"Obama Administration Announces Financial Regulatory Overhaul"

G. Michael O'Leary, Jeff C. Dodd, Melinda Brunger & Peter Bogdanow
June 24, 2009

On June 17, 2009, the Obama administration released its detailed, 88-page Financial Regulatory Reform proposal to overhaul the financial regulatory system (the Plan). Click here for a copy of the Plan (PDF). The leading focus of the Plan involves granting the Federal Reserve and the Treasury Department, in consultation with and the approval of certain other federal regulators, broad powers to regulate and, if necessary, rescue any financial institution (including broker-dealers (e.g., Lehman Brothers) and insurance companies (e.g., AIG)) that are so large the failure of which would pose a systemic risk to the financial system as a whole. The scope of the Plan reaches far beyond large financial institutions, and would also affect private investment funds (and not simply hedge funds), public companies, issuers and sponsors of asset-backed securitizations, broker-dealers, investors in over-the-counter derivatives (OTC derivatives), including credit default swaps, and sellers of consumer financial products, including residential mortgages.

This is the first in a series of reports that will focus on the Plan and its impact on various market players. Our next report will focus on the Plan’s proposals as they relate to securitization, including the role of consumer financial products. This e-alert focuses on key changes affecting private investment funds, OTC trading, executive compensation and broker-dealers.

Registration and Regulation of Private Investment Funds

Although some funds that trade commodities or futures are currently required to register with the CFTC, and some advisers to hedge funds voluntarily register as investment advisers, the Plan proposes to expand regulation of private investment funds by subjecting all advisers to funds, including hedge funds, private equity funds and venture capital funds, to registration and enhanced reporting and other requirements. Many of the Plan’s proposals echo the provisions featured in bills that have been introduced in Congress. Key provisions in the Plan include the following:

- *Registration Requirements*: All advisers to hedge funds (and other private pools of capital, including private equity funds and venture capital funds) whose assets under management exceed some modest threshold will be required to register under the Investment Advisers Act. Although the Plan does not define the “modest threshold” for registration, there is one bill in the Senate (with one co-sponsor) that proposes a $50 million threshold, and other bills introduced in Congress that propose a $30 million threshold. Currently, investment advisers required to register must do so with the SEC if they have $30 million or more in assets under management.
- *New Recordkeeping and Disclosures*: All funds advised by registered investment advisers would be subject to recordkeeping requirements and requirements to make disclosures to investors, creditors and counterparties.
- *Regular Examinations*: The Securities and Exchange Commission (SEC) would conduct regular, periodic examinations of funds advised by registered investment advisers to monitor compliance with the expanded new rules.
- *Treatment by Type of Fund*: The Plan indicates that the regulatory requirements for these funds may vary across types of private pools. Accordingly, it is possible that reporting requirements for venture capital funds may differ from requirements for hedge funds.
- *Systemic Risk Reporting and Regulation*: So that regulators may assess whether the fund or fund family advised by an SEC-registered investment adviser is so large, highly leveraged, or interconnected that it poses a threat to financial stability, all such funds must report on a confidential basis the amount of assets under management, borrowing and off-balance sheet exposures, and other relevant information. Any fund identified as a systemic risk would be subject to the rigorous capital and other regulatory requirements applicable to other systemic risk financial institutions.

***In Summary*:** The proposals to require confidential reports of funds would increase regulation and oversight of various types of funds, mandate disclosures to investors as well as regulators, and enhance the ability of regulators to take enforcement action against regulated funds.

Regulation of OTC Derivatives

The Plan would impose a comprehensive regulatory regime for OTC derivatives, including credit default swaps. The proposed OTC derivatives regulation includes the following:

- *Central Clearing*: All standardized OTC derivatives would be cleared through regulated central counterparties (CCPs), which will impose robust margin requirements and other risk controls. Customized OTC derivatives must not be used solely as a means to avoid a CCP.
- *Capital and Governance Standards for OTC Dealers*: OTC derivatives dealers would be subject to conservative capital requirements (more conservative than the existing bank regulatory capital requirements for OTC derivatives), business conduct standards, reporting requirements and conservative requirements relating to initial margins on counterparty credit exposures.
- *Recordkeeping and Public Reporting Requirements*: All OTC derivatives would be subject to recordkeeping and reporting requirements, some of which may be satisfied by clearing standardized transactions through a CCP or by reporting customized transactions to a regulated trade repository. CCPs and trade repositories would make aggregate data on open positions and trading volume available to the public and make data on individual counterparty's trades and positions available on a confidential basis to the CFTC, SEC and the institution's primary regulators.

***In Summary*:** All of these proposals would increase transparency of the OTC markets, decrease the confidentiality of trading strategies and positions, and enhance the ability of regulators to take enforcement action against market participants.

Restrictions on and Standards for Executive Compensation

Excessive executive compensation and insufficient oversight have been blamed by the administration, the news media, institutional and activist shareholders and the SEC as a major cause of the current economic and financial crisis. The Plan accelerates the trend toward federal regulation and oversight of executive compensation. The Plan outlines the following principles to better align compensation practices at financial firms with the interests of shareholders and the stability of firms and the financial system:

- Compensation plans should properly measure and reward performance,
- Compensation should be structured to account for the time horizon of risks,
- Compensation practices should be aligned with sound risk management,
- Golden parachutes and supplemental retirement packages should be reexamined to determine whether they align the interests of executives and shareholders, and
- Transparency and accountability should be promoted in the process of setting compensation.

Although TARP recipients are required to adopt compensation plans that conform to principles similar to the ones laid out above, the administration has not yet made proposals for other companies. However, some members of Congress, including Representative Barney Frank, chairman of the House Financial Services Committee, and an important player in the regulatory overhaul, has proposed that the SEC require that boards adopt compensation plans that conform to these principles.

To further advance these principles, the Plan proposes the following legislation:

- *Say on Pay*: Public company shareholders would have a non-binding vote on the executive compensation disclosed in the annual proxy statement, which typically consists of the compensation for the CEO, the CFO and the three other most highly compensated employees of the company (the top five). The Plan suggests that the compensation of each of the top five will be submitted to a separate vote. In addition, in mergers and other extraordinary transactions of public companies, shareholders would have a non-binding vote on all golden parachutes at the special meeting called to approve the merger or other extraordinary transaction.

- *Higher Independence Standards for Compensation Committees and Consultants*: All listed companies would be required to have compensation committees composed solely of independent directors. In addition, compensation committees would be given the responsibility and the resources to hire their own independent compensation consultants and outside counsel, similar to the powers granted to audit committees under Sarbanes-Oxley. Finally, the SEC would create standards for ensuring the independence of compensation consultants. NASDAQ and NYSE already require that compensation decisions be approved by independent directors and most, but not all, listed companies already grant the proposed authority to compensation committees.

***In aggregate*:** The Plan's proposals on executive compensation would strengthen the hand of shareholder activists, heighten scrutiny of compensation amounts and award types, highlight possible incentives for excessive risk taking by executives, and mandate increased independence and oversight of compensation practices by public companies.

Further evidence of the enhanced focus on executive compensation can be seen in recent statements by the SEC. In a statement on June 2, 2009, SEC Chairman Mary Schapiro announced that the SEC intends to seek legislation giving shareholders of public companies a non-binding "say on pay" vote, requiring more independence of compensation committees, and requiring enhanced disclosure about how a company and its board manage risks, both generally and in the context of compensation. She also stated that the SEC will consider whether greater disclosure is needed about a company's overall compensation approach, beyond compensation of only the top five, and about compensation consultant conflicts of interest. In a further statement made on June 10, 2009, Chairman Schapiro indicated the SEC will be reviewing proposals to provide more disclosure regarding the following:

- How a company and its board of directors manage risks,
- A company's overall compensation approach, and
- Potential conflicts of interest by compensation consultants.

Broker-Dealer Regulation

Traditionally, one of the important consequences of being characterized as a "broker" as opposed to an "investment adviser" has been that, while brokers are subject to a variety of regulatory requirements and owe many duties to their clients, they do not, as a general rule, owe fiduciary duties to their clients; investment advisers do. The RAND Corporation conducted a study for the SEC concerning the broker/dealer and investment advisory industries. The report concluded that, among other things, the differences in roles and duties of broker-dealer firms and investment advisory firms are not well understood. The Plan makes the same observation and proposes that regulation of these two functions be harmonized. Included among the administration's specific proposals are the following:

- *Fiduciary Duties to Investors*: Broker-dealers who provide investment advice about securities to investors would have the same fiduciary obligations as registered investment advisers. In a speech on June 18, 2009, SEC Chairman Mary Schapiro stated that "all financial service providers that provide personalized investment advice about securities should owe a [consistent] fiduciary duty to their … clients."
- *Plain English Disclosure to Investors*: Broker-dealers would be required to provide to investors simple and clear disclosure regarding the scope of the terms of their relationships with investment professionals.
- *Restrictions on Conflicts of Interest and Other Practices*: Certain conflicts of interests and sales practices that may be contrary to the interests of investors would be prohibited.

Harmonize Futures and Securities Regulation

The Plan also included a call to the CFTC and SEC to develop specific proposals to harmonize the treatment of economically equivalent instruments and to develop consistent procedures for reviewing and evaluating new financial products. The Plan calls upon the CFTC and the SEC to complete a report to Congress by September 30, 2009, that makes recommendations for changes to statutes and regulations that would eliminate the non-essential differences in regulations of similar financial instruments. Although the Plan does not purport to outline all of the areas where harmonization is necessary, it does specifically point to financial options and futures products. We expect that there will be several extremely significant regulatory initiatives that will arise from the harmonization effort.

The Road Ahead

This Plan will move to Congress, with the administration likely to send legislation language to Congress over the next several months. House Financial Services Chairman Barney Frank has indicated he intends to move quickly on legislation, and he is likely working on his own version of the Plan. The Senate will need to take up the Plan as well (Senate Banking Committee Chairman Christopher Dodd has also expressed strong support for the Plan). It is unclear whether Congress will attempt to adopt this Plan as a single bill or will attempt to move the Plan in separate pieces. Many of the proposals in the Plan are consistent with the eight-part declaration for financial regulatory reform adopted by the G-20 leaders at the April 2009 London summit.

There is no clear timeline for Congress to approve legislation. Nevertheless, the administration generally chose to avoid turf battles with regulators, which should facilitate the adoption of the package in Congress. Finally, the administration will adopt portions of the Plan through regulation to the extent feasible (e.g., compensation disclosure, portions of which may be adopted by SEC action). However, criticism of the Plan by several important participants indicates that approval of legislation and implementation of the proposals reflected in the Plan may encounter roadblocks or delays.

In response to the current economic downturn and the evolving governmental approach to abate its effects, Andrews Kurth formed its Economic Recovery/Government Opportunities Task Force (ERGO). ERGO is a cross-disciplinary effort designed to assist our clients in three broad areas related to economic recovery:

- The Financial Stability Plan, including Government initiatives such as TALF and PPIP that are intended to re-establish viable markets and create opportunities for the business and investment community,
- Recovery Act/Stimulus Appropriations, including the 2009 American Recovery and Reinvestment Act, and
- Financial Regulatory matters, including prospective changes to the regulatory framework of financial institutions and financial intermediaries, and the reallocation of enforcement authority among federal and/or state authorities.

Andrews Kurth remains committed to keeping the business community informed about these developments and potential opportunities. Should you have any questions about these matters, please contact G. Michael O'Leary, Jeff Dodd, Melinda Brunger, Pat Sargent, Mark Solomon or your Andrews Kurth contact.