

## News Bulletin

August 3, 2009



## Summer Reading: White Paper Related Regulatory Reforms

We acknowledge that this might not be good beach reading. However, we thought that it would be useful to assess the state of proposed reforms since the release of the Obama Administration's White Paper on June 17<sup>th</sup>.

With the Congressional summer recess only days away, we suspect that the "status report" that is attached to this update will not become stale for at least a little while. Detailed client alerts on each of the aspects of the regulatory reform initiatives are available on our [Regulatory Reform website](#).

It is impossible to predict whether the proposed legislation summarized below will be adopted as law. It is likely that the proposals will continue to be the subject of debate for the next several months before final legislation is proposed and adopted.

### Money Market Funds

In an effort to restore stability to money market funds on a more permanent basis, on June 24<sup>th</sup>, the SEC voted to propose changes that would require money market funds to hold a portion of their portfolios in highly liquid investments, reduce their exposure to long-term debt and restrict their investments to only the highest quality portfolio securities. The proposals would also require monthly reporting of portfolio holdings, and allow suspension of redemptions if a fund "breaks the buck" to allow for the orderly liquidation of fund assets.

Specifically, the SEC's proposals, if adopted, would strengthen the regulation of money market funds by:

- requiring that money market funds have certain minimum percentages of their assets in cash or securities that can be readily converted to cash, to pay redeeming investors;
- shortening the weighted average maturity limits for money market fund portfolios from 90 days to 60 days;
- limiting money market funds to investing in only the highest quality securities (i.e., eliminate their ability to invest in so-called "Second Tier" securities);
- requiring funds to stress test fund portfolios periodically to determine whether the fund can withstand market turbulence;
- requiring money market funds to report their portfolio holdings monthly to the SEC and post them on their websites;
- requiring funds to be able to process purchases and redemptions at a price other than \$1; and

- permitting a money market fund that has “broken the buck” and decided to liquidate to suspend redemptions while the fund undertakes an orderly liquidation of assets.

### Registration of Private Investment Funds

On June 15<sup>th</sup>, the Administration introduced draft legislation titled the Private Fund Investment Advisers Registration Act of 2009 (the “Registration Act”), which would require the registration of investment advisers to hedge funds and other private investment vehicles, including private equity funds and venture funds. The Registration Act would require that all advisers with more than \$30 million in assets under management register with the SEC and be subject to ongoing reporting and compliance requirements. For example, registered advisers would be subject to SEC examination and recordkeeping requirements. In addition, advisers would be subject to confidential reporting of the amount of assets under management, borrowings, off-balance sheet exposures, counterparty risk exposures and other information that would be deemed necessary to minimize the potential for systemic risk. Based on this information, regulators would determine whether a fund should be supervised and regulated as a Tier 1 financial holding company.

### Consumer Protection Agency Act

On June 30, 2009, a draft of the Consumer Financial Protection Agency Act of 2009 (the “CFPAA”) was released. The CFPAA establishes a new agency (the “Agency”) to oversee consumer protection in financial services. If enacted, the CFPAA will subject federally chartered financial institutions to state consumer protection laws that have, in the past, been preempted. However, the CFPAA will not preempt state laws unless state laws are inconsistent with the CFPAA and are less protective than the CFPAA. The CFPAA transfers authority to the Agency from existing statutory authorities. The CFPAA applies to “consumer financial products or services.” These are understood to include financial products or services that are to be used primarily for personal, family or household purposes. A covered person is any person that engages directly or indirectly in a financial activity. The Agency’s powers do not extend to persons regulated by the SEC or the CFTC. The Agency will have a five-member board. Four of the members would be appointed by the President and be subject to confirmation by the Senate. Board members will be selected based on strong competencies and experiences related to consumer financial products. The fifth member will be the Director of the National Bank Supervisor (see below). The Agency’s mission is to promote transparency, simplicity, fairness, accountability and access in the market for consumer financial services. The Agency will seek to ensure that:

- consumers have, understand and can use the information that they need in order to make responsible choices about consumer financial products and services;
- consumers are protected from abuse, unfairness and deception and that the markets for these products operate fairly and efficiently; and
- traditionally underserved consumers and communities receive access to financial services.

The CFPAA notes that states are encouraged to prescribe more rigorous standards for covered persons. National banks will be subject to nondiscriminatory state consumer protection laws.

### Investor Protection Act

On July 10, 2009, the Treasury released draft legislation, the Investor Protection Act of 2009 (the “Proposed IPA”), intended to provide new investor protection tools to the SEC. Broker-dealers and investment advisers are currently subject to different regulatory standards. The Investment Advisers Act of 1940 (the “Advisers Act”) subjects investment advisers to common law fiduciary and anti-fraud obligations, subject to certain exceptions. Broker-dealers, which are regulated by the Securities Act of 1934 (the “Exchange Act”), are subject to the general anti-fraud provisions of the Exchange Act, as well as the standards imposed by the Financial Industry Regulatory Authority (“FINRA”) and other self-regulatory organizations (“SROs”), with respect to, among other things,

“suitability” of an investment for clients, but are not held to be “fiduciaries” in respect of their clients. The Administration believes that investors do not distinguish between the recommendations of broker-dealers and investment advisers and these differing legal standards “are no longer meaningful.” The Administration seeks to harmonize these differing standards of conduct.

The Proposed IPA would amend both the Advisers Act and the Exchange Act to authorize the SEC to issue rules that require broker-dealers and investment advisers to be held to a fiduciary standard “to act solely in the interest of the customer or client without regard to the financial or other interest of the broker, dealer or investment adviser providing the advice,” when providing investment advice to retail customers or clients (or such other customers or clients as the SEC may determine). The Proposed IPA would also require the SEC to issue rules to facilitate the delivery of “simple and clear” disclosures regarding the investor’s relationship with these investment professionals. In addition, it would require the SEC to “examine, and where appropriate,” promulgate rules prohibiting sales practices, conflicts of interest and compensation schemes for financial intermediaries, such as broker-dealers and investment advisers that the SEC “deems contrary to the public interest and the interest of investors.” The Proposed IPA would allow the SEC to compensate whistleblowers who voluntarily provide “original information” in connection with successful enforcement actions resulting in monetary sanctions exceeding \$1 million with up to 30% of the monetary sanctions imposed. Current law grants the SEC authority to pursue aiding and abetting claims under only the Exchange Act. The Proposed IPA would extend its authority to such claims under the Securities Act of 1933, the Advisers Act and the Investment Company Act. It should be noted that the proposed legislation would not give individuals the right to pursue aiding and abetting claims.

### Proposed Reforms Relating to Securitization

The Administration released legislative language that addresses some of the proposals set forth in the White Paper relating to securitization. The legislative language, titled “Improvements to the Asset-Backed Securitization Process,” would form part of the Proposed IPA.

The legislation requires federal bank regulators and the SEC to prescribe regulations that would require securitizers to retain an economic interest in a material portion of the credit risk for any asset that is securitized. The legislation does not specify the forms of retention—presumably the regulations will do so and also will provide for exceptions to the 5% retention requirement. [Regulations may also address the Administration’s goal of limiting an issuer’s ability to hedge retained credit risk.] The legislation requires that ABS issuers remain reporting issuers for a longer period, even if the number of holders of an asset-backed issuance falls below the 300-holder threshold. The legislation requires that the SEC implement regulations that will require additional disclosures by the ABS issuer, as well as disclosure relating to compensation provided to brokers or originators. The SEC also will be required to adopt regulations requiring disclosures regarding the representations, warranties and enforcement mechanisms. It is not clear whether there will be additional legislative language addressing the other proposals relating to securitization included in the White Paper.

### Proposed Reforms Relating to Credit Rating Agencies

On July 21, 2009, the Administration introduced legislative language titled the Improvements to the Regulation of Credit Rating Agencies. The objective of the reforms is to increase transparency, tighten oversight, and reduce reliance on credit rating agencies. The legislation: (1) prohibits credit rating agencies from providing other services, like consulting services, to companies that contract for ratings; (2) prohibits or requires the management and disclosure of conflicts of interest arising from the way a rating agency is paid; and (3) requires that credit rating agencies implement procedures to review ratings of an issuer if the issuer has hired a rating agency employee within a year of its rating.

Rating agencies will be required to designate a chief compliance officer that will be responsible for compliance and internal controls and processes. The chief compliance officer must report directly to the board or the senior officer of the credit rating agency. The chief compliance officer will be prohibited from engaging in certain

activities, such as setting compensation and marketing. Rating agencies will be required to be registered with the SEC and will be subject to SEC examination.

The proposed legislation also puts forward a number of actions that should be taken or evaluated that are intended to reduce undue reliance by investors on ratings.

### Proposed Reforms Relating to Regulation of Tier 1 FHCs, Resolution Authority and Payment Systems

On July 24, 2009, the Administration released various legislative proposals relating to the reform of banking regulation. As discussed in the White Paper, the legislation introduces several new agencies or regulators. A Financial Services Oversight Council will be created to coordinate financial regulatory policy. A National Bank Supervisor will take on the roles of the Office of Thrift Supervision and the Office of the Comptroller of the Currency and the thrift charter will be eliminated. The Office of National Insurance (within the Treasury) will monitor the insurance industry and identify potential industry issues, recommend which insurance companies should be designated as Tier 1 FHCs, and consult and coordinate with state insurance regulators.

Entities designated as Tier 1 FHCs will be subject to consolidated supervision and regulation by the Federal Reserve. These entities will be subject to the activity restrictions now applicable only for bank holding companies. Tier 1 FHCs also will be subject to more stringent capital, liquidity and risk management standards. The proposed legislation will require that all financial holding companies (not just Tier 1 FHCs) comply with higher minimum capital requirements. The legislation also strengthens the firewalls between banks and their affiliates (including, for example, their investment bank affiliates) in order to prevent conflicts of interest and not subject financial institutions to transactions and activities that may be riskier.

The proposed legislation on payment systems authorizes the Federal Reserve Board to prescribe standards to manage risks posed by systemically important financial market utilities and for the conduct of systemically important payment, clearing and settlement activities by financial institutions. The Federal Reserve will play a more active role in supervising risk management standards and policies for systemically important financial market utilities.

### Conclusion

The White Paper introduced significant regulatory reform proposals. In the period since its release, the Administration has been actively engaged in formulating legislative language that details many of the proposals included in the White Paper. The proposed legislative language that has been released begins to provide important details regarding many of the measures outlined in the White Paper. Some of the legislative proposals only provide a bit more insight regarding the Administration's views and additional details will be required before any informed judgment can be made regarding the potential impact of the changes. Of course, all of the legislative proposals will be the subject of extensive debate in the months to follow. We will continue to provide regular updates.

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*Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.*

## Appendix A

STATUS REPORT		
Area of Focus	Action to Date	Link
Money market funds	SEC has introduced proposed amendments	<a href="http://www.sec.gov/rules/proposed/2009/ic-28807.pdf">http://www.sec.gov/rules/proposed/2009/ic-28807.pdf</a>
Executive compensation	SEC has introduced proposed rules Legislative say-on-pay	<a href="http://www.treas.gov/press/releases/reports/titl-eixsubtdexcomp%20.pdf">http://www.treas.gov/press/releases/reports/titl-eixsubtdexcomp%20.pdf</a>
Accounting standards	Pending	
Insurance (Office of National Insurance)	Pending	

STATUS REPORT		
Area of Focus	Action to Date	Link
GSEs	Study pending	
Securitization <ul style="list-style-type: none"> <li>accounting</li> </ul>	166/167 already issued	
<ul style="list-style-type: none"> <li>Risk retention/hedging</li> <li>Enhanced disclosure</li> </ul>	Proposed Investor Protection Act (July 23, 2009) SEC action pending	
Credit Rating Agencies	<ul style="list-style-type: none"> <li>SEC adopted proposals in February 2009</li> <li>Several SEC proposals pending</li> <li>Legislative language (July 21, 2009)</li> </ul>	SEC: <a href="http://www.treas.gov/press/releases/reports/titl&lt;br/&gt;eixsubtdexeccomp%20.pdf">http://www.treas.gov/press/releases/reports/titl eixsubtdexeccomp%20.pdf</a>  Legislative language: <a href="http://www.financialstability.gov/docs/regulator&lt;br/&gt;yreform/titleIX_subtC.pdf">http://www.financialstability.gov/docs/regulator yreform/titleIX_subtC.pdf</a>

STATUS REPORT		
Area of Focus	Action to Date	Link
OTC Derivatives	<ul style="list-style-type: none"> <li>• SEC/CFTC study pending</li> <li>• Frank proposal</li> <li>• Legislative language pending</li> </ul>	
Harmonize standards applicable to broker-dealers and investments advisers	Investor Protection Act of 2009	<a href="http://www.ustreas.gov/press/releases/docs/tg205071009.pdf">http://www.ustreas.gov/press/releases/docs/tg205071009.pdf</a>
Consumer protection	Consumer Protection Agency Act of 2009	<a href="http://www.financialstability.gov/docs/CFPA-Act.pdf">http://www.financialstability.gov/docs/CFPA-Act.pdf</a>
Regulation of “shadow banking system”	Private Fund Investment Advisers Registration Act of 2009 (July 15, 2009)	<a href="http://www.treas.gov/press/releases/reports/title%20iv%20reg%20advisers%20priv%20funds%2007%2015%2009%20fnl.pdf">http://www.treas.gov/press/releases/reports/title%20iv%20reg%20advisers%20priv%20funds%2007%2015%2009%20fnl.pdf</a>

STATUS REPORT		
Area of Focus	Action to Date	Link
Resolution Authority	Title XII – Financial Crisis Management and Enhanced Resolution Authority (July 23, 2009)	<a href="http://www.ustreas.gov/press/releases/reports/title%20xii%20resolution%20authority%207232009finala.pdf">http://www.ustreas.gov/press/releases/reports/title%20xii%20resolution%20authority%207232009finala.pdf</a>
Payment and Clearing Systems	Title VIII – Payment, Clearing and Settlement Supervision (July 23, 2009)	<a href="http://www.ustreas.gov/press/releases/reports/tileviii_payments_072209.pdf">http://www.ustreas.gov/press/releases/reports/tileviii_payments_072209.pdf</a>
Overall Banking Regulation	Title III Improvements to Supervision and Regulation of Federal Depository Institutions (July 23, 2009)	<a href="http://www.ustreas.gov/press/releases/reports/tileiii_natlbanksupervisor_072309.pdf">http://www.ustreas.gov/press/releases/reports/tileiii_natlbanksupervisor_072309.pdf</a>