retail customers.

DFA also grants the SEC specific authority to require that all broker-dealers and investment advisers, when providing personalized investment advice about securities to retail customers (and such other customers as the SEC provides by rule), act in the best interest of the customer without regard to the financial or other interest of the broker-dealer or investment adviser. DFA also states, however, that:

- any such rules must provide for a standard of conduct no less stringent than the standard applicable to investment advisers under Section 206(1) and (2) of the Advisers Act when providing personalized investment advice about securities;
- the receipt of compensation based on commissions or other standard compensation for the sale of securities will not, in and of itself, be considered a violation of such standard of conduct;
- the sale of only proprietary or other limited range of products by a broker-dealer will not, in and of itself be considered a violation of such standard. However, DFA provides that the SEC may by rule require that the broker-dealer provide notice of these circumstances to each retail customer and obtain the consent or acknowledgment of the customer;

[13] That client alert is available at: http://www.jordenburt.com/attachments/3324.pdf

- this grant of authority does not require a broker-dealer or its registered representative to have a continuing duty of care or loyalty after personalized investment advice about securities is provided; and
- in accordance with any such rules, any material conflicts must be disclosed and may be consented to by the customer.

6. *Harmonizing Enforcement Efforts*

DFA also addresses the subject of SEC enforcement actions against violations of the standard of conduct applicable to providing personalized investment advice about securities to retail customers. Among other things, DFA provides that the SEC must seek to prosecute and sanction such violations to the same extent, regardless of whether the advice in question was given by an investment adviser or a broker-dealer.

7. *Other SEC Mandates*

DFA directs the Commission to:

- facilitate simple and clear disclosures to investors regarding the terms of their relationships with broker-dealers and investment advisers, including any material conflicts of interest; and
- examine and, where appropriate, "promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for brokers, dealers, and investment advisers that the SEC deems contrary to the public interest and the protection of investors."

The language quoted in the last bullet point above seems especially remarkable as an exceedingly broad grant of potential regulatory power to the SEC.

B. <u>Improving Investor Understanding of Investment Products and Services</u>

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

- the degree of "financial literacy" that is characteristic of different subgroups of investors;
- 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. <u>Mutual Fund Advertising</u>

DFA provides that the United States Comptroller General must 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 must make its report to Congress within 18 months after DFA's enactment.

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

DFA contains language to clarify 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, however, 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. DFA simply grants clear authority to the SEC to resolve this issue by rule and does not in any way pre-judge what the answer should be. DFA does not mandate that the SEC in fact take any action at all (or even consider the matter).

F. Investor Access to Information on Investment Advisers and Broker-Dealers

Not later than 6 months after DFA's enactment, the SEC must complete a study of ways to improve investor access to "registration information" about registered and previously-registered investment advisers, broker-dealers, and their associated persons. This includes information about disciplinary actions, regulatory, judicial, and arbitration proceedings, and any "additional information that should be made publicly available." Not later than 18 months after completion of this study, the Commission must implement any recommendations that the study makes.

G. Disqualifying "Bad Actors" from Making Certain Regulation D Offerings

Within 1 year after DFA's enactment, the SEC must issue rules that disqualify certain persons from making private offerings of securities in reliance on Rule 506 of Regulation D. The disqualified persons are those that have been convicted of certain types of felonies or misdemeanors or have been subject to regulatory orders that bar the person from certain types of conduct or that are based on certain types of legal violations.

This provision concerning "bad actors" was added to the Senate Bill in connection with its passage by the Senate in May. Another provision pertaining Regulation D offerings that had been under consideration in connection with the Senate Bill was not included in DFA. That provision would have given state securities regulators an increased role in Regulation D offerings under certain circumstances.

H. Enhanced Recordkeeping Requirements for Certain Custodians

DFA gives the SEC authority to require a person who has "custody or use" of a registered investment company's assets to maintain its records concerning such custody or use for a specified period of time.

In addition, the SEC is specifically granted access to any person's records pertaining to that person's custody or use of assets of: (i) any registered investment company, or (ii) clients of an adviser registered under the Advisers Act. However, a person with custody or use of such assets who is subject to regulation and examination by a federal financial regulatory agency could satisfy these access requirements merely by providing the SEC a detailed listing of the assets of the registered investment company or client.

I. Other Changes

DFA incorporates numerous other changes relating to SEC regulation, including:

- authorizing the SEC to modify the number of days within which beneficial ownership reports are required to be made under Sections 13(d) and 16(a) of the 1934 Act;
- requiring the SEC: (i) to revise its rules concerning procedures that transfer agents must follow with respect to missing security holders, and (ii) to extend those rules to broker-dealers;
- prohibiting "manipulative" short sales of securities, as well as providing for certain other reforms with respect to short selling;[14] and
- clarifying that the SEC has the legal authority to adopt rules that require public companies to include in their proxy materials candidates nominated by shareholders for election to the board of directors.

VI. BUREAU OF CONSUMER FINANCIAL PROTECTION

A. The Bureau and its Director

DFA includes the Consumer Financial Protection Act of 2010 (the "CFPA"), which establishes a new Bureau of Consumer Financial Protection (the "Bureau") as an independent bureau within the Federal Reserve System. The Bureau will be headed by a Director appointed by the President with the advice and consent of the Senate. The Director will be appointed for a

[14] *See also* the study referred to in part IV.I.2. above concerning short selling.

five-year term and could be removed only by the President and only for cause (which includes "inefficiency").

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

B. Potentially Comprehensive Nature of CFPA Regulation

The CFPA gives 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 carries 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 are vested in the Bureau.

Different Covered Persons will be subject to different levels of regulation. For example, some aspects of CFPA regulation will 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 must adopt such rules within a prescribed period of time; or
- the Bureau has reasonable cause to determine that the Covered Person is engaging or has engaged in a pattern of conduct that poses risks to consumers with regard to the offering or provision of Consumer Financial Products or Services.

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

1. *Overview*

The general touchstone of whether a product or service is 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 are subject to regulation under the CFPA as Covered Persons.

Moreover, certain "related persons" of a Covered Person are themselves generally deemed to be Covered Persons and potentially subject to many of the same regulatory requirements as other Covered Persons. Such related persons 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 are subject to various regulatory requirements under the CFPA, though they may not themselves be Covered Persons. The concept of a "service provider" is 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 providing support services of a type provided to business generally (or a similar ministerial service) will not result in "service provider" status.

2. *Definition of Consumer Financial Product or Service*

As discussed immediately above, the basic scheme of the Bureau's jurisdiction depends, ultimately, on identifying what is a Consumer Financial Product or Service. That, however, is 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. These have 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 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 or services as coming within its jurisdiction.

Accordingly, insurance and securities firms will need to carefully evaluate all of their activities to determine whether any of them will: (i) fall within the definition of Consumer Financial Products or Services; or (ii) cause the firm to be a "service provider" or "related person" (as discussed in subpart C.1. above). If so, those activities will generally be subject to

regulation by the Bureau, unless a specific exclusion is available. Some potentially applicable exclusions are discussed in subparts 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 provides, in effect, 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" will come within the definition. For these purposes, the "business of insurance" is 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, provide significantly broader and clearer relief for insurance firms than did certain previous versions of the CFPA. Still, it remains foreseeable that disagreements may arise over the extent to which various activities of insurance firms in fact fall within the exclusions.

2. *Preservation of State Insurance Regulation*

The CFPA contains provisions that specifically preserve state insurance regulators' authority with respect to any person regulated by such a regulator, so long as the person is acting in a regulated capacity. But these provisions generally do not preclude the Bureau from also exercising jurisdiction with respect to the regulated person.

In a similar vein, the CFPA contains language to the effect that the CFPA does not preempt any provisions of state laws or regulations (which include, but are not limited to insurance laws or 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 is not deemed inconsistent with the CFPA if it affords consumers greater protection than is afforded under the CFPA.

The intention and effect of these provisions, in conjunction with the "business of insurance" exclusions discussed above, appears to be to preserve generally intact the current state regulation of the business of insurance.[15] Nevertheless, the Bureau could still have some jurisdiction over insurance firms. For example, a firm that offers a Consumer Financial Product or Service that does not constitute the "business of insurance" could be subject to CFPA

---

[15] This is consistent with the Federal Insurance Office Act of 2010, as discussed in the text accompanying footnote 4, above.

regulation even if the firm is also subject to state insurance regulation with respect to that product or activity.

Similarly, if an insurance firm conducts activities that make it a "related person" or a "service provider" to a Covered Person (as discussed in subpart C.1. above), such activities could be subject to CFPA regulation even if they are also subject to state insurance regulation (and even if they constitute the business of insurance).

E. Applicability to Securities Firms

1. *Certain Financial Advisory Services*

As noted in subpart C.2. above, the Consumer Financial Products and Services covered by the CFPA generally include "providing financial advisory services to consumers on individual financial matters or relating to proprietary financial products or services." However, the CFPA contains provisions that, in effect, exclude such financial advisory services from the act, if they are provided by a person regulated by the SEC or regulated by a state securities regulator, but only to the extent that such person acts in a regulated capacity. (For purposes of the CFPA, "persons regulated by" the SEC include, among others: (i) broker-dealers registered under the 1934 Act, (ii) advisers registered under the Advisers Act, (ii) funds registered under the 1940 Act, and (iii) any employee, agent, or contractor acting on behalf of, registered with, or providing services to, any such person.)

These exclusions with respect to financial advisory services apply only to the extent that the person providing the service is acting "in a regulated capacity." It is foreseeable that questions may 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.

To the extent that the CFPA may apply to certain financial planning services, the CFPA is closely related to the financial planning study mentioned in part V.A.2. above, and, more generally, to the overall subject matter of part V.A.

2. *General Preservation of Exclusive SEC Regulation*

In addition to the specific exclusion discussed in subpart 1. above for certain financial advisory services, the CFPA contains broad provisions that preserve the SEC's sole jurisdiction over persons regulated by the SEC. Again, however, these exclusions apply only to the extent that any such person is acting "in a regulated capacity," and differences of interpretation may arise as to whether that requirement is satisfied in a particular case.

3. *General Preservation of State Securities Regulation*

As noted in subpart D.2. 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 includes state securities regulatory provisions.

Moreover, the CFPA also contains language that preserves, more specifically, state securities regulators' jurisdiction over any person that they regulate. This is similar to, but more general than, the provisions noted in subpart 1. above that specifically exclude certain financial advisory services that are provided by persons subject to state securities regulation.

Nevertheless, state securities regulation, even if it applies, generally will not preclude regulation by the Bureau. Rather, if a firm provides a Consumer Financial Product or Service (or is a "related person" or a "service provider" to a Covered Person) that firm will generally be subject to regulation by the Bureau, even if the product or activity in question is also subject to regulation under state securities laws. An exception to this general principle is discussed in subpart 1. above with respect to certain financial advisory services. As noted there, the applicability of state securities regulation may exclude that type of services from regulation under the CFPA.

F. Coordination Between Bureau and Other Regulators

Even in areas where the Bureau does not have direct jurisdiction, it could very well have considerable influence. That is because, among other things, DFA directs the Bureau to coordinate with other regulators (including the SEC and state regulators) to promote consistent regulatory treatment of consumer financial and investment products and services.

VII. SIPC REFORMS

DFA makes various reforms to the Securities Investor Protection Corporation ("SIPC") insurance of securities accounts. Among other things:

- the standard SIPC coverage limit for cash is permanently increased from $100,000 to $250,000, subject to possible future inflation adjustments; and
- the minimum assessments on SIPC members are increased.

VIII. APPLICATION OF SECTION 3(a)(8) EXEMPTION FOR CERTAIN INSURANCE PRODUCTS

DFA contains a provision that was intended primarily to, in effect, overrule SEC Rule 151A. Under Rule 151A, most fixed indexed annuities would have been ineligible to rely on the exemption in Section 3(a)(8) of the 1933 Act. This would have meant that, absent some other exemption, the offer and sale of such fixed indexed annuities would be subject to the securities registration and broker-dealer regulation provisions of the federal securities laws.

DFA, however, provides that the SEC must treat such annuities, as well as many other non-variable insurance and annuity products, as exempt under Section 3(a)(8), provided that certain state insurance law "nonforfeiture" and customer suitability standards are satisfied, leaving such insurance products subject to regulation by state insurance departments.

The SEC's adoption of Rule 151A also had been under legal attack in the United States Court of Appeals for the District of Columbia Circuit, which held that the SEC arbitrarily and capriciously failed to analyze the impact of the rule on efficiency, competition and capital formation. Although the court initially gave the SEC an opportunity to cure this deficiency, the SEC failed to do so and, on the day before the Senate passed DFA, the court vacated Rule 151A.

Although Rule 151A has been vacated, DFA still includes the provision expanding the Section 3(a)(8) exemption. It is not clear what action, if any, the SEC will take in response to the vacatur of Rule 151A. It is clear, however, that DFA's expansion of the Section 3(a)(8) exemption for many types of annuity and life insurance products will be of great interest to many issuers and distributors of such products.

IX. CERTAIN POTENTIAL LEGAL EXPOSURE

A. Study of Private Right of Action Against Aiders and Abettors

The Comptroller General of the United States must, under DFA, study the impact of authorizing a private right of action against any person who aids or abets another person in violation of the securities laws. Currently, there generally are no such private rights for aiding and abetting under the federal securities laws. Any legislation to provide such a right could have profound implications for investment advisers, funds, and insurance companies whose activities are subject to the securities laws. This would be of particular concern if conduct that is merely "reckless" (rather than "knowing") were deemed sufficient to maintain a private action for aiding and abetting. (As discussed in part III.C. above, DFA establishes recklessness as a generally-sufficient basis to support an action by the SEC to redress aiding and abetting of a securities law violation.)

B. Longer Statute of Limitations for Securities Violations

DFA extends to 6 years the statute of limitations for any person to be prosecuted, tried or punished for certain "securities fraud offences," including specified offences under the 1933 Act, the 1934 Act, the Advisers Act, and the 1940 Act.

C. Review of Financial Fraud Sentencing Guidelines

DFA also requires the United States Sentencing Commission to review its guidelines and make any revisions necessary to ensure that sentencing for securities fraud, financial institutions fraud, and other similar offenses appropriately accounts for the potential and actual harm to the public and the financial markets from these offences.

D. Extraterritorial Jurisdiction for Securities Antifraud Actions

DFA specifies that United States District Courts have jurisdiction over various antifraud actions and proceedings brought by the SEC or the United States under the federal securities laws if:

- significant steps in furtherance of the violation have occurred in the United States, even if the securities transaction occurs outside the United States and involves only foreign investors; or
- conduct has occurred outside the United States that has a foreseeable substantial effect within the United States.

Although the foregoing provisions relate only to actions brought by the SEC or the United States, DFA also requires the SEC to conduct a study to determine whether the same principles of extraterritorial jurisdiction should be extended to cover private rights of action for antifraud violation under the 1934 Act. The SEC must solicit public comment at the outset of the study and to make its report and recommendations to Congress within 18 months after DFA's enactment. The study will consider such questions as:

- the proper scope of any such private right of action, including whether such right should be available to all private actors or whether it should be limited, for example, to institutional investors;
- the economic costs and benefits of any such private right of action; and
- the implications any such private right of action would have on international comity.

X. CREDIT RATINGS

DFA contains extensive reforms in the regulation of credit rating agencies. These reforms will significantly affect the nature, quality, cost, and availability of credit ratings. These changes will be of considerable relevance to the many insurers, funds, and investment advisers who take account of such ratings when evaluating investments.

One of the most prominent questions has been the extent to which the regulatory structure set out in federal statutes and regulations should continue to rely for any purpose on the existence of ratings. DFA resolves this question by removing references in various federal statutes that make legal or regulatory consequences flow from the existence or absence of a specified credit rating. For example, credit ratings prescribed under various provisions of the 1934 Act and the 1940 Act will be eliminated and replaced with "such standards of creditworthiness as are established by" the SEC.

Moreover federal agencies (including the SEC) are generally required to review references in their regulations that require the use of a credit rating and to replace such references with "such standards of creditworthiness as each respective agency shall determine as appropriate." We mention but two examples of the impact this will have.

Money market funds are one example, to the extent that they currently operate pursuant to provisions in Rule 2a-7 under the 1940 Act that use credit ratings. The SEC will need to delete those references and replace them with other standards, and money market funds will need to revise their procedures accordingly.

Certain non-variable insurance products registered with the SEC on Form S-3 are another example. In order to be registered on Form S-3 (rather than Form S-1), some of these products currently are required to have an investment grade rating from a credit rating agency. Accordingly, the basis on which such products may be registered in the future is now in doubt.

XI. DERIVATIVES REGULATION

DFA effects major enhancements and reforms in the regulation of swaps and other derivatives. These changes will have significant implications for many funds and insurance companies who use derivatives for hedging or other investment purposes, and for firms that give investment advice concerning derivatives. A few examples are discussed below.

A. Need for New Arrangements for Derivatives Trading

Many swaps that have in the past not been required to be settled through a clearing organization or traded on an exchange will now be required to be so cleared or traded. This and other new requirements under DFA will in many cases require funds, insurance companies, and others who use derivatives to enter into new or revised agreements with custodians, counterparties and others pursuant to which they conduct these activities. In some cases, there may be new requirements to post margin and other additional costs for these activities. Numerous other "back office," compliance, and administrative procedures also may need to be revisited.

B. Bank Spin-Off of Certain Derivatives Trading Operations

One of the most contentious aspects of DFA has been its requirement that banks conduct certain of their derivative trading operations through separate subsidiaries. It is unclear whether, as a result of this requirement, some banks will spin off or sell their derivative trading business to a company that is wholly independent of the bank. In any case, the changes required by DFA will probably cause some degree of disruption in or reworking of the banks' derivatives trading relationships with some customers, including funds and insurance companies.

C. Possible Status as "Major Swap Participant"

Under DFA, a fund, insurance company, or other investor that has a "substantial position" in any category of swaps may be deemed to be a "major swap participant" or a "major security-based swap participant." The CFTC and SEC must adopt rules to define "substantial position" for these purposes, and it is very uncertain what definitions they will prescribe. The matter is of great importance, however, because a major swap participant or a major security-

based swap participant will be subject to a wide variety of potentially burdensome and costly regulatory and financial requirements.

D. Status of Stable Value Contracts

Insurance companies and others who provide guarantees in connection with the "stable value funds" that are popular investment options under Section 401(k) and other retirement plans have expressed particular concerns. For example, if contracts that provide such guarantees were deemed to involve "swaps," the party providing the guarantee could in some cases be deemed to be a "swap dealer" or a "security-based swap dealer." This could make it impractical, or at least much more burdensome and costly, to provide such guarantees. However, late in the legislative process, the House and Senate conferees agreed to language that at least provides additional time to address this issue.

Specifically, under DFA, the SEC and CFTC will conduct a joint study to determine whether stable value contracts fall within the definition of a swap. The SEC and CFTC also must consult with the Department of Labor, Treasury, and state insurance regulators. The study must be completed within 15 months after DFA's enactment, and, if the study concludes that a stable value contract is a swap, the SEC and CFTC will jointly determine whether any exemption from such definition is appropriate. However, until any such determination, DFA will exclude stable value contracts from the definition of a swap.

E. Preemption of Insurance Regulation for Swaps

There have been proposals to regulate certain swaps as insurance. For example, the National Conference of Insurance Legislators and the New York Insurance Department have each put forth the concept of regulating certain credit default swaps in the same manner as financial guarantee insurance.

DFA preempts such concepts, by providing that neither any swap nor any security-based swap may be regulated as insurance under state law.

XII. THE "VOLCKER RULE"

A. Basic Requirements

DFA contains certain provisions that embody what has commonly been referred to as the "Volcker Rule." These provisions prohibit most banks and companies that are affiliated with banks from: (1) engaging in "proprietary trading," or (2) sponsoring or having any ownership interest in a hedge fund or a private equity fund. However, there will be important exclusions from these basic prohibitions, some of which are discussed further below.

DFA also addresses the conduct of these activities by other nonbank financial companies that are subject to enhanced prudential supervision by the Fed (as discussed in part I.B. above). For such companies that are not banks or affiliates of banks, the above prohibitions as to

proprietary trading, hedge funds, and private equity funds will not apply. Nevertheless, DFA provides that such Fed-supervised nonbank financial companies will be subject to additional capital requirements and quantitative limits with regard to any such activities. The additional capital and quantitative limits are to be determined pursuant to the coordinated rulemaking discussed in subpart B. below.

B. Council Study and Coordinated Rulemaking

Many of the details about the above requirements are to be determined by a coordinated rulemaking in which the appropriate federal banking agencies, the SEC, and the CFTC will participate. DFA prescribes that this rulemaking be coordinated by the Council and be based on a study conducted by the Council. The study must be concluded no more than 6 months after DFA's enactment and must make recommendations about how to implement the Volcker Rule so as, among other things, to:

- reduce the risk of unsound activities by banks or their affiliates or by nonbank financial companies supervised by the Fed;
- limit the inappropriate transfer of federal subsidies from institutions that benefit from deposit insurance and federal liquidity facilities to other entities;
- reduce conflicts between: (i) the self-interest of banks or their affiliates or of nonbank financial companies supervised by the Fed; and (ii) the interests of their customers; and
- appropriately accommodate the business of insurance within any insurance company (subject to regulation in accordance with the relevant insurance company investment laws), while protecting the safety and soundness of any affiliate bank (or of other affiliates of such a bank).

Insurers have had concerns that the Volcker Rule might restrict their customary investment and hedging activities. The mandate to the Council that is reflected in the last bullet point above provides some room for optimism that the study and coordinated rulemaking may resolve these concerns satisfactorily. DFA requires that, pursuant to the coordinated rulemaking, rules implementing the Volcker Rule be adopted no more than 9 months after completion of the Council's study.

C. Key Definitions

1. *Proprietary Trading*

DFA defines "proprietary trading" broadly for these purposes to include transactions in the below listed instruments "as a principal for the trading account of" the entity subject to the Volcker Rule:

- any security, derivative, or commodity futures contract;
- any option on any of the foregoing; or
- any other financial instrument as may be prescribed pursuant to the coordinated rulemaking.

A "trading account" for this purpose is one that is used principally for short-term transactions or such other purposes as may be prescribed pursuant to the coordinated rulemaking.

2. *Hedge Funds and Private Equity Funds*

Hedge funds and private equity funds are defined broadly for these purposes to mean:

- an issuer that would be an investment company but for the exclusion in Section 3(c)(1) or 3(c)(7) of the 1940 Act; or
- such similar funds as may be prescribed pursuant to the coordinated rulemaking.

The concept of "sponsoring" a hedge fund or a private equity fund is also broadly defined, to include:

- serving as a general partner, managing member, or trustee of a fund;
- in any manner selecting or controlling (or having employees, officers, directors, or agents who constitute) a majority of the directors, trustees, or management of a fund; or
- sharing the same name (or a variant of the same name) with a fund for any purpose.

D. Exclusions from Volcker Rule

DFA identifies certain activities that will generally be permitted without being subject to the restrictions set forth in subpart A. above. Among others, these activities include:

- transactions in federal, state, and local government securities;
- transactions in connection with underwriting or market-making-related activities that are not designed to exceed the reasonably expected near term demands of clients, customers or counterparties;
- organizing and offering a private equity or hedge fund, provided that a series of requirements set out in the statute are met, including that: (i) the fund is organized and offered in connection with bank's (or its affiliate's) providing bona fide trust, fiduciary, or investment advisory services and only to persons that are customers of those services; (ii) neither the bank nor its affiliate have any ownership interest in the fund, share the same name with the fund, or guarantee any obligations of the fund;
- certain activities that occur solely outside the United States;
- activities by a bank or its affiliated entity that are designed to reduce its specific risks in connection with other positions, contracts or holdings;
- transactions by an insurance company (or its affiliate) for the insurance company's general account, if: (i) the transaction is conducted in compliance with, and subject to, the insurance company investment laws, regulations, and written guidance of the insurance company's domiciliary jurisdiction; and (ii) the appropriate federal banking agencies, after consultation with the Council and the relevant insurance commissioners, have not jointly determined, after notice and comment, that the particular law, regulation, or written guidance described clause (i) above is

insufficient to protect the safety and soundness of a bank or bank affiliate or the financial stability of the United States; and

- any other activities that, pursuant to the coordinated rulemaking, are determined to promote safety, soundness, and financial stability.

Again, insurance companies may find especially helpful the concepts reflected in the penultimate bullet point in the foregoing list.

It should be cautioned that DFA gives the relevant regulatory bodies considerable latitude, pursuant to the coordinated rulemaking, to limit any of the exclusions reflected in the above list of bullet points, based on such considerations as conflicts of interest, risks to a bank or its affiliate, or threats to the financial stability of the United States.

DFA also provides a "de minimis" exclusion that allows a bank or its affiliate to make an investment in a hedge fund or a private equity fund for the purpose of: (i) establishing the fund and providing the fund with sufficient initial equity to attract unaffiliated investors, or (ii) otherwise making a de minimis investment. Numerous limits and conditions will attach to any such investment, however, including that the investment be "immaterial." DFA provides that what is immaterial for this purpose will be determined pursuant to the coordinated rulemaking, provided that, in no case may the aggregate of all interests of the bank or its affiliates in hedge funds and private equity funds exceed 3% of Tier 1 capital.

XIII. SENIOR PROTECTION FROM MISLEADING PROFESSIONAL DESIGNATIONS

DFA establishes an Office of Financial Literacy within the new Bureau of Consumer Financial Protection. The Office of Financial Literacy is authorized to make monetary grants to states and state securities, insurance and consumer protection agencies to provide financing for a wide variety of measures (including enforcement and remedial measures) designed to address the problem of using misleading professional designations in the sale of financial products to persons 62 years of age or older.

The following definitions apply to these provisions:

- "Financial products" means "an insurance product (including an insurance product that pays a return, whether fixed or variable), a bank product, or a loan product."

- "Misleading designation" means "a certification, professional designation, or other purported credential that indicates or implies that a salesperson or adviser has special certification or training in advising or servicing seniors." Excluded from this definition are certain designations issued by or obtained from academic institutions, certain associations, or states.

- "Misleading or fraudulent marketing'' means the use of a misleading designation by a person that sells to or advises a senior in connection with the sale of a financial

product. Sales practices which do not involve the use of designations will not satisfy this definition.

Grants could be made for the following purposes:

- to hire staff to identify, investigate, and prosecute (through civil, administrative, or criminal enforcement actions) cases involving misleading or fraudulent marketing;
- to fund technology, equipment, and training for regulators, prosecutors, and law enforcement officers, in order to identify salespersons and advisers who target seniors through the use of misleading designations;
- to fund technology, equipment, and training for prosecutors to increase the successful prosecution of salespersons and advisers who target seniors with the use of misleading designations;
- to provide educational materials and training to regulators on the appropriateness of the use of designations by salespersons and advisers in connection with the sale and marketing of financial products;
- to provide educational materials and training to seniors to increase awareness and understanding of misleading or fraudulent marketing;
- to develop comprehensive plans to combat misleading or fraudulent marketing of financial products to seniors; and
- to enhance provisions of state law to provide protection for seniors against misleading or fraudulent marketing.

Grants will be made based upon applications, for three year periods of not more than $500,000 per year. To qualify for a grant, the applicant must have adopted rules regarding the use of designations or annuity suitability that meet or exceed those of the NAIC or the North American Securities Administrators Association. The statute contemplates federal funding for such grants in the total amount of $8 million per year for each fiscal year 2011-2015.

****

This Bulletin does not constitute legal or other professional advice or service by JORDEN BURT LLP and/or its attorneys.

For additional information:

Jorden Burt has formed a special Task Force to monitor these and similar developments. To obtain additional information about particular developments 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 developments 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.