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Nasdaq	2305.93	
+0.05	(+0.00%)	
S&P 500	1114.61	
-0.62	(-0.06%)	
NYSE	6976.10	
-13.78	(-0.20%)	

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The Financial Regulatory Reform Legislation: What's In, What's Out and What's Next

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The following is a brief summary, as of June 3, 2010, of the fundamental differences in provisions of particular interest to the investment management industry in the proposed financial regulatory reform legislation as approved by the U.S. House of Representatives and the U.S. Senate, a list of certain proposals which were omitted by or defeated in both the House and Senate and are unlikely to be revived, and the expected timeline for reconciliation of the final financial regulatory reform bill.

The Senate approved a far-reaching financial regulatory reform bill on Thursday, May 20, 2010, entitled the Restoring American Financial Stability Act (the Senate Bill). The Senate Bill was sponsored primarily by Senator Christopher J. Dodd (D-CT), chairman of the Senate Committee on Banking, Housing and Urban Affairs, and was approved by a vote of 59 to 39.[1] The next step in the legislative process is to reconcile the Senate Bill with the Wall Street Reform and Consumer Protection Act (the House Bill), which was sponsored by Representative Barney Frank (D-MA), chairman of the House Committee on Financial Services, and approved by the House of Representatives in December 2009.[2] A conference committee comprised of members of the Senate and the House will meet this month to begin the negotiations.

The 12 members of the Senate appointed to the conference committee were announced on May 25, 2010, and it is likely that the five Republican members of the committee, each of whom opposed the Senate Bill, will attempt to stall the reconciliation process. Although the House appointees to the committee have not yet been announced, Representative Frank will chair the reconciliation committee, and it is likely that he will aggressively push the other members to have a bill ready for President Obama's signature on or before July 4, 2010, when the current legislative session is scheduled to recess for the summer. Our belief is that the Obama Administration would like to see financial reform legislation pass prior to the midterm elections, both to bolster Democratic campaigns for hotly contested seats and to avoid the more difficult task of negotiating reform legislation in the event that the Democratic party's majorities in the House and the Senate are diminished. In light of the Obama Administration's strong feelings about the proposed financial regulatory reform, Representative Frank has gone on record to state that he believes the conferees "will be more the agents of collective decision-making than autonomous dealers." (4) Although President Obama aims to sign a reconciled bill into law this summer, the precise contours of the reform will still be unknown. Both the Senate and House Bills delegate extensive rulemaking responsibilities to the SEC and the CFTC, and the proposed Bills also both give these agencies a substantial amount of discretion. We will provide periodic updates regarding the rulemaking process as it unfolds.

THE BILLS: MATERIAL DIFFERENCES

PROPRIETARY TRADING. The Senate and House Bills differ with regard to the manner in which proprietary trading by banks would be regulated. Under both Bills, however, "proprietary trading" would encompass investments that do not benefit clients i.e., buying and selling securities for its own account, including interests in hedge funds and private equity funds. Regulations would also restrict banks from otherwise "sponsoring" hedge funds or private equity funds.

The Senate Bill expressly prohibits proprietary trading, with some exceptions. This ban has come to be known as the Volcker Rule, after the rule's original

CEO Wealthmeter

+48.41M (+0.50%)
Holdings: 7.40B
Salary: Unknown
Eric Schmidt Google
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+28.52M (+0.71%)
Holdings: 2.93B
Salary: 150.00K
Michael J. Saylor MicroStrategy Inc
MSTR | News | Chart | Profile

+6.25M (-0.13%)
Holdings: 13.22B
Salary: 81.84K
Jeffrey P. Bezos Amazon.com Inc
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+5.26M (+0.95%)
Holdings: 555.12M

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proponent, former Federal Reserve chairman Paul Volcker. There is an exemption for bank trading of U.S. government bonds, mortgage bonds and municipal bonds. The ban on proprietary trading would be subject to modifications or recommendations made by a Financial Stability Oversight Council (FSOC) (5), which would be created pursuant to each of the Bills in order to monitor and prevent systemic risks to the economy from the banking sector. FSOC would also be tasked with considering the impact of the Volcker Rule on systemic risk and proposing any necessary modifications or further recommendations.

Instead of the Volcker Rule, the House Bill gives FSOC and regulators from the SEC and CFTC a much broader mandate to impose standards on companies where proprietary trading would pose either an “internal” or “systemic” risk. Proprietary trading would be addressed in rules by these agencies. The House Bill was passed in December 2009, before President Obama introduced the Volcker Rule in a speech to the public on January 21, 2010. Recently, however, Representative Frank noted that he would support implementing the Volcker Rule into the final bill. (6)

INVESTMENT ADVISER REGISTRATION. There are only a few material differences between the Senate Bill and the House Bill with respect to investment adviser registration. Both amend the Investment Advisers Act of 1940 to eliminate the “private adviser” exemption currently in Section 203(b)(3) thereof, thereby requiring all hedge fund managers with more than $100 million of assets under management to register with the SEC and those with assets under management of under $100 million to register with the appropriate state authorities (and deregister with the SEC if a currently registered investment adviser has between $25 million and $100 million of assets under management). Registration would now require disclosure of greater information, including, but not limited to, assets under management, counterparty risk exposures, investment positions, side letters and valuation policies. While the House Bill does not explicitly list side letters and valuation policies as required disclosures, the SEC is given the authority to require registrants to include this information. Under both Bills, the SEC would be permitted to share this information with FSOC but both agencies would be required to keep such information confidential.

Under both Bills, Section 203 would contain exemptions from registration for advisers to “venture capital funds” (such term to be defined in the future by the SEC) and for a “foreign private adviser” (in the Senate Bill) or “foreign private fund adviser” (in the House Bill), each defined as any investment adviser with (i) no place of business in the U.S., (ii) fewer than 15 clients domiciled or resident in the U.S., and (iii) less than $25 million of assets under management attributable to U.S. clients and investors in the private funds advised by such adviser, and which neither holds itself out generally to the public in the U.S. as an investment adviser nor acts as an investment adviser to any registered investment company or company elected to be a business development company under the Investment Company Act of 1940. The Senate Bill also contains exemptions from registration for advisers to “private equity funds” and “family offices” (each term to be defined in the future by the SEC), while the House Bill would exempt from registration advisers to “private funds” if the adviser acts solely as an adviser to private funds and has less than $150 million of assets under management in the U.S. The respective Bill also would require the SEC to issue final rules regarding the maintenance of records and filing of annual or other reports by investment advisers to such “private funds” or “private equity funds,” as the case may be.

DERIVATIVES. More so than in other areas of focus in the two Bills, there are several significant differences between the Senate Bill and the House Bill regarding proposed federal oversight of derivatives. While both the Senate and House Bills would require most derivative transactions to be insured by a third-party clearinghouse and executed or traded on public exchanges (referred to as “swap execution facilities” or “designated contract markets”), the Senate Bill requires a larger share of derivatives to pass through clearinghouses (referred to as “derivatives clearing organizations”) and requires any person that accepts funds or other collateral from a customer with respect to cleared swaps to be registered with the CFTC as a futures commission merchant.

The Senate Bill also contains a controversial provision introduced by Senator Lincoln which would require large banks to spin off some of their derivatives business (specifically, all trading in swaps) into separate subsidiaries under the threat of being denied access to federal assistance, including FDIC insurance. Obama Administration officials, including Secretary Geithner, and some Senators who voted in favor of the Senate Bill have stopped short of endorsing this rule, leading to widespread speculation that it will not survive the reconciliation process.

FAILING FINANCIAL COMPANY FUND. Both the House Bill and the Senate Bill contain provisions to create a fund to cover the costs of liquidating failing financial companies. The House Bill proposes that its Systemic Dissolution Fund be $150 billion and would be financed by a fee on financial institutions with more than $50 billion in assets (including hedge funds with more than $10 billion of assets under management), whereas the Senate Bill proposes that its Orderly Liquidation Fund be $50 billion and would be financed by bank holding companies or nonbank financial companies supervised by the Federal Reserve with more than $50 billion in assets (with no specific mention of hedge funds). Under both the House Bill and the Senate Bill, risk-based assessments would be imposed by the FDIC on the eligible financial companies, with the FDIC taking into account, among other factors, general economic conditions affecting financial companies and, with respect to the particular financial company being assessed, its financial condition (including the extent and type of offbalance-sheet exposures), the risks presented by it to the financial stability of the U.S. economy and the extent to which it has benefitted or likely would benefit from the orderly liquidation of a covered financial company.

OMITTED OR DEFEATED LEGISLATION

While the reconciliation process is obviously unpredictable, the House and the Senate each independently determined not to include certain proposed reforms in their respective Bills. We believe that it is very unlikely that these provisions would be revived at the reconciliation stage. These provisions include:

- a ban on naked credit-default swaps;
- restoration of part of the Glass-Steagall Act of 1933 (repealed in 1999) which would require the separation of commercial banking and Wall Street trading;
- specific leverage limits on hedge funds; and
- imposition of size limits on the largest financial companies.

The foregoing is intended to summarize the current status of the legislative financial regulatory reform efforts, and does not constitute legal advice. We are eager to address your specific questions about the proposed legislation and invite you to contact us with suggestions as to future topics.

If you would like to learn more about this topic or how Pryor Cashman LLP can serve your legal needs, please contact the following members of the Investment Management Practice Group:

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