House Passes Historic Securities, Derivatives and Systemic Risk Reforms: HR 4173

James Hamilton, J.D., LLM.
CCH Principal Analyst

Wolters Kluwer
Law & Business

Introduction

On December 11, 2009, the U.S. House of Representatives passed historic legislation overhauling the U.S. financial regulatory system. If enacted, the Wall Street Reform and Consumer Protection Act of 2009, HR 4173, would be the most significant reform of the U.S. financial system since the New Deal of the 1930s. The legislation would create a Financial Services Oversight Council to monitor systemically significant financial institutions, counterparties, and potential threats to the financial system. It would ensure that there is no place to hide by closing loopholes, improving consolidated supervision, and establishing robust regulatory oversight. The legislation also would provide for the orderly wind-down of failing firms that are systemically significant, ending the notion of "too big to fail." By dissolving these firms, the Act would avoid more taxpayer bailouts. The legislation also offers robust consumer protections and reforms, putting the regulation of consumer protection on a level playing field with the regulation of safety and soundness of financial institutions. It would create an independent agency focused solely on issuing meaningful consumer protection standards and monitoring predatory lending practices.

Moreover, the legislation increases transparency and accountability by establishing, for the first time, a regulatory system for the over-the-counter derivatives market. Under the new regime, most derivative trades will take place on exchanges or through clearinghouses. Other important aspects of HR 4173 include subjecting hedge funds to registration requirements and doubling SEC funding to hire more experts and investigators. The legislation also imposes stricter regulation of credit rating agencies under a new regime supervised by the SEC. A federal insurance office is created to gather information, mitigate systemic risk and provide for insurance expertise to the federal government.

This white paper focuses on the securities, derivatives, corporate governance, systemic risk and dissolution authority components of the legislation.

Systemic Risk Oversight

Title I, Subtitle A, of the legislation would create a systemic risk regulator, the Financial Services Oversight Council. The Council, whose members include the Federal Reserve Board (Fed), the SEC and the Commodity Futures Trading Commission (CFTC), would have to monitor the marketplace for threats to the stability of the financial system. The legislation also enables federal regulators to raise capital requirements and impose heightened prudential standards on large, interconnected firms that could pose a threat to financial stability. It also empowers the Federal Reserve Board to impose a host of additional requirements on institutions and activities deemed systemically important.

This new regulatory structure is not intended to replace or duplicate the regulation of securities or derivative exchanges that are already subject to regulations by the SEC or the CFTC. In looking at the statutory criteria for determining whether a financial company should face stricter prudential standards, it is hard to visualize the application of these criteria to derivatives and securities exchanges. Exchanges do not trade, but administer the marketplace where trading occurs. Thus, while derivatives and securities exchanges would technically meet the definition of a financial company under Title I, the House intended the legislation to address the players in the marketplace rather than the administration of the marketplace. [Peterson-Frank colloquy, Cong. Record, Dec. 9, 2009, H14425]

The new Financial Services Oversight Council would be chaired by the Treasury Secretary. The Council would subject financial companies and financial activities posing a threat to financial stability to much stricter standards and regulation, including higher capital requirements, leverage limits, and limits on concentrations of risk. [Section 1106] The Senate draft legislation, by way of comparison, would establish an Agency for Financial Stability composed of the SEC, Fed and CFTC, with an independent chair appointed by the President.

The legislation removes outmoded Gramm-Leach-Bliley Act restraints on the consolidated supervision of large financial companies by the Federal Reserve. It also gives specific authority to the Fed and other federal financial agencies to regulate for financial stability purposes and to address potential problems quickly.

The Federal Reserve would serve as the agent of the Council in regulating systemically risky firms on a consolidated basis and systemically risky activities wherever they occur, ensuring broad accountability for such regulation. The legislation also improves transparency by substantially enhancing the authority of the Government Accountability Office (GAO) to examine the Board of Governors of the Federal Reserve and the Federal Reserve Banks.

Among its other duties, the Council must monitor the financial services markets to identify potential threats to the stability of the U.S. financial system and identify financial companies and activities that should be subject to heightened prudential standards in order to promote financial stability and mitigate systemic risk. The Council must also issue formal recommendations to the SEC and other Council members to adopt heightened prudential standards for the firms they regulate in order to mitigate system risk.

Regulators' inability to see developments outside their narrow silos allowed the current crisis to grow unchecked. The legislation's information gathering and sharing requirements for the Council and all of the financial regulators, including the SEC and CFTC, will ensure constant communication and the ability to look across markets for potential risks. The Council will facilitate information sharing and coordination among its members regarding financial-services policy development, rulemaking, examinations,

reporting requirements and enforcement actions. Also, the Council must provide a forum for its members to discuss and analyze emerging market developments and financial regulatory issues.

The Council may require the submission of periodic and other reports from any financial company solely for the purpose of assessing the extent to which a financial activity or financial market in which the firm participates, or the firm itself, poses a threat to financial stability. Any burden on financial firms brought about by this requirement is mitigated by the Act's requirement that the Council coordinate with the SEC and other primary regulators and, whenever possible, rely on the information already collected from the firms by the SEC before requiring them to submit reports.

The reporting burden is further mitigated in two ways. The Council must: (1) coordinate with the foreign regulator of a financial company that is a foreign financial parent and any appropriate multilateral organization before requiring the submission of reports; and (2) rely on information already being collected by the foreign regulator or multilateral organization with English translation.

An important duty of the Council is to advise Congress on financial regulation and make recommendations that will enhance the integrity, efficiency, orderliness, competitiveness and stability of the U.S. financial markets. The Council must meet at least quarterly.

The Council may issue formal recommendations, publicly or privately, that the SEC and other federal financial regulators adopt heightened prudential standards for firms they regulate in order to mitigate systemic risk. Within 60 days of receiving a Council recommendation, the SEC or other federal financial regulators must notify the Council of any actions taken in response to the recommendation or why the regulator failed to respond.

However, in applying systemic risk standards recommended by the Council to any foreign financial parent or any branch or subsidiary of a foreign parent operating in the United States, the SEC and other financial regulators must give due regard to the principles of national treatment and equality of competitive opportunity. The regulators also must consider the extent to which the foreign financial parent is subject to comparable standards on a consolidated basis in its home country that are administered by a comparable foreign supervisory authority.

The Council may subject a financial company to heightened prudential standards upon determining that material financial distress at the company could pose a threat to financial stability, or that the nature of the company's activities could pose a threat to financial stability. In making this determination, the Council must consider several factors, including the amount and nature of the firm's financial assets and liabilities and its off-balance-sheet exposures, as well as its transactions with other financial companies. The company's importance as a source of credit for households, businesses, and state and

local governments must also be considered, as well as its status as a source of liquidity for the financial system.

Moreover, the Council must consider the degree to which the firm is already regulated by the SEC or other federal financial regulator. With regard to a foreign financial parent, the Council must consider the extent to which the foreign parent is subject to comparable standards on a consolidated basis in its home country that are administered by a comparable foreign supervisory authority. Once a company becomes an identified financial company, heightened prudential standards can be imposed on it in order to mitigate risks to the financial system, including capital, liquidity and risk-management requirements. [Section 1103]

In a colloquy with Chairman Frank, Rep. McCarthy established that it is the intent of the House that the analysis of systemic risk and assessment factors would be applied by the Council for dissolution fund assessments. The factors used for identifying companies subject to stricter standards should be applied in light of the more detailed and balanced risk matrix set out in the dissolution-fund section of the legislation. [Cong. Record, Dec. 10, 2009, H14675]

A financial company subjected to heightened prudential standards may appeal the Council's determination that it poses a systemic risk through procedures to be established by the Council. In addition, HR 4173 provides that a financial company can seek judicial review of the Council's determination in the U.S. Court of Appeals for the District of Columbia. [Section 1103]

In a colloquy with Chairman Frank, Rep. Kilroy established that it is the not the intent of the legislation to subject nondepository captive finance companies to strict prudential standards because they do not pose the types of risks that warrant such heightened treatment. Nondepository captive finance companies typically provide financing on a nonrevolving basis only to customers and to dealers who sell and lease the products of their parent or affiliate. As such, they are involved in only a narrow scope of financial activity. Equally important, their loans are made on a depreciating asset, a fact taken into account when the loans are entered into. If they are not a depository institution, they therefore have no access to the federal deposit insurance safety net. [Cong. Rec., Dec. 9, 2009, H14431]

The legislation authorizes requirements for the inclusion of contingent capital into the capital structure of large financial holding companies. Contingent capital is a special form of debt that, when a company gets into trouble, will immediately convert into equity on previously negotiated terms, thus causing the firm to be recapitalized without requiring a penny from the taxpayer. A requirement for large firms to carry contingent capital amounts to a requirement that they carry privately-funded bailout insurance. The elegance of this solution is that it is market-based and privately-funded.

For large financial firms that are poorly run, the market-imposed terms on which they could receive contingent capital could be more onerous than their better-run competitors. Further, although not eliminating the need for a systemic dissolution fund, it is the intent of the House that contingent capital becomes the first line of defense against financial contagion and serves to mitigate the effects of future crises. [Cong. Record, Dec. 9, 2009, H14434]

Securities Holding Companies

Title I, Subtitle L, of the Act would institute a comprehensive regime to regulate securities holding companies similar to the SEC's consolidated supervised entity scheme that became a casualty of the financial crisis. Securities holding companies, defined as non-natural persons controlling SEC registered brokers and dealers, must generally register with the Federal Reserve Board and become subject to the Fed's comprehensive supervision. The exceptions to registration are those securities holding companies already subject to comprehensive consolidated supervision by a foreign regulator and those that are financial holding companies already subject to stricter standards. Also, securities holding companies that are affiliates of an insured bank or foreign bank are excepted.

Supervised securities holding companies and their affiliates must make and keep for prescribed periods of time such records and reports that the Board determines to be necessary to prevent evasions and to monitor compliance, and must promptly provide these reports at the Board's request. The records and reports may include a balance sheet and income statement; an assessment of consolidated capital, and an independent auditor's report attesting to the securities holding company's compliance with its internal risk management and internal control objectives.

To the fullest extent possible, the Board must accept reports that the supervised securities holding company has been required to provide to the SEC or other regulator or self-regulatory organization.

The Board may examine any supervised securities holding company and its affiliates to prevent evasions and monitor compliance. Again, to the fullest extent possible, the Board must use the reports of examinations conducted by the SEC and other federal or state functional regulators.

The Board must, by regulation or order, set capital-adequacy and other risk-management standards for a securities holding company appropriate to protect the safety and soundness of the company and address the risks that the firm poses to financial stability. In imposing these standards, the Board must consider differences among types of business activities.

The Board must also consider the amount and nature of the company's financial assets and liabilities, including the degree of reliance on short-term funding, off-balance-sheet

exposures and relationships with other financial companies. The Board must also consider the company's importance as a source of credit for households, businesses and state and local governments, its status as a source of liquidity for the financial system, as well as the nature, scope and mix of the company's activities. In imposing the standards, the Fed may differentiate among supervised securities holding companies on an individual basis or by category, taking into consideration the listed criteria.

Securitization

In many ways, the financial crisis was at root a crisis of securitization. Although traditional securitization was a successful tool for bundling loans into asset-backed securities, in the last decade it morphed into the short-term financing of complex, illiquid securities whose value had to be determined by theoretical models. The inherent fragility of this new securitization model was masked by the actions of market intermediaries, particularly credit rating agencies. The collapse of structured securitization revealed the ugly reality that, far from managing and dispersing risk, it had increased leverage and concentrated risk in the hands of specific financial institutions.

There is a growing consensus that securitization must and should survive the financial crisis because it remains essential to the global financial markets, despite its role in the subprime crisis. Thus, Title I, Subtitle F, of the legislation reforms the process of securitization. It would require companies that sell products like mortgage-backed securities to retain a portion of the risk, discouraging them from selling junk because they would have to keep some of it for themselves. The legislation would require companies that sell products like mortgage-backed securities to keep some "skin in the game" by retaining at least five percent of the credit risk. [Section 1502] In addition, the legislation would require issuers to disclose more information about the assets underlying securities. [Section 1503]

The SEC must adopt regulations requiring issuers of asset-backed securities to disclose for each tranche or class of security information regarding the assets backing that security. In adopting these regulations, the SEC must set standards for the format of the data provided by issuers of an asset-backed security, which must, to the extent feasible, facilitate comparison of such data across securities in similar types of asset classes.

To help investors perform their own due diligence, the SEC regulations must require issuers of asset-backed securities, at a minimum, to disclose asset-level or loan-level data, including data having unique identifiers relating to loan brokers or originators. The issuer must also disclose the nature and extent of the compensation of the broker or originator of the assets backing the security, and the amount of risk retained by the originator or the securitizer of those assets.

The SEC must also adopt regulations for asset-backed securities that require each credit rating agency to include in any report accompanying a credit rating a description of the representations, warranties and enforcement mechanisms available to investors and how they differ from the representations, warranties and enforcement mechanisms in issuances of similar securities. The regulations must also require any originator to disclose fulfilled repurchase requests across all trusts aggregated by the originator so that investors can identify asset originators with clear underwriting deficiencies. [Section 1504]

Reverse mortgages have also been the subject of securitization. Reverse mortgages are unique mortgage products that allow homeowners over the age of 62 to borrow against their homes to receive either cash or a line of credit. The loan is paid back when the homeowner dies or sells the home. A report by the National Consumer Law Center found many of the abusive practices that were common in the subprime lending market are also common in reverse mortgage transactions, including high fees, incentives for brokers that are harmful to borrowers, and lenders steering consumers to products that are costlier than necessary.

As originally written, reverse mortgages did not clearly fall within the Consumer Financial Protection Agency's authority. The Schakowsky Amendment clarified that the CFPA has regulatory authority over lenders and brokers that issue reverse mortgages and directs the new agency to consult with HUD as it develops regulations. The amendment would also require the CFPA to begin rulemaking within one year of enactment in order to develop regulations that will make sure that reverse mortgage transactions are not unfair, deceptive or abusive.

Dissolution Authority

The federal government's responses to the impending bankruptcy of Bear Stearns, Lehman Brothers, and AIG were complicated by the lack of a statutory framework for avoiding the disorderly failure of securities firms and other non-bank financial firms, including affiliates of banks or other insured depository institutions. In the absence of such a framework, the government's only avenue to avoid the disorderly failures of Bear Stearns and AIG was the use of the Federal Reserve's lending authority. This mechanism was insufficient to prevent the bankruptcy of Lehman Brothers, an event that demonstrated how disruptive the disorderly failure of a non-bank financial firm can be to the financial system and the economy. These market events demonstrated the weaknesses of financial company insolvency regimes.

According to Treasury, the lack of a federal regulatory regime and resolution authority for large systemic non-bank financial institutions contributed to the financial crisis and, unless addressed with legislation, will constrain a federal response to future crises. Thus, Title I, Subtitle G, would create a resolution authority to wind down large, interconnected, financial companies in an orderly manner.

The legislation thus seeks to end “too big to fail” by empowering federal regulators to rein in and dismantle financial firms that are so large, interconnected, or risky that their collapse would destabilize the entire U.S. financial system. By ensuring that financial companies cannot become so large that their failure would pose a threat to economic stability, the legislation seeks to protect taxpayers from future bailouts. By outlining clear and objective standards for regulators to examine financial companies, HR 4173 should reduce the level of risk their activities pose to financial stability.

Regulators would be able to dissolve large, highly complex financial companies in an orderly and controlled manner, ensuring that shareholders and unsecured creditors, not taxpayers, would bear the losses. When a financial firm enters the dissolution process, management responsible for the failure would be dismissed, parties that should bear losses—particularly shareholders and unsecured creditors—would do so, and the firm would cease as a going concern. Thus, the legislation establishes an orderly process for the dismantling of any large failing financial company in a way that protects taxpayers and minimizes the impact to the financial system.

If a large financial company fails, the legislation holds the financial industry and shareholders, not taxpayers, responsible for the cost of the wind down. Any costs for dismantling a failed financial company will be repaid first from the assets of the failed firm at the expense of shareholders and creditors. Any shortfall would then be covered by a dissolution fund pre-funded by large financial companies. In this instance the legislation follows the “polluter pays” model where the financial industry has to pay for its mistakes, not taxpayers.

The FDIC will be able to unwind a failing firm so that existing contracts can be dealt with and creditors’ claims can be addressed. Unlike traditional bankruptcy, which does not account for complex interrelationships of such large firms and may endanger financial stability, this more flexible process will help prevent contagion and disruption to the entire system and the overall economy.

The legislation clarifies that if a large financial firm gets to the point where it cannot pay its debts, and it is of such size that those debts threaten systemic negative consequences reverberating throughout the economy, it dies. There is no bailout. There is no continuation of that entity. The firm goes into receivership and the FDIC may use the dissolution fund to wind down the company.

If dissolution of a firm is necessary before the fund is built up, the FDIC may borrow money from the Treasury with an absolute requirement of repayment in this fund. No taxpayer dollars will be used. They may be lent, in some cases, but they must be repaid and there must be a repayment schedule. There is nothing in the legislation that allows a failing institution to be continued with federal money. HR 4173 creates a dissolution fund, not a bailout fund. [Cong. Record, Dec. 9, 2009, H14413, H14422]

Corporate Governance and Compensation

Title II requires a non-binding annual shareholder advisory vote on executive compensation. Similarly, there must also be a shareholder advisory vote on golden parachutes. The SEC may exempt categories of public companies and, in determining the exemptions, must consider the potential impact on smaller companies. The legislation also requires at least annual reporting of say-on-pay and golden-parachute votes by all institutional investors, unless such votes are otherwise required to be reported publicly by SEC rule. The measure also provides that compensation approved by a majority say-on-pay vote is not subject to clawback, except as provided by contract or due to fraud to the extent provided by law.

The measure would not set any limits on pay but would ensure that shareholders have an advisory vote on their company's executive pay practices without micromanaging the company. Knowing that they will be subject to some collective shareholder action should give boards pause before approving a questionable compensation plan.

In a major governance reform, public companies must have a compensation committee composed of independent directors. Similarly, compensation consultants must satisfy independence criteria established by the SEC. The SEC is allowed to exempt categories of public companies, taking into account the potential impact on smaller companies. [Section 2003]

To be considered independent, a compensation committee member cannot accept any consulting, advisory, or other compensatory fee from the company and cannot be an affiliated person of the company or any of its subsidiaries. The SEC would be authorized to exempt a particular relationship with a compensation committee member from these independence standards.

The legislation gives the compensation committee sole discretion to retain compensation consultants meeting independence standards to be promulgated by the SEC. The compensation committee would be directly responsible for the appointment, compensation and oversight of the compensation consultant. However, there is no requirement that the compensation committee implement or act consistently with the recommendations of the compensation consultant. In addition, the hiring of a compensation consultant would not affect the committee’s ability or obligation to exercise its own judgment in carrying out its duties.

The compensation committee would also be authorized to retain independent counsel and other advisers meeting SEC independence standards. As with compensation consultants, the compensation committee would be directly responsible for the appointment, compensation, and oversight of such independent counsel and other advisers. But the compensation committee would not have to implement or act consistently with the advice or recommendations of such independent counsel and other advisers, and the retention

would in no way affect the committee's ability or obligation to exercise its own judgment.

Financial institutions with more than $1 billion in assets must disclose compensation structures that include any incentive-based elements. Federal financial regulators, including the Fed, SEC, and FDIC, will jointly determine the disclosure requirements and incentive-based compensation standards. Also, federal regulators must proscribe inappropriate or imprudently risky compensation practices as part of solvency regulation. [Section 2004]

The legislation authorizes the SEC to issue proxy access regulations regarding the nomination of directors by shareholders to serve on a company's board of directors, thereby further democratizing corporate governance. This provision is needed because, without it, the SEC could face lawsuits from corporations and industry groups alleging that the Commission lacked the authority to grant shareholders this right. Congress believes that proxy access is necessary for shareholders to have a meaningful choice in exercising their right to vote for board members and to hold boards accountable. Regulation of proxy access and disclosure is a core function of the SEC and is one of the original responsibilities that Congress assigned to the Commission in 1934. The legislation would create a new federal right to proxy but would also ensure that existing laws on the right to proxy are upheld. [Section 7222]

OTC Derivatives

Under Title III, credit default swap markets and all other OTC derivative markets would be subject to comprehensive federal regulation under an SEC-CFTC regime in order to guard against activities in those markets posing excessive risk to the financial system and to promote the transparency and efficiency of those markets. The Senate draft would also authorize the federal regulation of derivatives under a dual SEC-CFTC regime.

In setting out the first comprehensive system of regulation of the OTC derivatives market, the House legislation would establish a central clearing requirement for swaps transactions between dealers and large market participants that are accepted by a clearinghouse. Non-cleared swaps must be reported with major participants and dealers adhering to strengthened capital and margin requirements.

OTC derivatives include swaps, which are financial contracts that call for an exchange of cash flows between two counterparties based on an underlying rate, index or credit event or the performance of an asset. Swaps allow a company to lock in prices on everything from currency to oil.

Title III divides jurisdiction over swaps between the SEC and the CFTC. The SEC oversees activity in swaps that are based on securities such as equity and credit-default swaps. The CFTC is responsible for all other swaps.

Under this legislation, swaps will be centrally cleared if a clearinghouse will accept the transaction and when regulators determine clearing is necessary. Cleared, listed swaps must be traded on an exchange or a registered swap-execution facility. All swap trades must be reported, with counterparties adhering to recordkeeping and reporting requirements. Swap dealers, similar to large financial institutions, will be held accountable to new standards for capital, margin, business conduct and other requirements to reduce their ability to again place the financial system in turmoil.

In addition, HR 4173 contains many strong provisions regarding market transparency and makes progress solving some of the jurisdictional issues that have plagued financial regulation in the past. The legislation calls for international harmonization by requiring foreign boards of trade to share trading data and adopt speculative position limits on contracts that trade U.S. commodities similar to U.S.-regulated exchanges.

The legislation would exempt commercial end users from the clearing requirement. These firms, such as airlines, manufacturers, and other small- to medium-sized businesses, often use derivatives markets to hedge their price risk. Regulators would have to define the types of risk a company may hedge and still remain eligible for the limited exception to clearing. The legislation will hold swap dealers like big banks accountable to new standards for capital, margin and business-conduct requirements and will benefit end users' ability to continue to effectively hedge price risk by not submitting them to onerous cash collateral requirements.

The House reform legislation would require over-the-counter derivatives trading to be conducted through clearinghouses, which are set up to police derivatives trading. Under HR 4173, if a clearing mandate applies to a swap or class of swaps, then the swap dealers and major swap participants not only have to clear such trades but also have to execute them on or through a futures or securities exchange or a swap-execution facility. This provision provides greater price transparency and will narrow spreads, all to the benefit of end users. For the end users, the bill also provides an exemption from the clearing mandate and, consequently, from the execution mandate. The House defeated an amendment that would have imposed an execution mandate on end users.

So clearly, the legislation differentiates between larger brokers and banks who do present a systemic threat to the market and smaller companies who use derivatives to hedge and manage the risk associated with running an effective business. The Murphy Amendment clarifies that end users who do not pose a systemic risk to the financial markets should not be designated as major swap participants or major security-based swap participants and should not incur the unintended costs.

Legitimate end users would be exempt from derivatives regulation. However, to justify this approach there must be integrity in the administration of the process. While the House bill exempts end users, there is an exception to the exemption. If an end user is engaged in an activity that can cause financial stability problems, they will lose the exemption. The question is what should trigger the loss of the end-user exemption. The legislation says systemic risk.

The Peterson Amendment provides some clarity regarding the limited exception to clearing requirements. Specifically, it requires the CFTC to define the terms "commercial risk," "operating risk," and "balance sheet risk," which are used in the statute to define what types of risk a company may hedge and still remain eligible for the exception to clearing. By providing for the agency to define these terms, the burden shift to the CFTC to ensure that companies seeking the limited exception to the clearing requirement do not abuse that exception.

Under the Murphy Amendment, "major swap participant" and "major security-based swap participant" are defined more restrictively in terms of allowing financial companies to be exempt from being classified as a major swap participant. Thus, more financial companies would face a higher regulatory standard. Also, it is slightly less restrictive with respect to manufacturing companies being classified as a major swap participant or major security-based swap participant. Congress wants those who are systemically risky to be held to a higher standard of accountability, but it does not want to capture manufacturing companies and other end users in that regulation. They will be permitted to do business and use derivatives to hedge their actual risk.

Defining the terms "major swap participant" and "major security-based swap participant" was a significant challenge in the bill. The definitions generally exempt end users while ensuring that regulation captures the financial players to which the new regulations should apply. The House rejected an absolute, guaranteed exemption for end users from the definition so that they never would be considered a major swap participant. The House would not do that because it did not know what the future will bring and because one of these end users could, one day, get so large with regard to their swap activity so as to have an impact on the financial system.

The House also defeated an amendment that would have authorized the SEC and the CFTC to set margin or collateral requirements for swaps and securities-based swaps involving end users. With regard to swap dealers and major swap participants and their security-based swap counterparties, the legislation authorizes the SEC and the CFTC to set margin requirements appropriate for the uncleared swaps that they hold.

Because swap dealers and major swap participants are so heavily involved in the swap market and are interconnected with potentially hundreds of different counterparties, Congress believes it is important to regulate their margins for the protection of their customers and the financial system as a whole. However, there is no need for the SEC and the CFTC to put margin requirements on end users in order to protect the swap dealers and major swap participants. They can look out for themselves. The end user community of energy companies, manufacturers and others did not cause the problem.

There was concern that, with derivatives trading required to be conducted through clearinghouses, large financial institutions would own and control the clearinghouses and effectively set rules for their own derivatives deals. The Lynch Amendment prevents large financial institutions and major swap participants from taking over these new

clearinghouses by imposing a 20-percent-voting-stake limitation on ownership interest in those institutions and the governance of the clearing and trading facilities.

The Lynch Amendment specifically provides that these restricted owners, which are defined as swap dealers, security-based swap dealers, major swap participants and major security-based swap participants, cannot own more than a 20 percent voting stake in derivatives-clearing organization, a swap-execution facility, or a board of trade. Further, the rules of the clearing organization, swap-execution facility and board of trade must provide that a majority of the directors cannot be associated with a restricted owner.

The legislation will resolve jurisdictional issues between regulators that have compromised past efforts at financial regulation. The House measure will also strengthen confidence in trader position limits on physically deliverable commodities as a way to prevent excessive speculative trading.

Heeding the G-20's advice to prevent regulatory arbitrage, the legislation calls for international harmonization by requiring foreign boards of trade to share trading data and adopt speculative position limits on contracts that trade U.S. commodities similar to U.S.-regulated exchanges. The SEC and CFTC are also directed to consult and coordinate with foreign regulators to create consistent international standards with respect to the regulation of derivatives.

The SEC and the CFTC may engage in information-sharing arrangements with foreign regulators consistent with the public interest and the protection of investors and counterparties. In addition, the SEC and CFTC are authorized to prohibit a foreign entity from participating in the United States in any swap or security-based swap activities upon determining that the regulation of derivatives in the entity's foreign jurisdiction undermines the stability of the U.S. financial system.

The legislation specifically forbids federal assistance to support derivatives-clearing operations or the liquidation of a derivatives-clearing organization set up under the Commodity Exchange Act or a clearing agency described in the Exchange Act unless Congress expressly authorizes such assistance.

The legislation implements important corporate governance reforms in the derivatives markets. In addition to complying with several core principles listed in the Act, such as having adequate financial resources and effective risk management, derivatives-clearing organizations registered with the SEC must designate a compliance officer to review compliance with the core principles and establish procedures for the remediation of non-compliance. The compliance officer must also prepare an annual report, certifying its accuracy, on the compliance efforts of the derivatives-clearing organization. The compliance report will accompany the financial reports that the clearing organization must furnish to the SEC.

A security-based swap must be submitted for clearing if a registered clearing agency will accept the instrument for clearing, and the Commission has determined that the security-based swap must be cleared. Clearing agency rules must prescribe that all security-based swaps submitted to the clearing agency with the same terms and conditions are economically equivalent and may be offset with each other within the clearing agency. The rules must also provide for non-discriminatory clearing of a security-based swap executed bilaterally or on or through the rules of an unaffiliated national securities exchange or swap-execution facility. [Section 3203]

The SEC must review each security-based swap, or any group, category, type or class of security-based swaps to make a determination that such security-based swap, or group, category, type or class of security-based swaps should have to be cleared. The SEC must provide at least a 30-day public comment period regarding these determinations.

A clearing agency must submit to the SEC each security-based swap, or any group, category, type or class of security-based swaps that it plans to accept for clearing. The clearing agency must also provide notice of the submission to its members in a manner to be determined by the Commission.

In addition to publicly disclosing these submissions, the SEC must review each submission and determine whether the security-based swap, or group, category, type, or class of security-based swaps, described in the submission must be cleared. Then the Commission must provide at least a 30-day public comment period regarding its determination whether the clearing requirement will apply to the submission. Finally, the SEC must make its determination within 90 days after receiving a submission unless the submitting clearing agency agrees to an extension.

In reviewing a submission, the SEC must consider several factors, including the existence of significant outstanding notional exposures, trading liquidity, adequate pricing data, operational expertise and resources, and credit support infrastructure to clear the contract on terms that are consistent with the material terms and trading conventions on which the contract is then traded. Importantly, the SEC must also consider the effect on the mitigation of systemic risk, taking into account the size of the market for the contracts and the resources of the clearing agency available to clear the contract. Other factors include the effect on competition, including appropriate fees and charges applied to clearing, and reasonable legal certainty in the event of insolvency of the relevant clearing agency.

After a determination on a submission, the SEC may, at the request of a counterparty or on its own initiative, stay the clearing requirement until the completion of a review of the terms of the security-based swap, with the review to be completed within 90 days unless the clearing agency agrees to an extension.

All security-based swaps that are not accepted for clearing by any clearing agency must be reported either to a security-based swap repository or, if there is no security-based

swap repository that would accept the security-based swap, to the Commission within such time period as the Commission may by regulation prescribe. Counterparties to a security-based swap may agree on which counterparty will report the security-based swap. With regard to security-based swaps where only one counterparty is a security-based swap dealer, the security-based swap dealer must report the security-based swap.

A clearing agency that clears security-based swaps must provide the SEC with all of the information the Commission determines it needs to carry out its duties. The SEC must adopt data collection and maintenance requirements for security-based swaps cleared by clearing agencies that are comparable to the corresponding requirements for security-based swaps accepted by security-based swap repositories and security-based swaps traded on swap-execution facilities. The Commission must share such information on request, with the CFTC, the federal banking agencies, the Financial Services Oversight Council, DOJ, and other persons the SEC deems appropriate, including foreign financial regulators.

For its part, a clearing agency that clears security-based swaps must provide to the Commission such information as is required by, and in a form and at a frequency to be determined by, the Commission. The clearing agency must also designate a compliance officer who reports to the board or a senior officer. In addition to ensuring compliance with the securities laws and regulations, the compliance officer must establish procedures for the remediation of non-compliance issues found during compliance office reviews, internal or external audits, self-reported errors or validated complaints.

The compliance officer must annually prepare and sign a report on the compliance of the clearing agency with the securities laws and its policies and procedures, including its code of ethics and conflict-of-interest policies. The compliance report will accompany the financial reports of the clearing agency that must be furnished to the Commission, and include a certification that the report is accurate and complete.

The SEC may exempt a clearing agency from registration for the clearing of security-based swaps upon finding that the clearing agency is subject to comparable, comprehensive regulation on a consolidated basis by the CFTC, a prudential regulator, or the appropriate authorities in the organization’s home country.

A security-based swap that is subject to the clearing requirement must generally be traded on a national securities exchange or on a registered swap-execution facility. If there is no national securities exchange or swap-execution facility that makes the security-based swap available to trade, the counterparties must comply with any SEC recordkeeping and transaction-reporting requirements with respect to security-based swaps.

The legislation ensures that the CFTC’s authority over derivatives will not in any way limit the Federal Energy Regulatory Commission’s authority to regulate energy markets. FERC plays a critical role in ensuring that those markets deliver energy reliably and at just and reasonable rates. The bill preserves FERC’s role in three ways:

First, the bill amends the Commodity Exchange Act to fully preserve the FERC's authority over agreements, contracts, and transactions entered into pursuant to a FERC-approved tariff or rate schedule. An exception is made for instruments that are executed, traded, or cleared on a CFTC-registered entity. However, it is the intent and understanding of Congress that the CFTC cannot construe this exception to limit the FERC's underlying authority. [Cong. Record, Dec. 9, 2009, H14442] For example, FERC-regulated entities, such as Regional Transmission Organizations and Independent System Operators, would not have to register with the CFTC based on their utilization of Financial Transmission Rights or other instruments to facilitate the physical operation of the electric grid. The CFTC also will not require instruments of that nature to be executed, traded or cleared on some other CFTC-registered entity.

Second, in any area where the FERC and the CFTC have overlapping authority, the bill requires the two agencies to conclude a memorandum of understanding delineating their respective areas so as to avoid conflicting or duplicative regulation. Where the FERC has regulatory authority, the CFTC is permitted to step back and let the FERC do its job. It is the understanding and expectation of the House that the CFTC will recognize the FERC's primacy with regard to energy markets that it comprehensively regulates.

Third, HR 4173 states that it does not in any way limit or affect the FERC's existing authority, under Section 222 of the Federal Power Act and Section 4A of the Natural Gas Act, to protect against manipulation of the electricity and natural gas markets. As one of the principal authors of these anti-manipulation provisions, which were included in the Energy Policy Act of 2005, Rep. Ed Markey views the preservation of this authority as critical to ensuring fair and transparent energy markets. These provisions were drafted broadly to allow the FERC to protect against the use of any manipulative or deceptive device or contrivance in connection with FERC-regulated electricity and natural gas markets, regardless of where such manipulation occurs.

Hedge Funds

Hedge funds and other private funds are not currently subject to the same set of standards and regulations as banks and mutual funds, reflecting the traditional view that their investors are more sophisticated and therefore require less protection. This exemption has enabled private funds to operate largely outside the framework of the financial regulatory system, even as they have become increasingly interwoven with the financial markets. As a result, there is no data on the number and nature of these firms or ability to calculate the risks they pose to the broader markets and the economy.

By mandating the registration of hedge fund advisers and others who currently operate in the shadows of the financial markets and subjecting them to recordkeeping and disclosure requirements, the legislation gives the SEC, for the first time, the information needed to better understand exactly how these entities operate and whether their actions pose a threat to the financial system as a whole.

Title V, Subtitle A, would require investment advisers to hedge funds and other private investment funds to register with the SEC if they have assets under management of at least $150 million and would subject them to significant disclosure and other requirements. Current law generally does not require hedge fund and other private fund advisers to register with any federal financial regulator.

The legislation accomplishes the registration of hedge fund advisers by eliminating the Investment Adviser Act's private-adviser exemption, which exempts from registration investment advisers that have fewer than 15 clients, do not hold themselves out to the public as investment advisers, and do not act as investment advisers to registered investment companies or business development companies. When the Commission establishes the registration requirements for private funds, it must consider the relative risk profile of different classes of private funds. [Section 5003] The legislation creates a limited exemption for foreign private fund advisers.

The legislation mandates the registration of private advisers to private pools of capital so that regulators can better understand exactly how those entities operate and whether their actions pose a threat to the financial system as a whole. In addition, new recordkeeping and disclosure requirements for private fund advisers will give regulators the information needed to evaluate both individual firms and entire market segments that, until now, have largely escaped any meaningful regulation, without posing undue burdens on those industries. [Section 5004] Under the legislation, advisers to hedge funds, private equity firms, and other private pools of capital will have to follow some basic ground rules in order to continue to operate in the capital markets. Regulators will have authority to examine the records of these previously secretive investment advisers.

The legislation authorizes the SEC to require registered investment advisers to maintain records of, and submit reports about, the private funds they advise in two instances—first, as the SEC determines is necessary or appropriate in the public interest and for the protection of investors, and second, as the SEC determines, in consultation with the Federal Reserve Board and any other entity that the SEC identifies as having systemic risk responsibility, is necessary for the assessment of systemic risk. The records and reports of any private fund are further deemed to be the records and reports of the registered investment adviser.

The SEC may, after considering the public interest and potential to contribute to systemic risk, set different reporting requirements for different classes of private fund advisers, based on the particular types or sizes of private funds they advise.

The proprietary information that hedge funds and private funds disclose to the SEC is confidential, except that the Commission may not withhold information from Congress. Also, the SEC may provide the information to the other federal agencies or SROs. The information can also be disclosed pursuant to a federal court order in an action brought by the SEC or the United States.

The SEC cannot compel the hedge fund or private fund to disclose proprietary information to counterparties and creditors. For purposes of these provisions, proprietary information must include sensitive, non-public information regarding the investment adviser's investment or trading strategies, analytical or research methodologies, trading data, computer hardware or software containing intellectual property, and any additional information that the Commission determines to be proprietary.

The legislation requires hedge fund advisers covered by the asset threshold exemption to maintain the required records and gives the SEC the discretion to require reports in the public interest or for investor protection. In adopting regulations for investment advisers to mid-sized private funds, the SEC must consider the size, governance and investment strategy of the funds in order to ascertain if they pose a systemic risk to the financial markets. [Section 5007]

The House legislation contains a registration exemption for advisers to venture capital funds. The SEC must define the term "venture capital fund" and provide an adviser to such a fund an exemption from the registration requirements. However, the Commission must require advisers to venture capital funds to maintain records and provide annual or other reports as the Commission determines necessary or appropriate in the public interest or for the protection of investors. [Section 5006]

The legislation mandates confidential reporting to the SEC of the amount of assets under management, borrowings, off-balance-sheet exposures, counterparty credit risk exposures, trading and investment positions, and other important information relevant to determining potential systemic risk and potential threats to overall financial stability. The legislation would require the SEC to conduct regular examinations of the funds to monitor compliance with these requirements and to assess potential risk.

In addition, the SEC would share the disclosure reports received from funds with the Federal Reserve Board and the new systemic risk regulator, the Financial Services Oversight Council. This information would help determine whether systemic risk is building up among hedge funds and other private pools of capital and could be used if any of the funds or fund families are so large, highly leveraged, and interconnected that they pose a threat to overall financial stability and should therefore be under the broad oversight of the new federal systemic risk regulator.

The Act would require the SEC to provide guidance to hedge funds, private equity firms, and other private pools as they adjust to the legislation's new registration requirements.

The Comptroller General would have to conduct a study and report to Congress within two years on the costs to the hedge fund industry of the legislation's registration and reporting requirements. The Act would delay the effective date for one year, although advisers would have the discretion to register earlier with the SEC.

Senate legislation would require the SEC registration of hedge fund and other private fund advisers and disclosure of information to the Commission under a confidentiality regime.

Credit Rating Agencies

Credit rating agencies, i.e., nationally recognized statistical ratings organizations (NRSROs), have assumed a central role in the global capital markets. They faced growing criticism over the past years that reached a crescendo in the recent financial crisis. In response, Title V, Subtitle B, of the Act enhances the SEC's oversight and regulation of NRSROs.

After nearly a century of self-regulation, the rating agencies became subject to SEC oversight after the enactment of the Credit Rating Agency Reform Act of 2006. The Act authorizes the SEC to oversee credit rating agencies registered with the Commission as NRSROs. Currently, credit rating agencies operate under a voluntary system of registration with the SEC. The legislation changes that by requiring rating agencies to register with the SEC. The Garrett Amendment allows a voluntary withdrawal from registration with the Commission for those rating agencies who earn less than $250 million of net revenue for providing credit ratings on securities and money market instruments issued in the United States. The amendment would have the effect of allowing the smallest of rating agencies to opt out of the system at some time in the future, while maintaining the close supervision of the largest rating agencies, the ones most likely to issue the ratings used by investors.

HR 4173 significantly reforms the credit rating agencies that played a central role in the financial crisis by giving inflated ratings to mortgage-backed securities and other financial instruments. In the wake of the Enron accounting scandal, Congress established an independent Public Company Accounting Oversight Board to effectively regulate the accounting industry. HR 4173, in addition to mandating that the rating agencies establish internal controls to resolve conflicts of interest and institute better corporate governance, also has language that creates a prototype independent committee to oversee the SEC regulation and enforcement of the rating agencies. This oversight committee will be dominated by end users of credit ratings and is designed to serve as a template for future, stronger oversight if SEC enforcement proves inadequate. [Cong. Rec., Dec. 9, 2009, H14434]

The Credit Ratings Agency Advisory Board established by the SEC will consist of seven members appointed by the Commission, only two of whom may be former employees of a credit rating agency. Members of the Board must be prominent individuals of integrity and reputation with a commitment to the interests of investors and an understanding of the role that ratings play to the investor community. The Board must ensure that the Commission fully executes its oversight duties with respect to the rating agencies. The Board must issue an annual report to Congress.

In addition, H.R. 4173 takes strong steps to stem market reliance on credit rating agencies and impose accountability on rating agencies by increasing liability. As gatekeepers to the markets, credit rating agencies will be held to higher standards and incentivized to do their jobs correctly and effectively, with repercussions if they fall short.

The Commission must establish an office that administers the SEC rules with respect to the practices of credit rating agencies in determining ratings, in the public interest and for the protection of investors, including rules designed to ensure that credit ratings are accurate and are not unduly influenced by conflicts of interest. The new office must be sufficiently staffed to carry out the mission. [Section 6002]

Differentiation is a key concept in the reform of credit rating agencies. This means that credit rating agencies should differentiate the credit ratings that they assign to structured credit products from those they assign to unstructured debt. The Act provides that the SEC may adopt rules requiring statistical rating organizations to establish credit rating symbols that distinguish credit ratings for structured products from credit ratings for other products that the Commission determines appropriate or necessary in the public interest and for the protection of investors, provided that the rules do not prevent public pension funds or other state regulated entities from investing in rated products.

The SEC also must revise Regulation FD (17 CFR §243.100) to remove the exemption for entities whose primary business is the issuance of credit ratings. [Section 6007]

The legislation enhances the accountability of NRSROs by clarifying the ability of individuals to sue NRSROs. It would amend the Exchange Act to provide that, in an action for money damages against a rating agency, it is enough for pleading any required state of mind that the complaint state with particularity facts giving rise to a strong inference that the rating agency knowingly or recklessly violated the securities laws. In addition, statements made by rating agencies will not be deemed forward-looking statements for purposes of the Exchange Act’s safe harbor. [Section 6003]

Thus, in any private action against a rating agency, the same pleading standards with respect to knowledge and recklessness must apply to the rating agency as would apply to any other person in the same or similar private right of action against such person. What this provision does is hold rating agencies to the same standard with regard to knowledge and recklessness as everybody else. It does not say that rating agencies will be held accountable for simply being wrong through legitimate error. However, if the rating agencies know what they are saying is wrong, or they are reckless in not looking at an accounting report, they will be held accountable. [Cong. Rec., Dec. 10, 2009, H14681]

At the core of the Securities Act is the idea that a company should provide investors with basic information about the securities it is issuing. It requires issuers to publicly disclose significant information about themselves and terms of the securities. Those who make material misstatements of fact or omissions in a registration statement can be held accountable under Securities Act Section 11. This provision now covers many experts in

the financial world, such as accountants, lawyers, investment bankers, directors, officers, and executives of the issuers. However, credit rating agencies are exempt from Section 11 liability by SEC rule.

The legislation levels the playing field by stating that Rule 436(g) will have no force, thereby effectively removing the "expert" exemption for credit ratings included in a registration statement. Thus, NRSROs will now have greater liability under the securities laws if a rating is included in a registration statement. Rating agencies would be liable for omitting information from a registration statement, putting them on the same level as other experts like accountants, auditors, and lawyers. The provision is intended to make credit rating agencies more accountable for their work by making them liable for misstatements or omissions of fact from a statement. [Section 6012]

Transparency is a hallmark of the legislation. Investors will gain access to more information about the internal operations and procedures of NRSROs, methodologies, ratings performance and short-comings in ratings assessment. In addition, the public will now learn more about how NRSROs get paid.

The issuer-pay model has long allowed inherent conflicts of interest for which NRSROs have been criticized. The legislation contains new requirements designed to mitigate these conflicts of interest. The Act requires each NRSRO to have a board with at least one-third independent directors. The independent directors will oversee policies and procedures aimed at preventing conflicts of interest and improving internal controls, among other things. Moreover, the compensation of the directors cannot be linked to the business performance of rating agencies and must be structured to ensure the independence of their judgment.

The Act adds a new duty to supervise NRSRO employees and authorizes the SEC to sanction supervisors for failing to do so. It also includes revolving-door protections when certain NRSRO employees go to work for an issuer. Additionally, the bill significantly enhances the responsibilities of NRSRO compliance officers to address conflicts of interest. The compliance officer would report directly to the board and would review all of the agency's policies to manage conflicts of interest and, in consultation with the board, resolve any conflicts of interest that arise.

The compliance officer must also assess the risk that compliance or noncompliance may compromise the integrity of the rating process. Similarly, the compliance officer must review compliance with internal controls with respect to the procedures and methodologies for determining credit ratings, including quantitative models and qualitative inputs used in the rating process, and assess the risk that such compliance with the internal controls or lack thereof may compromise the integrity and quality of the credit rating process. [Section 6002]

The measure also requires the compliance officer to be responsible for administering the policies and procedures required to be established by the legislation and, more broadly,

ensure compliance with securities laws and SEC regulations. The compliance officer must annually prepare and sign a report on the compliance of the rating agency with the securities laws and its own internal policies and procedures, including its code of ethics and conflict-of-interest policies, in accordance with SEC rules. This compliance report must accompany the financial reports of the rating agency that have to be filed with the Commission and must include a certification that the report is accurate and complete.

The legislation removes all references to credit ratings in federal statutes under the jurisdiction of the Committee on Financial Services. The bill directs the agencies to devise a standard of creditworthiness to serve as a substitute for ratings in rules and regulations. [Section 6009]

Currently, nationally recognized statistical rating organizations are those credit rating agencies that are registered with the SEC and, therefore, regulated. Most often, the phrase is shortened to its initials, NRSRO. However, in formal contracts and statutes, the words are spelled out and each word matters. The legislation changes the term to "nationally registered statistical rating organization" wherever it appears in the Securities Act and the Exchange Act. [Section 6005] This was done to indicate that these rating agencies are merely registered and have no nationally-recognized seal of approval.

Rep. Kanjorski attempted to change the language back to "nationally recognized" with a floor amendment, noting that the change would put thousands of contracts in default and upset numerous federal and state regulations. The amendment was defeated. Chairman Frank supports the change to "nationally registered" because the purpose of the name change is to tell investors to use their own judgment rather than completely relying on the rating agencies. Chairman Frank acknowledged that several states and private institutions have imbedded in their statutes the old language. He pledged to meet with various state agencies and pension funds to see if there is some legislative fix short of going back to the old name. [Cong. Record, Dec. 11, 2009, H14752]

The legislation directs the SEC to conduct five separate studies of the regulation of credit rating agencies. First, the SEC must study and report to Congress on the efficacy of creating a system whereby rating agencies are assigned on a rotating basis to issuers and obligors seeking a credit rating. Second, the SEC must study and report to Congress on whether the new requirements have deterred credit rating agencies from registering as NRSROs. A third study must examine the treatment of different classes of bonds (municipal versus corporate) by the rating agencies, including whether there are fundamental differences in the treatment of different classes of bonds that cause some classes of bonds to suffer from undue discrimination. The study must also examine whether there are factors other than risk of loss that are appropriate for the credit ratings agencies to consider when rating bonds and whether those factors vary across different sectors. The study must also look at the differing legal and regulatory regimes governing disclosures for corporate bonds and municipal bonds, as well as the types of financing arrangements used by municipal issuers.

A fourth SEC study and report to Congress must examine the efficacy of implementing a standardized rating system whereby ratings symbols contain multiple characters, each representing a range of default probabilities and loss expectations under standardized and increasingly severe levels of market stress. The fifth study and report must be on the efficacy of standardizing credit ratings terminology so that all credit rating agencies issue credit ratings using identical terms, as well as standardizing the market stress conditions under which ratings are evaluated.

More broadly, the legislation directs the Comptroller General to study and report to Congress and the SEC on alternative means for compensating credit rating agencies that would create incentives for accurate ratings and on any statutory changes needed to facilitate the use of these alternative means of compensation. In addition, the study must examine alternative methodologies to assess credit risk, including market-based measures, as well as the effect of liability in private actions. The GAO study must also examine the effect of liability in private actions arising under the Exchange Act.

Performance Fee Exemption

Investment advisory contracts with qualified purchaser pools are exempt from the Investment Adviser Act's prohibition on performance fees based on a congressional belief that investors in such pools are sophisticated enough to be allowed to enter into a fee arrangement. Advisers Act Section 205(e) gives the SEC greater flexibility to exempt advisory contracts with institutional clients from the ban on performance fees because these clients can appreciate the risks and are in a position to protect themselves from overreaching by the adviser. The statute directs the SEC to consider such factors as financial sophistication, net worth, and amount of assets under management in making exemptive determination. Section 5011 of HR 4173 would amend Section 205(e) to provide that, if the Commission uses a dollar-amount test in connection with such factors, such as a net-asset threshold, the Commission must, within one year after enactment and every five years thereafter, adjust for the effects of inflation on the test. Any adjustment that is not a multiple of $100,000 must be rounded to the nearest multiple of $100,000.

Disclosure Reforms

Title V, Subtitle C, Part 1, imposes various disclosure reforms. As discussed below, these include provisions creating an investment advisory committee, establishing a harmonized fiduciary standard for broker-dealers and advisers, authorizing consumer testing and outreach, and other measures.

Investment Advisory Committee

The Act codifies the Investment Advisory Committee that the SEC recently administratively established to advise the Commission on regulatory priorities, including issues concerning new products, trading strategies, fee structures, and the effectiveness of disclosure; initiatives to protect investor interest; and initiatives to promote investor confidence in the integrity of the marketplace. The membership on the Investor Advisory Committee consists of individuals representing the interests of individual and institutional investors who use a wide range of investment approaches. The advisory panel must meet at least twice a year, and its members will receive compensation for participation in meetings and travel expenses. Funding, as is necessary, is authorized to support the work of the Committee. [Section 7101]

Fiduciary Standard for Broker-Dealers and Advisers

The current regulatory regime treats brokers and advisers differently and subjects them to different standards of care even though the services they provide investors are very similar and investors view their roles as essentially the same. This regime was established during the New Deal and, although amended many times since, remains rooted in the last century. The legislation brings regulation into today's reality and mandates a harmonized federal fiduciary standard for brokers and investment advisers in their dealings with retail customers. In the future, every financial intermediary, such as brokers and investment advisers, that provides personalized investment advice to retail customers will have a fiduciary duty to the investor. [Section 7103]

The SEC must adopt rules providing that the standard of conduct for all brokers and investment advisers is to act in the best interest of their customers without regard to their own financial or other interest. Any material conflicts of interest must be disclosed to the customer, who must consent. However, the Act specifically provides that brokers or dealers are not subject to a continuing duty of care or loyalty to the customer after providing personalized investment advice about securities.

Under this harmonized standard, broker-dealers and investment advisers will have to put customers' interests first. The receipt of compensation based on commissions or fees will not, in and of itself, be considered a violation of the standard applied to a broker or dealer or investment adviser. The legislation defines retail customers as those receiving personalized investment advice from a broker, dealer, or investment adviser for use primarily for personal, family, or household purposes.

The legislation clarifies that the SEC must not define "customer" to include investors in a private fund managed by an investment adviser when that private fund has also entered into an advisory contract with the same adviser. This is designed to prevent advisers from being subjected to an irresolvable conflict of interest when they manage a pooled investment with the interest of each individual investor in mind.

Additionally, the SEC must, to the extent practicable, harmonize its enforcement and remedy regulations across brokers, dealers and investment advisers with respect to the provision of investment advice.

Consumer Testing

Recognizing the benefits that can accrue from field testing and consumer outreach, the legislation clarifies the SEC's authority to gather information (e.g., through focus groups), communicate with investors or other members of the public through telephonic or written surveys, and engage in temporary experimental programs (e.g., pilot programs to field test disclosures). The purpose is to help inform the Commission's rulemaking and other policy functions. [Section 7102]

Accelerated Reporting

With regard to beneficial ownership reporting and short-swing profit reporting, the legislation authorizes the SEC to adopt rules shortening current reporting timeframes and help the markets receive more timely information concerning substantial ownership interests in issuers that may be important for purposes of obtaining the accurate pricing of listed securities. [Section 7105]

Enforcement and Remedies

Title V, Subtitle C, Part 2, addresses SEC enforcement and remedies. As discussed below, these include provisions on arbitration, enforcement actions, information sharing, use of grand jury information, aiding and abetting liability, extraterritorial reach of federal securities laws, and other matters.

Arbitration

Broker-dealers generally require their customers to contract at account opening to arbitrate all disputes. Although arbitration may be a reasonable option for many consumers to accept after a dispute arises, mandating a particular venue and up-front method of adjudicating disputes, and thereby eliminating access to courts, may unjustifiably undermine investor interests.

Thus, the legislation would enable the SEC to restrict or even prohibit the use of mandatory arbitration clauses in contracts with broker-dealers. Mandatory arbitration clauses inserted into brokerage firm contracts will no longer restrict the ability of defrauded investors to seek redress in the courts for wrongdoing. [Section 7201]

Historically, claims for violations of the federal securities laws were considered to be non-arbitrable based on the doctrine enunciated by the U.S. Supreme Court in *Wilko v. Swan* (U.S. Sup. Ct. 1953), 1952-1956 CCH Dec. ¶90,640. In *Wilko*, the Court held that an agreement to arbitrate claims under Section 12(a)(2) of the Securities Act was not enforceable. However, as arbitration gained increasing judicial favor, the Court began to chip away at the *Wilko* doctrine and in 1989 expressly overruled it. The Court ruled that a pre-dispute agreement to arbitrate an investor's securities claims against a brokerage firm was enforceable in view of the strong federal policy favoring arbitration. [*Rodriguez v. Shearson/American Express, Inc*. (U.S. Sup. Ct. 1989), 1989 CCH Dec. ¶94.407]

SEC Enforcement Actions

To expedite cases against violators of securities laws, the SEC will generally have to complete enforcement investigations, compliance inspections and exams within 180 days. [Section 7209] Also, the legislation would allow subpoenas to be served nationwide in SEC enforcement actions in federal court. Currently, the Commission can issue a subpoena only within the federal district where a trial takes place or within 100 miles of the courthouse. Witnesses in civil cases brought by the Commission are, however, often located outside of a trial court's subpoena range. The SEC has nationwide service of process of subpoenas in administrative proceedings. [Section 7210]

The SEC would also be authorized to impose collateral bars against regulated persons. The Commission would have the authority to bar a regulated person who violates the securities laws in one part of the industry, such as a broker-dealer who misappropriates customer funds, from access to customer funds in another part of the securities industry, for example, an investment adviser. By expressly empowering the SEC to impose broad prophylactic relief in one action in the first instance, this provision would enable the SEC to more effectively protect investors and the markets while more efficiently using SEC resources. [Section 7206]

The legislation expressly authorizes the SEC to bring actions against persons formerly associated with a regulated or supervised entity, such as an investment company or an SRO, for misconduct that occurred during that association. This provision closes a loophole in the securities laws that had allowed those who engaged in misconduct while working for an entity regulated by the SEC, like a stock exchange, to resign and avoid being held accountable for their wrongdoing. [Section 7212]

Many provisions of the federal securities laws that authorize the sanctioning of a person who engages in misconduct while associated with a regulated or supervised firm explicitly provide that such authority exists even if the person is no longer associated with that firm. Several provisions, however, do not explicitly address this issue. The legislation amends those provisions that do not explicitly address this issue to make it clear that the SEC, or in applicable cases the PCAOB, may sanction or discipline persons who engage in misconduct while associated with a regulated or supervised firm even if they are no longer associated with that firm.

The legislation streamlines the SEC's existing enforcement authorities by permitting the SEC to seek civil money penalties in cease-and-desist proceedings under federal securities laws. The measure would ensure appropriate due process protections by making the SEC's authority in administrative penalty proceedings coextensive with its authority to seek penalties in federal court. As is the case when a federal district court imposes a civil penalty in an SEC action, administrative civil money penalties would be subject to review by a federal appeals court. [Section 7208]

Information Sharing

The legislation would allow the SEC to share information with domestic regulators, foreign securities regulators, the PCAOB, and state securities agencies engaged in the investigation and prosecution of violations of applicable securities laws without waiving any privileges the SEC may have with respect to such information. [Section 7213] The language is modeled on a provision in the Federal Deposit Insurance Act that enables the federal bank regulatory agencies to share information with other regulators without waiving their privileges with respect to such information. Also, the SEC cannot be compelled to disclose privileged information obtained from any foreign securities regulator or law enforcement authority if such authority has in good faith determined that the information is privileged.

Use of Grand Jury Information

Under existing law, the SEC may access grand jury information only in the rare case in which it can demonstrate that it has a particularized need for the information and that the information is sought preliminarily to or in connection with a judicial proceeding. As a practical matter, the particularized need standard and the required nexus with an ongoing or imminent judicial proceeding severely limit the situations in which the Department of Justice can share with the SEC even the most critical information relevant to parallel investigations.

In most cases, the SEC must therefore conduct a separate, duplicative investigation to obtain the same information. This both entails an inefficient use of government resources and frequently burdens private parties and financial institutions with the need to provide essentially the same documents and testimony in multiple investigations. The need for the SEC to conduct a separate investigation also can result in substantial delays. The legislation works a narrow modification of the grand jury secrecy rule to aid the SEC in its investigations and greatly enhance the efficient use of the law enforcement resources devoted to those investigations. [Section 7214]

This modification is modeled on Section 964 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 providing banking and thrift regulators with access to grand jury information. The legislation authorizes government attorneys to seek

court authorization to release certain limited grand jury information to SEC personnel for use in matters within the SEC's jurisdiction.

The legislation permits the sharing of information only with regard to conduct that may constitute violations of the federal securities laws. With regard to that information, however, the measure lessens the burden in obtaining court approval. The court could approve the sharing of the information upon a showing of a substantial need in the public interest rather than the higher particularized need standard. In addition, the judicial proceeding requirement would not apply to the SEC, permitting information to be shared at an earlier stage in an investigation and in connection with an SEC administrative proceeding.

Aiding and Abetting

The current law for determining aiding and abetting violations and the scope of primary liability remains unsettled, resulting in challenges for the SEC in charging people who play substantial roles in fraud cases. Specifically, the Exchange Act provides that the SEC can prosecute people for knowingly aiding and abetting securities fraud. A growing number of courts, however, have held that knowingly means actual knowledge, rather than recklessness, resulting in a standard that is higher for aiding and abetting violations than for the primary fraud violation, which would include recklessness. HR 4173 clarifies that recklessness is sufficient for bringing an aiding and abetting action, thus harmonizing the standard for aiding and abetting and the primary violation. Thus, the SEC would not be at a disadvantage charging someone as an aider and abettor rather than a primary violator. [Section 7215]

The Exchange Act and the Investment Advisers Act presently permit the SEC to bring actions for aiding and abetting violations of those statutes in civil enforcement actions. The House legislation would authorize the SEC to bring similar actions for aiding and abetting violations of the Securities Act and the Investment Company Act. In addition, the legislation would clarify that the knowledge requirement to bring an aiding and abetting claim can be satisfied by recklessness. HR 4173 also clarifies that the Investment Advisers Act expressly permits the imposition of penalties on aiders and abettors.

International Reach of Securities Laws

The rapid globalization of financial markets in recent years has cast into stark relief issues surrounding the international reach of U.S. securities laws. Since the federal securities laws are silent on their international reach, federal courts have developed tests, including the conduct test, which focuses on the nature of the conduct within the United States as it relates to carrying out the alleged fraudulent scheme.

The legislation authorizes the SEC and the United States to bring civil and criminal law enforcement proceedings involving transnational securities frauds, which are securities

frauds in which not all of the fraudulent conduct occurs within the United States and not all of the wrongdoers are located domestically. Specifically, the legislation would amend the Securities Act and the Exchange Act to provide that U.S. district courts have jurisdiction over violations of the antifraud provisions that involve a transnational fraud if there is conduct within the United States that constitutes significant steps in furtherance of the violation, even if the securities transaction occurs outside the United States and involves only foreign investors. [Section 7216]

SEC Funding and Authority

Title V, Subtitle C, Part 3, would double SEC funding over the next five years from $1.115 billion in fiscal year 2010 to $2.25 billion in fiscal year 2015. This will enable the SEC to hire additional staff with industry expertise. In total, nearly $10 billion over the next six years will help the SEC better oversee the multi-trillion dollar securities markets. The Senate legislation would make the SEC a self-funded agency through the transaction and registration fees it collects. [Section 7301]

In addition, the SEC will obtain additional funding via assessments on investment advisers. The legislation authorizes the SEC to create a new user fee paid by investment advisers to support the Commission's work related to the inspection and examination of investment advisers. Broker-dealers currently pay fees to FINRA to cover the costs of their primary regulator, but investment advisers do not pay such fees to the SEC, which serves as their front-line regulator. [Section 7302]

In addition, the examination statistics of investment advisers and broker-dealers reveal disparities and further vulnerabilities in the present regulatory framework. Last year, the SEC examined only nine percent of investment advisers, while FINRA examined more than 50 percent of broker-dealers. This new fee would help to increase the resources available at the SEC to inspect investment advisers and better protect investors.

In assessing the fee, the Commission must consider several factors, including the size of the adviser and the number and types of its client. The SEC may retain any excess fees imposed in one year for application in future years. Fee increases are not subject to judicial review.

The legislation also provides and clarifies several important rulemaking authorities. The SEC will now regulate and establish formal rules for municipal financial advisors.

There is currently no requirement that mutual funds hold liquid securities. The legislation allows the SEC to impose limits on illiquid investments by mutual funds.

The securities lending program of AIG greatly contributed to its downfall. The legislation authorizes the SEC to regulate stock loans and borrowing in order to enhance market transparency, reduce collateral risk exposures, and limit conflicts-of-interest in the

securities lending process. The SEC would have broader authority to collect information from and coordinate with foreign regulatory bodies, as well as to pursue legal cases across national borders. [Section 7401]

The legislation would also expand the scope of securities that must be reported to the SEC or its designee under the Lost and Stolen Securities Program, to include cancelled, missing or counterfeit securities certificates. [Section 7402]

For many years the SEC has relied on Exchange Act Section 20(a), which imposes joint and several liability on control persons unless they can establish an affirmative defense. Recent court decisions, however, have concluded that the provision is available only to private parties. The legislation clarifies that the SEC may once again impose joint and several liability on control persons unless they can establish an affirmative defense. [Section 7220]

Several of the Exchange Act's antifraud provisions apply only to those transactions that involve securities registered on an exchange. Congress believes that, in today's trading environment, the same standards should apply to transactions whether they involve securities registered on an exchange or not registered on an exchange. Thus, the legislation broadens the SEC's authority under several sections of the Exchange Act to also apply the antifraud provision to securities transactions not conducted on exchanges. The SEC's existing antifraud rulemaking powers would be expanded to cover short sales in the over-the-counter markets and of non-equity securities, as well as all options on securities. Government securities are excluded in order to avoid any possible impact of SEC rules on that market. The general antifraud provisions for these transactions would continue to apply. [Section 7221]

Since 1975, the SEC has had the authority to examine all the records of broker-dealers and other persons registered under the Exchange Act, as well as all records of advisers registered under the Investment Advisers Act. The SEC's authority to examine registered investment companies, however, has remained limited to required records. The legislation would change the authority under the Investment Company Act to apply to all records and, by fixing this anomaly, allow the SEC to gain a better understanding of the operations of investment companies. [Section 7219]

The legislation also amends the Exchange Act, the Investment Company Act, and the Investment Advisers Act to subject registered individuals and firms to whatever reasonable periodic, special or other information and document requests that the SEC, by rule or order, deems necessary or appropriate to conduct surveillance or risk assessments of the securities markets. [Section 7218]

The legislation also authorizes the SEC to require that registered management investment companies provide and maintain a bond against losses caused by any officer or employee of the company or any officer or employee of the company's investment adviser. [Section 7217]

Other SEC Reforms

Title V, Subtitle C, Part 4 would mandate other Commission reforms. As discussed below, these include provisions requiring a study on employment of former SEC staff by regulated firms, mandating the equal treatment of SRO rules, requiring testimony on accounting issues, establishing a forum on financial reporting, permitting greater state regulation of investment advisers, imposing new custodial requirements on advisers, mandating improved notice to missing shareholders, instituting greater short-sale disclosure, and other reforms.

Revolving Door

In an effort to address the revolving door problem, the legislation directs the U.S. Comptroller General to conduct a study to review the number of SEC employees who leave the Commission to work for financial institutions regulated by the SEC and file a report within one year with Congress. The report must review the length of time these employees work for the SEC before they leave to work for regulated financial institutions. [Section 7414]

Importantly, the Comptroller General must determine if greater restrictions are needed to prevent SEC employees from joining regulated firms when they leave the Commission. It must also determine whether the number of former SEC employees going to the industry has led to SEC enforcement inefficiencies. The Burgess Amendment struck out language requiring the report to identify any information-sharing engaged in by SEC employees while they worked for the Commission because the definition of "information" is not sufficiently clear. For example, if an SEC staff member shared information as basic as the date of a meeting on a calendar, he or she might otherwise be considered a part of the SEC revolving door.

The Burgess Amendment gets to the heart of the issue, which is to find those who have circumvented federal regulations without ensnaring those who have basic and nonessential information. Rep. Burgess likened this to the innocent-spouse provision in the IRS statutes. If someone simply shares a page from a calendar, for example, that does not or should not make the person part of the revolving door that Congress seeks to prevent with the underlying language of the bill. [Cong. Record, Dec. 10, 2009, H14737]

Self-Regulatory Organizations

Exchange Act Section 29(a) voids any condition, stipulation or provision binding any person to waive compliance with any provision of the Exchange Act, any rule or regulation under it or any rule of an exchange. The legislation would extend this safeguard to the rules of FINRA and registered clearing agencies. [Section 7404] This change is consistent with provisions of the Exchange Act that encourage allocation of self-regulatory responsibilities among SROs to avoid overlapping and duplicative

regulation. The change is particularly important now that FINRA has taken over the regulation of NYSE members' conduct in relation to customers.

The legislation also amends the Exchange Act to require fingerprinting of the personnel of registered securities information processors, national securities exchanges, and national securities associations. This change would bring these entities in line with the entities already listed in the statute, and would aid in ensuring that the entities are aware of whether their employees have criminal backgrounds. [Section 7403]

Testimony on Accounting

To reduce the complexity of financial reporting and to provide more accurate and clear financial information to investors, the legislation requires the chairs of the PCAOB, the SEC and the FASB to testify annually before Congress on accounting and auditing issues. The testimony must discuss the reassessment of complex and outdated accounting standards. The agency chairs must additionally discuss how to improve the understandability, consistency and overall usability of the existing accounting and auditing literature. Congress also wants information on how the development of principles-based accounting standards is progressing. In addition, there must be a discussion of how to encourage the use and acceptance of interactive data, as well as efforts to promote disclosures in plain English. [Section 7407]

This provision represents an assertion of congressional oversight of accounting and auditing standard-setting and will help Congress reassess complex accounting standards and improve the understandability of financial statements, as well as encourage the acceptance of interactive data. At the same time, the legislation will encourage U.S. regulators and standard-setters to fulfill their own roles and initiatives to achieve greater transparency, promote greater uniformity, and reduce complexity in financial reporting, not only domestically but also globally.

Financial Reporting Forum

The legislation also establishes a Financial Reporting Forum composed of, among others, the chairs of the SEC, FASB and the PCAOB, to meet at least quarterly and discuss issues critical to financial reporting. The Forum must report annually to Congress detailing any determinations or findings, including any legislative recommendations related to financial reporting. Other members of the Forum must include representatives of the auditor, investor and financial institution communities, as appointed by the SEC. [Section 7417]

State Regulation of Advisers

The legislation could move the regulation of thousands of investment advisers from the SEC to the states by raising the assets under management trigger for federal regulation

from $25 million to $100 million and authorizing the SEC to move it even higher. The Act sets up state oversight of investment advisers with up to $100 million in assets under management. The $25 million trigger for state regulation was set in the National Securities Markets Improvement Act of 1996. [Section 7418]

As part of the 1996 Act, Congress determined that the SEC should regulate larger investment advisers while states should oversee smaller advisers. The legislation would eliminate any remaining application of federal law to investment adviser firms that the states now solely regulate.

If no state in which an investment adviser is registered conducts examinations of advisers, the adviser must register with the SEC. If an adviser would have to register with five or more states, then the adviser may maintain its registration with the SEC.

Custodial Requirements

Section 7419 requires those who advise and manage large amounts of money on behalf of others either to employ an independent custodian to hold those assets or to have an independent reviewer verify the accuracy of statements to investors. This requirement is designed to give investors peace of mind that their statements reflect actual funds.

Specifically, the legislation directs the SEC to adopt a rule making it unlawful under Advisers Act Section 206(4) for an investment adviser to have custody of a client's funds or securities in excess of $10 million unless the funds or securities are maintained with a qualified custodian either in a separate account for each client under the client's name, or in accounts that contain only client funds and securities under the name of the investment adviser as agent or trustee for the client. In addition, the qualified custodian must not provide investment advice with respect to these funds or securities.

The rule must include any exceptions that the SEC determines are in the public interest and consistent with investor protection. Any exemption granted must ensure that at least once per year, a client receives a report from an independent entity with a fiduciary responsibility to the client to verify that the assets in the client's account are in accord with those stated on the client's account statement.

The legislation would expand the scope of records to be maintained and subject to examination by the SEC under both the Investment Company Act and the Investment Advisers Act to custodians or others who have custody or use of the investment company's or the investment adviser's clients' securities, deposits or credits.

Notice to Missing Shareholders

The legislation mandates enhanced due diligence for the delivery of dividends and other valuable property rights to missing shareholders. The SEC must adopt rules requiring that paying agents provide a single written notification to each missing shareholder that the shareholder has been sent a check that has not yet been negotiated. The written notification may be sent along with a check or other mailing but must be provided no later than seven months after the sending of the not-yet-negotiated check. There is a de minimis exclusion from the notification requirement for checks of less than $25. Also, the notification requirement will have no effect on state escheatment laws. [Section 7421]

Under the SEC rules to be adopted, a shareholder will be considered missing if a check is sent to that person and the check is not negotiated within six months, or before the paying agent sends the next regularly-scheduled check, whichever comes first. The term "paying agent" includes any issuer, transfer agent, broker, dealer, investment adviser, indenture trustee, custodian or any other person that accepts payments from the issuer of a security and distributes the payments to the holders of the security.

Short Sales

The legislation implements several reforms of the short sale process, pursuant to the Managers' Amendment to HR 4173. The legislation requires every institutional investment manager effecting a short sale of an equity security to file a daily report with the SEC in such form as the Commission prescribes. The report must include the name of the institution, the name of the institutional investment manager, the title, class, CUSIP number, number of shares or principal amount, aggregate fair market value of each security, and any additional information requested by the Commission. Also, the SEC must adopt rules providing for the public disclosure of the name of the issuer and the title, class, CUSIP number, and the aggregate amount of the number of short sales of each security following the end of the reporting period. At a minimum, this public disclosure must occur every month. [Section 7422]

In addition, every SEC-registered broker or dealer must notify its customers that they may elect not to allow their fully paid securities to be used in connection with short sales. Moreover, broker-dealers using a customer's securities in connection with short sales must notify the customer that the firm may receive compensation in connection with lending the customer's securities. The Commission, by rule, may prescribe the form, content, time and manner of delivery of any required notice.

SRO Rule Changes

Exchange Act Section 19(b)(1) provides that SROs must file any proposed rules or changes to existing rules with the SEC, which in turn must publish notice of the proposed

rule or rule change. The legislation amends Section 19(b)(2) to provide that the SEC must, within 35 days of publication of notice (or up to 90 days if the SRO consents) approve the proposed rule change or begin proceedings to determine if the proposed rule change should be disapproved, including notice of the grounds for disapproval under consideration and an opportunity for a hearing. At the conclusion of the proceeding, which must occur within 200 days of the receipt of a proper filing, the SEC must approve or disapprove the proposed rule change. The Commission may extend the time for concluding the proceedings by up to 60 days if it finds good cause for the extension and publishes its reasons for so finding, or for such longer period to which the SRO consents. [Section 7423]

The Commission must approve an SRO proposed rule change if it finds that the proposed change is consistent with the requirements of the Exchange Act and the rules and regulations adopted under it. The Commission must disapprove a proposed SRO rule change if it does not make such a finding. The SEC cannot approve any proposed rule change prior to the 30th day after publication of notice of its filing, unless the Commission finds good cause for so doing and publishes its reasons.

FINRA Amendment

The Cohen Amendment stripped a provision out of the legislation that would have authorized the SEC to delegate the regulation of investment advisers to FINRA. The provision had been inserted during the bill mark-up by the Financial Services Committee. Offered by Committee Ranking Member Spencer Bachus, the amendment would have allowed the SEC to permit or require FINRA to enforce compliance by its members and associated persons with the provisions of the Act. The Bachus Amendment would have empowered FINRA to enforce the fiduciary duty provisions in the Investment Advisers Act against not only broker-dealer members but also against any affiliated investment advisory firm or any associated person. Additionally, the amendment would have given FINRA sweeping rulemaking authority. The provision would have extended FINRA's jurisdiction to SEC registered investment advisers that manage almost 80 percent of all advisory firms' assets under management.

The House declined to outsource a core mission of the SEC to an SRO out of concern that the high level of investor protection provided under the Advisers Act would be diminished if FINRA were to obtain the additional authority. The SEC must remain the proper, independent regulator of investment advisers because the Commission is in the best position to oversee advisers under the Investment Advisers Act.

SEC Commissioner Luis Aquilar had earlier rejected the main argument in favor of putting oversight in the hands of an industry self-regulator, which is that the SEC lacks resources. The issue of resources masks the real situation, he said, since no private organization has the existing resources to expand investment adviser oversight. No one can suggest that FINRA will oversee advisers using the budget and staff it has in place. Instead, the investment advisers will need to be assessed a bill for this additional

oversight. And if advisers have to write a check to someone, he noted, it makes much more sense for that check to go to the SEC since the Commission already has the team and expertise in place. This issue really boils down to whether Congress will enhance the SEC by strengthening its authority and resources, including fees from advisers, or weaken the Commission by transferring its direct oversight powers to an industry organization.

Sarbanes-Oxley Amendments

Title V, Subtitle C, Part 6, would amend the Sarbanes-Oxley Act of 2002. As discussed below, the changes would, among other things, subject auditors of broker-dealers to PCAOB oversight, exempt small businesses from internal controls reporting, strengthen the SEC's power to recover funds for investors, and improve existing whistleblower protections.

PCAOB Reforms

Closing a statutory loophole revealed by the Madoff scandal, the Public Company Accounting Oversight Board will gain the power needed to examine the auditors of broker-dealers. Thus, the legislation would bring auditors of broker-dealers under the PCAOB oversight regime. The Board will inspect the audit reports on broker-dealer financial statements and will have investigatory, examination and enforcement authority over the auditors of broker-dealers. In addition, brokers and dealers would be brought into the Board's funding scheme by paying a fee allocation in proportion to their net capital compared to the total net capital of all brokers and dealers that are not issuers, in accordance with the rules of the Board. The Act also authorizes the Board to refer an investigation concerning a broker or dealer's audit report to the relevant self-regulatory organization. Moreover, the Board is authorized to share with the SRO all information and documents received in connection with an investigation or inspection without breaching its confidential status. [Section 7601]

The legislation specifically provides that the Board may, by rule, conduct and require a program of inspections of registered public accounting firms that provide one or more audit reports for a broker or dealer. In establishing such a program, the Board may allow for differentiation among classes of brokers and dealers. If the Board decides to establish an inspection program, it must consider in establishing any inspection schedules whether differing schedules would be appropriate with respect to registered public accounting firms that issue audit reports only for one or more brokers or dealers that do not receive, handle or hold customer securities or cash or are not members of the Securities Investor Protection Corporation. Further, a public accounting firm need not register with the Board if the firm is exempt from the inspection program that may be established by the Board.

The House legislation would also change the name of the Public Company Accounting Oversight Board to "Auditor Oversight Board." [Section 7610] In addition, the Act would create an ombudsman within the Board to act as a liaison between the Board and registered accounting firms and issuers with regard to the issuance of audit reports. [Section 7609]

The Act would also allow the Board to share information with foreign regulatory and law enforcement agencies engaged in the investigation and prosecution of violations of applicable accounting and auditing laws without waiving any privileges the SEC may have with respect to that information. The information sharing is conditioned on the foreign auditor oversight authority providing any assurances of confidentiality that the Board determines appropriate.

In addition, the legislation would enhance the PCAOB's ability to access the audit work papers and audit documentation of foreign public accounting firms when they perform audit work or other material services on which a registered public accounting firm relies in conducting an audit. This statutory change will resolve international conflicts that have impaired the Board's ability to fulfill its statutory obligation to inspect non-U.S. registered public accounting firms.

The Act provides that the foreign public accounting firm must be subject to the jurisdiction of the U.S. federal courts for purposes of enforcing a Board request for audit documentation. Any foreign accounting firm that issues an audit report, or performs audit work or other material services on which a registered accounting firm relies in the conduct of an audit, must designate to the SEC or the Board a U.S. agent upon whom may be served any papers in any action brought to enforce this section or any request by the SEC or Board under this section.

In addition, any registered accounting firm that relies on the work of a foreign accounting firm in issuing an audit report or performing audit work must produce the foreign firm's audit work papers and all other audit documents related to any such work in response to a request for production by the Board. The accounting firm must also obtain the agreement of the foreign accounting firm to production of the documentation at Board request as a condition of its reliance on the work of the foreign firm.

Internal Controls

The Act exempts small businesses from the internal control audit attestation reporting requirements contained in Section 404(b) of the Sarbanes-Oxley Act. The SEC has repeatedly extended the deadline for non-accelerated filers to begin providing audited assessments of their internal controls over financial reporting. HR 4173 would make the exemption permanent for companies with less than $75 million in market capitalization. [Section 7606]

Disgorgement Fund

The Fair Fund provisions of the Sarbanes-Oxley Act take the civil penalties levied by the SEC as a result of an enforcement action and direct them to a disgorgement fund for harmed investors. The legislation would increase the money available to compensate defrauded investors by revising the Fair Fund provisions to permit the SEC to use penalties to recompense victims of the fraud even if the SEC does not obtain an order requiring the defendant to disgorge ill-gotten gains. Currently, in some cases, a defendant may engage in a securities law violation that harms investors, but the SEC cannot obtain disgorgement from the defendant because the defendant did not personally benefit from the violation. [Section 7605]

Whistleblower Protections

The legislation authorizes the SEC to establish a fund to pay whistleblowers for information that leads to enforcement actions resulting in significant financial awards using funds collected in enforcement actions not otherwise distributed to investors. The SEC currently has such authority to compensate sources in insider trading cases, and this provision would extend the Commission's power to compensate whistleblowers that bring substantial evidence of other securities law violations. SEC determinations on whistleblower awards are final and not subject to judicial review. [Section 7203]

The legislation also closes a loophole in Sarbanes-Oxley Act whistleblower protection by including any subsidiary or affiliate of company whose financial information is included in the consolidated financial statements of the company. Sarbanes-Oxley created federal whistleblower protections for employees when they disclose information about fraudulent activities within their companies. The Act would eliminate a defense now raised in a substantial number of actions brought by whistleblowers and apply the Sarbanes-Oxley whistleblower protections to both companies and their subsidiaries and affiliates. [Section 7607]

A letter from Senator Patrick Leahy, author of the Sarbanes-Oxley whistleblower statute, to the Department of Labor emphasized that federal whistleblower protection extends to employees of subsidiaries of companies and that the DOL should not interpret the statute to exclude employees working for company subsidiaries.

Other Investor Protections

Title V, Subtitle C, contains various other investor protections. As discussed below, these include provisions amending the Securities Investor Protection Act, requiring a post-Madoff report and mandating certain protections for seniors.

SIPA Amendments

The $65 billion Madoff fraud also exposed faults in the Securities Investor Protection Act of 1970 (SIPA), the law that returns money to the customers of insolvent fraudulent broker-dealers. The legislation fixes these shortcomings. The legislation increases the Securities Investor Protection Corporation (SIPC) cash advance limits to levels of coverage that are similar to those provided by the FDIC. Currently, under SIPA, any amount advanced in satisfaction of customer claims may not exceed $500,000 per customer. If part of the claim is for cash, the total amount advanced for cash payment must not exceed $100,000. The legislation increases the maximum cash advance amount to $250,000 and authorizes SIPC, subject to the approval of the SEC, to make inflationary adjustments every five years to that amount starting in 2010. [Section 7503]

The Act also updates SIPA to increase the minimum assessments paid by members of the Securities Investor Protection Corporation to the SIPC Fund. Currently, SIPA provides that the minimum assessment of a SIPC member must not exceed $150 per year, regardless of the size of the SIPC member. The Act strikes this current minimum assessment level and sets a new minimum assessment at 2 basis points of a SIPC member's gross revenues. [Section 7501]

The Act would extend SIPC insurance to futures positions held in a customer portfolio margining account under a program approved by the SEC. This provision is intended to address the possibility that current law would treat a portfolio margining customer as a general creditor with respect to the proceeds from such customer's futures positions, while the same portfolio margining customer would have priority for their securities holdings in the case of insolvency of their broker-dealer. [Section 7509]

Post-Madoff Report

Within six months, the SEC must report to Congress describing the implementation of reforms in the wake of the Madoff fraud. The report must include an analysis of how many post-Madoff reforms have been implemented and how extensively. The SEC must publish the report on its website. [Section 7306]

Senior Investors

Title V, Subtitle C, Part 7 would create a new grant program to provide states with the tools they need to prosecute securities fraud against seniors. The legislation recognizes the harm to seniors posed by the use of misleading professional designations by salespersons and advisers and establishes a mechanism for providing grants to states designed to give them the flexibility to use funds for a wide variety of senior investor protection efforts, such as hiring additional staff to investigate and prosecute cases;

funding new technology, equipment and training for regulators, prosecutors, and law enforcement; and providing educational materials to increase awareness and understanding of designations. ❒

About the Author

James Hamilton is a Principal Analyst at Wolters Kluwer Law & Business, a leading provider of corporate and securities information, and a prolific blogger (Jim Hamilton's World of Securities Regulation, at http://jimhamiltonblog.blogspot.com). Hamilton has been tracking, analyzing and explaining securities law and regulation for nearly 30 years as an analyst for CCH. He has written and spoken extensively on federal securities law and has been cited as an authority by a federal court. His analysis of the Sarbanes-Oxley Act, the *Sarbanes-Oxley Manual: A Handbook for the Act and SEC Rules*, is considered a definitive explanation of the Act. His other works include the popular guidebook *Responsibilities of Corporate Officers and Directors under Federal Securities Law*, the *Guide to Internal Controls*, and the monthly newsletter *Hedge Funds and Private Equity: Regulatory and Risk Management Update*. In addition to his many books and articles, Hamilton serves as a leading contributor to the industry-standard publication, the *CCH Federal Securities Law Reporter*. Hamilton received an LL.M. from New York University School of Law.

If you would like to post this white paper on your firm's intranet site, please contact Randy Kaplan at randy.kaplan@wolterskluwer.com or call 212-771-0866.

We welcome any and all inquiries to share or republish this material.