

ADMINISTRATION PROPOSES MAJOR REGULATORY CHANGES AFFECTING INSURANCE COMPANIES, INVESTMENT ADVISERS AND FUNDS

(June 22, 2009)

INTRODUCTION

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

On June 17, 2009, the Obama administration published a detailed "White Paper" that proposes numerous measures to address perceived inadequacies in regulation of the financial services industry.¹ The intent of such proposals is generally to modernize such regulation and address problems that are perceived to have contributed to the current economic situation.

It is difficult to overstate the potential impact on the insurance and investment fund/adviser industries if all of the White Paper's proposals were implemented to the maximum possible extent. The proposals are exceedingly numerous and complex, and even the 88 page (single space) White Paper does not begin to flesh out the details or implications of most of them. The White Paper does not explain the scope of some of the proposals. It is far from clear, moreover, how vigorously the administration will promote each proposal and what reaction it will receive on Capitol Hill. There are additional proposals which are in pending bills, or which have been promoted by one or more groups, and it is unknown how, or if, such alternative or additional proposals may proceed in Congress.

This Bulletin does not attempt to catalog, much less analyze, all of the proposals. Rather, this Bulletin merely attempts to communicate a sense of the significance of the consequences that the proposals may have for the insurance and investment fund/adviser industries. We believe the proposals merit serious additional attention.

There are two different aspects to the White Paper and its proposed regulatory changes. The first aspect arises from a recognition that there are certain companies in our economy which, for one reason or another, are so important to the health of the economy that they need to be regulated by the federal government. The White Paper proposes the regulation of such companies (including but not limited to the ones sometimes termed "too big to fail"), concentrating on "systemic risk" regulation and the "resolution" of such companies. "Resolution" is a euphemism for winding down those companies through an alternative to the

¹ The final version of the White Paper, issued by the Treasury Department, may be found at http://www.financialstability.gov/docs/regs/FinalReport_web.pdf, was issued by the Department of the Treasury and is entitled: "Financial Regulatory Reform--A New Foundation: Rebuilding Financial supervision and Regulation." Although the White Paper was formally published on June 17, 2009 a draft was informally released the day before.

U.S. Bankruptcy Code (or, presumably, state receivership or liquidation regimes for insurance companies). Much of the White Paper concentrates on how such companies, which are termed “Tier 1 FHCs²,” shall be identified, who shall identify them, and how the systemic risk and resolution regulation should be carried out. Many of the companies that one might initially think might qualify as Tier 1 FHCs would be in the lending and securities markets, but insurance companies and other large financial service companies also may be deemed Tier 1 FHCs.³

The second aspect of the White Paper involves the identification of certain other issues, or functional areas of the economy, which present sufficient risk to warrant federal regulation regardless of the presence or absence of Tier 1 FHCs in that market or segment of the economy. These areas of regulation may encompass Tier 1 FHCs, but also any other company or person active in that sector of the economy.

This Bulletin discusses some of most important ways in which the proposals in the White Paper would affect Jordan Burt’s core client groups.

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² “FHC” is an acronym for Financial Holding Company.

³ There is no articulated restriction on what types of businesses may have companies designated as Tier 1 FHCs; rather, the determination as to which companies are Tier 1 FHCs is to be made based upon stated criteria involving the size and impact that a company has on the financial markets or economy. The repeated references to AIG in the White Paper in the context of discussions of systemic risk and resolution at least imply that an insurance company could be designated as a Tier 1 FHC.

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ANALYSIS

I. INSURANCE

A. Systemic Risk Regulator (the Federal Reserve)

The administration White Paper espouses a type of “systemic” risk regulation mentioned in prior reports and recommendations of the Treasury and others. Systemic risk regulation by a *council* or *committee* has been proposed for the insurance area by the National Association of Insurance Commissioners (“NAIC”) (to include both state and federal regulators), by the European Union generally, and in recent comments attributed to Treasury Secretary Geithner. Nevertheless, the White Paper’s approach for the most part is to use a council *only* to help determine which entities should be regulated as systemic risks, and to vest the primary systemic regulatory authority over such entities in the Federal Reserve.

B. “Tier 1 FHCs” (What You Would Rather Not Be)

The administration White Paper singles out what it refers to as “Tier 1” financial holding companies (“Tier 1 FHCs”) for especially rigorous additional regulation to control systemic risks. A Tier 1 FHC would include any “financial firm” whose combination of size, leverage and interconnectedness with other firms and counterparties could pose a threat to the financial stability of the economy if it failed. This could include a bank holding company or an insurance

holding company (or a holding company containing any other financial firm), for example. It could also include a financial firm that is not part of any holding company.

C. Identifying Tier 1 FHCs

The Federal Reserve would determine which firms are Tier 1 FHCs, with input from a new Financial Services Oversight Council (“FSO Council”) and others. The FSO Council would consist of the Secretary of the Treasury (who would serve as the chairman), the Chairman of the Federal Reserve Board, the Director of a newly-created National Bank Supervisor, the Director of a newly-created Consumer Financial Protection Agency, the Chairman of the SEC, the Chairman of the CFTC, the Chairman of the FDIC, and the Director of the Federal Housing Finance Agency. An office would be created within Treasury that would provide full-time, expert staff to support the FSO Council’s various missions. Note that there is no representation on the Council from any state regulatory body, from the NAIC or from any body with recognized responsibility or expertise with respect to the insurance industry.

The White Paper recommends that the applicable legislation specify the factors that the Federal Reserve must consider in determining whether an entity is a Tier 1 FHC, but otherwise provides little useful guidance in that regard. Those factors include:

- the impact that the firm’s failure would have on the financial system and economy;
- the firm’s combination of size, leverage (including off-balance sheet exposures), and degree of reliance on short-term funding; and
- the firm’s criticality as a source of credit for households, businesses, and state and local governments and as a source of liquidity for the financial system.

To the extent necessary to reach a determination concerning Tier 1 FHC status, the Federal Reserve would have the authority to obtain information from or conduct examinations of any firm that meets a minimum size threshold (which the White Paper does not quantify). This is but one of several provisions in the White Paper providing for obtaining reports or other information from Tier 1 FHCs or from any U.S. financial firm that meets certain minimum size thresholds. The right to require reports and conduct examinations extends to subsidiaries of Tier 1 FHCs, including those that are regulated by another body.

While the above-listed factors do not seem to apply easily to most insurance companies, it certainly cannot be concluded that insurance companies could not qualify as Tier 1 FHCs. The White Paper mentions, numerous times, the example of AIG as a company which should have been subject to the type of systemic risk regulation advocated for Tier 1 FHCs. It is not clear whether any such a designation would stem from AIG’s role as a large, multi-line insurance company or from its other involvements in the financial markets through credit default swaps and other instruments, or both..

Moreover, in a press release issued after the administration published the White Paper, the NAIC expressed an interest in having representation on the FSO Council, a clear indication that the NAIC believes it possible that insurance companies under the regulation of the state insurance departments might be designated as Tier 1 FHCs.

Also, the White Paper includes, as one of the proposed responsibilities of the Office of National Insurance (“ONI” – described below), that ONI recommend to the Federal Reserve any insurance companies that the Office believes should be supervised as Tier 1 FHCs, a clear indication of an anticipation that insurance companies may be designated as Tier 1 FHCs. Also, the White Paper mentions several times that, although many Tier 1 FHCs may be bank holding companies, the ownership of an insured depository institution is not a prerequisite for Tier 1 FHC designation.

The process of determining which entities may, or may not, be designated as Tier 1 FHCs is in the initial definition and determination stages. Any large financial company with a significant position in its market should follow the development of this issue.

D. Regulation of Tier 1 FHCs

Although the scope and details of the proposed regulation of Tier 1 FHCs is still unclear, regulation would include the following areas, which are intended to be “macroprudential in focus” *i.e.*, (considering risk to the financial and economic systems as a whole):

- Capital requirements. Even if the entity is already subject to regulation that includes a capital requirement, the capital requirement for a Tier 1 FHC may be greater, in order to protect the system from systemic risks.
- Prompt corrective action. Prompt action should be taken to remedy the decline of capital levels below requirements.
- Liquidity standards. Rigorous liquidity risk requirements.
- Overall risk management. Sufficiently comprehensive and detailed risk-management practices.
- Market discipline and disclosure. Enhanced public disclosures to facilitate risk evaluation and management.
- Rapid resolution plans. A plan for the “rapid resolution” of the firm in the event of severe financial distress, approved by the Federal Reserve, must be put in place by the Tier 1 FHC.
- Restrictions on nonfinancial activities. The prudential regulations and supervisory guidance applicable to bank holding companies would be applied to all Tier 1 FHCs (including to those Tier 1 FHCs that are not, in fact, bank holding

companies). This could present major problems for some insurance companies and their affiliates.

With the exception of the last item (relating to bank holding company regulation), these are basically statements of principles. Without more detail about them, it is not possible to assess their likely impact on the operation of any financial service-related company. The impact could, however, be substantial.

There is a recognition, which may arise in part from the government's involvement with AIG, that diverse corporate groups consisting of regulated and non-regulated affiliates may present particular regulatory challenges. The White Paper would extend systemic regulation to any parent or subsidiary of a Tier 1 FHC (including those regulated and unregulated, U.S. and foreign) to prevent companies from having activities that might present serious systemic risk escape regulation. The White Paper specifically includes "insurance companies subject to supervision by state insurance supervisors" in this category. It is interesting that the NAIC is approaching this same concept from the opposite direction. At the recently-concluded summer meeting of the NAIC, the Group Solvency Issues Working Group discussed potential amendments to the Insurance Company Holding System Model Regulatory Act. The proposed amendments were prompted by concerns raised by several state insurance commissioners about the need for greater authority over non-insurance affiliates of regulated insurance companies, particularly activities of non-regulated affiliates that might impair effective regulation of the regulated insurance companies.

E. Other "Enhanced Oversight" of the Insurance Sector

1. Proposed Office of National Insurance (ONI)

The White Paper proposes the establishment of the Office of National Insurance ("ONI") within the Treasury Department, with a goal to "develop a modern regulatory framework for insurance." Although the White Paper does not describe the ONI as a "regulator," this goal certainly raises questions as to the ultimate responsibilities and potential impact of the ONI on the insurance industry. The White Paper states that the ONI would have the following responsibilities: (1) monitor all aspects of the insurance industry; (2) gather information and identify the emergence of any problems or gaps in regulation that could contribute to a future crisis; (3) recommend to the Federal Reserve any insurance companies that the ONI believes should be supervised as Tier 1 FHCs; (4) carry out the government's existing responsibilities under the Terrorism Risk Insurance Act; and (5) act as the voice of U.S. insurance regulation in relationships with other countries and international regulatory bodies and organizations.

Treasury is to support proposals "to modernize and improve our system of insurance regulation," subject to "six principles for insurance regulation:"

- Effective systemic risk regulation with respect to insurance.

- Strong capital standards and an appropriate match between capital allocation and liabilities for all insurance companies.
- Meaningful and consistent consumer protections for insurance products and practices.
- Increased national uniformity through either a federal insurance charter or effective “action” (presumably including regulation) by the states.
- Improve and broaden the regulation of insurance companies and affiliates on a consolidated basis, including those affiliates outside of the traditional insurance business.
- International coordination.

Although the Treasury issued a detailed paper early last year (the “Treasury Blueprint”⁴) that specifically mentioned reinsurance, the White Paper does not. At least part of the context of the reference to reinsurance in the Treasury Blueprint dealt with the issue of collateral for reinsurance agreements with non-U.S. reinsurers, and the Treasury Blueprint appeared to use that issue as an example of the need for a federal spokesperson for dealing with those outside the U.S. on certain issues. Since part of the stated purpose of the ONI is to interact with those outside the U.S., the failure of the White Paper to mention the reinsurance collateral issue probably should not be taken as a statement or implication that this issue would not be encompassed within the charge of the ONI.

How one views this proposal is a matter of perspective. Early statements from the NAIC and state insurance commissioners promote the theme that the White Paper preserves the state regulation of insurance, while statements from outside the U.S., where regulation of insurance typically is exercised by central governments, label the ONI as a “national insurance regulator.” Certainly the White Paper may bring about a fundamental change in the insurance regulatory structure. The ONI is the first instance of the federal government establishing a permanent presence in the regulation of insurance. The fact that large insurance companies may be regulated, at least as to systemic risk and resolution, as Tier 1 FHCs by the federal government would also be a fundamental change. However, one proposal in the Treasury Blueprint last year was for a much more comprehensive federal insurance regulator, a proposal noticeably absent from the White Paper. The scope of the federal regulation of insurance companies that might result from the White Paper is unclear at best.

⁴ The Treasury Blueprint may be found at <http://www.treas.gov/press/releases/reports/Blueprint.pdf>.

2. Possible Regulation of Executive Compensation

The White Paper contains suggestions regarding the compensation of executives at “financial firms” (not just Tier 1 FHCs). The White Paper suggests that federal regulators issue standards and guidelines to better align executive compensation practices of financial firms with long-term shareholder value. It is entirely unclear to what companies and persons such standards and guidelines might ultimately apply.

The White Paper also proposes other executive compensation measures that would be required by the SEC for all public companies. These measures would apply to publicly owned insurance companies (and their holding companies), regardless of whether such companies are Tier 1 FHCs. These additional measures would include a requirement to hold an annual non-binding shareholder vote on executive compensation, enhanced public disclosure about executive compensation, and requirements that compensation committees be more independent.

3. Expansion of Bank Holding Company Act Coverage

Certain holding companies are currently excluded from bank holding company status, notwithstanding that they own federally-insured thrift institutions, non-depository trust companies, industrial loan companies and credit card banks. The administration White Paper recommends that, in future, holding companies that include these types of subsidiaries be regulated as bank holding companies, even if they are not Tier 1 FHCs. This would make the holding company subject to the prudential regulations and supervisory guidance that are applicable to all other bank holding companies.

This area might be of particular concern to insurance companies or insurance holding companies which purchased depository institutions in order to seek TARP funds. Accordingly, the consequences of this White Paper proposal will need to be carefully considered by any insurance company whose holding company (i) is currently not regulated as a bank holding company but (ii) includes any federally-insured thrift institution, non-depository trust company, industrial loan company or credit card bank.

F. “Optional” Federal Insurance Charter

The administration White Paper mentions the concept of an optional federal insurance charter only in the context of the Treasury Department’s six principles of insurance regulation (described in subpart E.1. above); *i.e.*, in the six principles, federal charters and actions by states are two ways identified to achieve increased national uniformity in the regulation of insurance. While this statement does not necessarily envision a prominent role for an optional federal charter, neither does the White Paper dismiss the potential regulatory significance of an optional federal charter. There likely will be further developments in this area.

G. “Resolution Authority” for the Federal Government

The White Paper proposes “a new authority, modeled on the existing authority of the FDIC, that should allow the government to address the potential failure of a bank holding company or other nonbank financial firm when the stability of the financial system is at risk.” The goal of this authority is “to avoid the disorderly resolution of failing BHCs [Bank Holding Companies], including Tier 1 FHCs, if a disorderly resolution would have serious adverse effects on the financial system or the economy.”

The proposed exercise of this resolution authority is somewhat complex. The White Paper states that the process could be initiated by Treasury or the Federal Reserve, after required consultation with the President, and with the concurrence of two-thirds of the FDIC Board and two-thirds of the members of the Federal Reserve Board. An exception exists if the largest subsidiary is a broker-dealer or securities firm, in which case FDIC Board approval is not required, but two-thirds of the SEC Commissioners must approve instead. Interestingly, there is no analogous exception where the largest subsidiary is an insurance company. In that case, the White Paper states that the ONI will provide consultation on insurance matters, and state insurance authorities apparently have no voice at all.

Once the special resolution authority is invoked, the White Paper would vest in Treasury the authority to decide what steps should be taken pursuant to that authority. If Treasury decides for a receivership or conservatorship, Treasury should generally appoint the FDIC as the conservator or receiver, except that Treasury “should have the authority” to appoint the SEC as conservator or receiver where the largest subsidiary is a broker-dealer or securities firm. Interestingly, there is no analogous provision to the effect that, if the largest subsidiary is an insurance company, an insurance regulator may be appointed the conservator or receiver. This is perhaps ironic, in view of the considerable experience that state insurance regulators have in connection with insurance company conservatorships/receiverships under a Model Act that is substantially uniform across the U.S.

The White Paper also wishes to plan ahead for such resolutions, and the Federal Reserve is charged with ensuring that every Tier 1 FHC has a “credible” “rapid resolution plan” in place that can be activated if needed.

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

H. Regulation of Certain Swaps and Other Derivatives

There is a conceptual debate as to whether certain credit default swaps and other derivatives should be regulated as insurance. For example, the New York Department of Insurance proposed last autumn to regulate “covered” credit default swaps as financial guarantee

insurance. (A credit default swap is considered to be “covered” if the purchaser of the default protection actually owns the debt obligation on which the swap is based.) Similarly, the National Conference of Insurance Legislators (“NCOIL”) has been considering model legislation that would regulate certain credit default swaps (and perhaps certain other derivatives) in a manner similar to the way that financial guarantee insurance is regulated under New York law.

New York has now indefinitely delayed its plan to regulate covered credit default swaps, in view of other initiatives that are underway to address the problems presented by such instruments.⁵ NCOIL’s initiative is still ongoing. New York, however, believed, among other things, that it had jurisdiction to regulate only part of the credit default swap market (*i.e.*, covered swaps) as insurance, that the best solution would be for all credit default swaps to be regulated as a single market, and that such a single market would not be possible if New York exerted jurisdiction over covered credit default swaps.

For various reasons, regulating credit default swaps and other derivatives as insurance would require significant changes in the way these arrangements are structured and operated. This probably also would substantially reduce the utility and/or availability of these arrangements. Accordingly, a view has developed that regulation as insurance is not the best answer to the problems presented by credit default swaps and other derivatives. Rather, a consensus has developed in most quarters that these problems can be better addressed by “market regulation” measures, such as requiring or encouraging:

- increased standardization of these instruments;
- clearing of standardized instruments through regulated centralized clearing organizations or exchanges;
- robust collateral requirements;
- heightened reporting requirements; and
- increased federal regulatory oversight.

Indeed, various efforts toward these types of market regulation are already well along in the process of being implemented by regulators and industry participants.

The White Paper contains extensive recommendations for creating or enhancing the aforementioned types of “market regulation” solutions to the problems of credit default swaps and other derivatives. Implicitly, this argues against regulation of these instruments as insurance. It remains to be seen, however, whether NCOIL will persist in its initiative in the face of the

⁵ See www.ins.state.ny.us/press/2008/p0811201.htm.

growing consensus in favor of such market regulation solutions and the accelerating and ongoing process of implementing those solutions.

The ultimate resolution of these questions certainly will be highly important to many insurance companies. If any credit default swaps or other derivatives are to be regulated as insurance, some insurance companies may seek to enter the business of offering those products. On the other hand, such a development may not be welcomed by insurance companies that extensively use credit default swaps and other derivatives to hedge risks in their investment portfolios, if the utility or availability of those arrangements were substantially reduced because they are regulated as insurance.

I. What the White Paper Does Not Include

As noted previously above, the White Paper does not include any specific proposals in the following areas, which have been the subject of prior reports and suggestions:

- a federal insurance company charter (*see* subpart F. above);
- a federal insurance regulator, apart from (i) the regulation of any insurance company or insurance holding company that is deemed to be a Tier 1 FHC (*see* subparts A.-D. above), (ii) the proposed ONI (*see* subpart E.1. above), and (iii) the exertion of regulation pursuant to any federal resolution authority (*see* subpart G. above); and
- reinsurance transactions (the word “reinsurance” does not appear in the White Paper) (*see* subpart E.1. above).

II. INVESTMENT ADVISERS

A. Possible Regulation as a Tier 1 FHC

If an investment adviser is part of a Tier 1 FHC, that adviser would be subject to regulation as discussed in part I.A.-D. above for Tier 1 FHCs and their constituent companies. This would very possibly place substantial new reporting burdens and operational constraints on the adviser.

B. Possible Regulation of Executive Compensation

Regardless of whether the investment adviser is part of a Tier 1 FHC, the compensation that an investment adviser (or its holding company) pays to its personnel might be impacted by recommendations in the White Paper to the effect that federal regulators should issue standards and guidelines to better align executive compensation practices of “financial firms” with long-term shareholder value. It is entirely unclear to what companies and persons such standards and guidelines might ultimately apply.

If the adviser or its holding company is a public company, they may be affected by additional executive compensation measures that the White Paper recommends for public companies (regardless of whether those companies are Tier 1 FHCs). Those additional compensation recommendations for public companies are summarized under “Possible Regulation of Executive Compensation” in part I.E.2. above.

C. Regulation as Bank Holding Company in Certain Cases

Certain holding companies are currently excluded from bank holding company status, notwithstanding that they own federally-insured thrift institutions, non-depository trust companies, industrial loan companies and credit card banks. The administration White Paper recommends that, in future, holding companies that include these types of subsidiaries be regulated as bank holding companies, even if they are not Tier 1 FHCs. This would make the holding company subject to the prudential regulations and supervisory guidance that are applicable to all other bank holding companies.

Accordingly, the consequences of this White Paper proposal will need to be carefully considered by any investment adviser whose holding company (i) is currently not regulated as a bank holding company but (ii) includes any federally-insured thrift institution, non-depository trust company, industrial loan company or credit card bank.

D. Possible Coverage Under New Resolution Authority

The White Paper proposes extensive new “resolution authority” to avoid the consequences of a potential disorderly failure of bank holding companies, including Tier 1 FHCs. This proposed resolution authority, which is further discussed in part I.G. above, would provide federal authorities with exceedingly broad powers to take all actions they deem necessary to address any perceived financial stress on a financial firm. This is, in effect, a new form of federal regulation to which investment advisers will be potentially subject, to the extent that they are (or are members of) bank holding companies or Tier 1 FHCs.

E. Harmonization of Investment Adviser/Broker-Dealer Regulation

1. Holding Broker-Dealers to Fiduciary Standard

In making recommendations to clients, investment advisers are generally subject to fiduciary duties, while broker-dealers generally are subject to “suitability” requirements. The suitability requirement is commonly regarded as lower than a fiduciary standard. This disparate treatment as between investment advisers and broker-dealers seems to make little sense with respect to at least some types of products and services that are offered by both types of firms.

Accordingly, the White Paper recommends that the standard of care for broker-dealers when providing investment advice about securities to retail investors should be raised to a fiduciary duty, so as to be aligned with the standard applicable to investment advisers.

2. Regulating Investment Adviser/Broker-Dealer Compensation

The White Paper also recommends that the SEC be empowered to ban forms of compensation that encourage investment advisers and broker-dealers to put investors into products that are profitable for the seller but not in investors' best interest.

3. Mandatory Arbitration Clauses Threatened

The White Paper questions whether mandatory arbitration clauses unjustifiably undermine customers' interests. The paper recommends legislation that would give the SEC clear authority, after studying the matter, to prohibit mandatory arbitration clauses in investment adviser and broker-dealer agreements with retail customers.

III. MONEY MARKET FUNDS

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

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

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

B. Endorsement of SEC Initiative to Enhance Money Market Fund Resilience

The SEC expects later this week to consider proposals to strengthen the resilience of money market funds, in order to address the same problems discussed in the White Paper. The White Paper recommends that the SEC move forward with this effort and that, in this regard, the SEC consider:

- requiring money market funds to maintain substantial "liquidity buffers";
- reducing the maximum weighted average maturity of money market fund assets;
- tightening the credit concentration limits applicable to money market funds;
- improving the credit risk analysis and management of money market funds; and

- empowering money market fund boards of directors to suspend redemptions in extraordinary circumstances to protect the interests of fund shareholders.

These steps are very similar to steps that previously had been recommended by the Investment Company Institute.⁶ Changes of this type probably would somewhat enhance the stability of money market funds, while slightly increasing fund operating expenses and decreasing returns to investors.

C. Possible Need for Dramatic Changes in Money Market Funds

The White Paper expresses the view that the relatively modest steps listed in subpart B. above “should not, by themselves, be expected to prevent a run” on money market funds. Accordingly, the White Paper proposes that the President’s Working Group on Financial Markets should, by September 15, 2009, prepare a report considering more fundamental changes. According to the paper, this “could include,” for example, (i) moving away from a constant net asset value per share as the universal objective of money market funds or (ii) requiring money market funds to obtain access to reliable emergency liquidity facilities from private sources.

Even before the White Paper, various SEC officials had indicated that they intended to seriously consider steps that could somewhat fundamentally change the investment characteristics of money market funds. The White Paper could be interpreted as providing strong encouragement to the SEC in this regard. On the other hand, the White Paper could be interpreted as encouraging the SEC to wait for (or even defer to) the views of the President’s Working Group on Financial Markets in this regard.

The proposed September 15 deadline for the report of the President’s Working Group may reflect a sense of urgency. That is, the administration may believe that the risks are sufficiently high that it is important to have the benefit of the report’s recommendations by the time Treasury’s temporary money market guarantee program expires on September 18. The September 15 deadline may also reflect (a) the administration’s assumption that the Commission is likely to take action before September 18 and (b) a desire that any such Commission action have the benefit of the report of the President’s Working Group.

D. Possible Adverse Consequences of Dramatic Changes

To the extent that money market funds are required to make changes that fundamentally change their investment characteristics, money market funds may become much less attractive to investors. The administration’s White Paper recognizes this. Specifically, the paper recommends that the SEC and the President’s Working Group carefully consider ways to mitigate any potential adverse effects, such as investor flight from money market funds into unregulated or

⁶ See Report of the Money Market Fund Working Group of the Investment Company Institute (March 17, 2009), which may be found at http://www.ici.org/pdf/ppr_09_mmmwg.pdf.

less regulated money market investment vehicles “or reductions in the term of money market liabilities issued by major financial and non-financial firms.”

While money market funds certainly present some risks to investors, on the whole they have yielded enormous benefits to investors, as compared to competing cash-equivalent products (principally products offered by banks). The administration’s White Paper seems perhaps ominous for money market funds, because the White Paper seems to lay less stress on preserving these benefits for investors to the maximum extent possible than on minimizing any adverse consequences from a demise of the money market fund concept. Moreover, as a practical matter, the President’s Working Group may be less sympathetic to the money market fund concept than is the SEC. (The President’s Working Group consists of the Secretary of the Treasury (who chairs the group), the Chairman of the Federal Reserve Board, the Chairman of the SEC and the Chairman of the CFTC.)

IV. HEDGE FUNDS AND OTHER PRIVATE FUNDS⁷

A. SEC Regulation

The administration White Paper recommends that the advisers to hedge funds be required to register as investment advisers with the SEC, assuming their assets under management exceed some “modest” threshold.

This is similar to proposals that others have made (including in bills currently pending in Congress), and many hedge fund advisers already are so registered. The White Paper goes beyond some of these proposals, however, in requiring SEC registration not only of advisers to hedge funds, but also advisers to other private pools of capital, including private equity funds and venture capital funds. This is controversial, of course, because private equity and venture capital funds typically have not caused the types of problems that prompted the White Paper.

The White Paper contemplates that the SEC would require that the registered advisers to these private pools report to the SEC more information than do other registered advisers and be subject to more frequent examinations than are other registered advisers. For example, the White Paper states that these advisers should report, on a confidential basis, information about the funds’ assets, borrowings, off-balance sheet exposure, and other information necessary to assess whether the fund or fund family is so large, highly leveraged, or interconnected that it poses a threat to financial stability. It is contemplated that the SEC would share the reports that it receives with the Federal Reserve, who would determine whether any of the funds or fund families meets the Tier 1 FHC criteria.

⁷ Regulation in this area may be of indirect interest to insurance and reinsurance companies because of the role of hedge funds in prior years in providing significant liquidity to the reinsurance sector.

B. Possible Regulation as Tier 1 FHC

If the Federal Reserve determines that a hedge fund or other private fund (or its fund family) is a Tier 1 FHC, the fund (or fund family) would be regulated as such. The criteria for Tier 1 FHC status, as well as the consequences of falling into such status are discussed in part I.A.-D, above. Suffice it to say, the criteria are sufficiently vague that at least some hedge funds or fund families may have a legitimate concern about their status in this regard. Moreover, the regulatory requirements that would apply to a Tier 1 FHC would seem to be wholly inconsistent with the structure and *modus operandi* of most hedge funds.

C. Possible Compensation Regulation

Regardless of whether a hedge fund or other private fund is regulated as a Tier 1 FHC, the compensation practices with respect to that fund could be impacted by recommendations in the White Paper to the effect that federal regulators should issue standards and guidelines to better align executive compensation practices of “financial firms” with long-term shareholder value. It is entirely unclear to what types of firms and persons such standards and guidelines might ultimately apply.

D. Proposed Implementing Legislation

On June 16, 2009, Senator Jack Reed proposed the S. 1276 (the Private Fund Transparency Act of 2009),⁸ which reportedly is intended, in large part, to implement recommendations contained in the administration White Paper. Among other things, this legislation would:

- eliminate the provision in the Investment Advisers Act of 1940 that enables advisers with fewer than 15 clients to avoid registering as an investment adviser (except that this exclusion would be retained for certain foreign investment advisers); and
- require registered investment advisers to maintain and make available to federal regulators such information as may be necessary for the regulator’s supervision of systemic risk, which may include records of or information about the identity, investments or affairs of the adviser’s clients.

V. **PROPOSED CONSUMER FINANCIAL PROTECTION AGENCY**

The administration White Paper proposes the creation of a new Consumer Financial Protection Agency (“CFPA”).

⁸ This legislation may be found at <http://www.thomas.gov/cgi-bin/query/z?c111:S.1276>:

A. Products and Services Under CFPA's Jurisdiction

The White Paper describes the CFPA's jurisdiction as covering "financial services and products such as credit, savings and payment products and related services, as well as the institutions that issue, provide, or service these products and provide services to the entities that provide the financial products." This type of language, which appears multiple times in the White Paper, seems theoretically broad enough to cover virtually any type of "consumer" financial product or service.

While it seems clear that the CFPA will concern itself only with "consumer" products and services, the White Paper provides no specific guidance as to who is a "consumer" for this purpose. For example, might at least certain types of institutional purchasers of a product or service fall outside the definition of a consumer?

The White Paper states that investment products and services that are "already regulated" by the SEC or CFTC would be outside the CFPA's jurisdiction. The paper leaves many questions unanswered in this regard. For example, would the CFPA have any jurisdiction where an SEC-regulated broker-dealer offers and sells a product that is not registered under the securities laws? Would the answer depend on whether the basis for non-registration of the product was (a) that the product was not a security or (b) that the product, although a security, was exempt from registration with the SEC?

Accordingly, significant questions exist as to whether the CFPA would have jurisdiction over any securities offerings that are exempt from SEC registration or over other types of products, such as fixed annuity and life insurance products that are not registered with the SEC. Statements made by some proponents of the CFPA suggest that its jurisdiction might be interpreted broadly enough to cover at least some of such products.

Certainly, some of the sweeping language of the White Paper could support such a broad interpretation. On the other hand, the portion of the White Paper dealing with the CFPA mentions specifically only a relatively narrow range of products and services, such as the following:

- credit cards, debit cards, consumer loans, mortgages and ATM machines;
- services such as debt collection, debt counseling, credit repair, debt negotiation, foreclosure rescue, mortgage modification, debt buying, and overdraft protection plans; and
- products and services subject to such laws as the Truth in Lending Act, Home Ownership and Equity Protection Act, Real Estate Settlement and Procedures Act, Community Reinvestment Act, Equal Credit Opportunity Act, Home Mortgage Disclosure Act, Fair Debt Collection Practices Act, SAFE Act, Credit Card Act of 2009, Fair Housing Act "to the extent it covers mortgages," Credit Repair Organization Act, and Fair Credit Reporting Act.

Accordingly, it may well be questioned whether the White Paper intends such products as annuities or life insurance (or securities that are exempt from SEC registration) to be subject to the CFPA's jurisdiction.

B. Impact of CFPA

The White Paper describes the function of the CFPA in the following potentially sweeping terms: "[T]o protect consumers of credit, savings, payment, and other consumer financial products and services, and to regulate providers of such products and services." Moreover, the White Paper describes sweeping powers that would be given to the CFPA to accomplish these results.

Accordingly, to the extent that the CFPA were to exercise jurisdiction over an entity's business or products, that entity could be significantly and adversely effected. If the CFPA were to assert jurisdiction over any products issued by an insurance company, for example, that company could be subject to numerous disclosure and regulatory requirements that are in addition to, and very probably inconsistent with, other requirements to which that company is currently subject.

At this point, however, it is impossible to know whether the CFPA's jurisdiction will extend to any of the products or services offered by entities such as insurance companies and investment advisers and funds. Moreover, it is not possible to know what manner of regulation the CFPA would impose on such products or services, even if it has such jurisdiction. Nevertheless, insurance companies and investment advisers and funds should follow the development of these issues.

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