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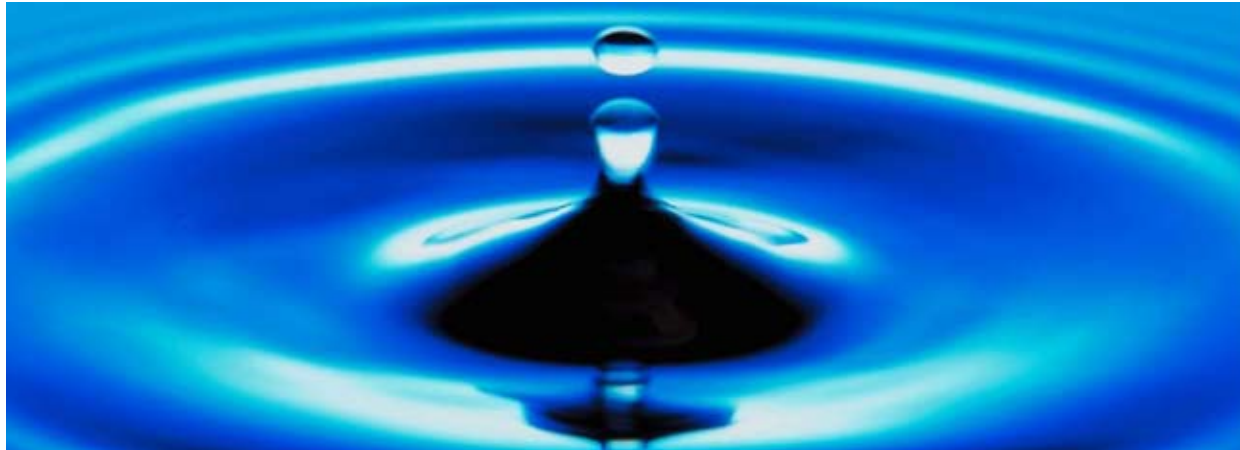
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News Bulletins: Banking

Changes to Credit Card Rules

On May 22, 2009, President Obama signed the Credit Card Accountability, Responsibility & Disclosure Act ("CARD Act or the Act").¹ This legislation implements significant changes relative to consumer protection when obtaining and/or using credit cards. The Act includes five sections: Consumer Protection, Enhanced Consumer Disclosures, Protection of Young Consumers, Federal Agency Coordination, and Miscellaneous Provisions. Much of the legislation will have a direct impact on Regulation Z, Truth-in-Lending, which is promulgated by the Federal Reserve Board of Governors. Changes to the impacted regulations have not yet been announced.

The CARD Act's three main provisions include numerous prohibitions and requirements. The effective date of the Act is later this year (2009), pending regulatory guidance. Prohibitions include, but are not limited to:

- Increasing Annual Percentage Rates (APRs) without 45 days prior notice
- Applying rate increases retroactively to existing balances

- Raising interest rates or cancelling repayment terms if a cardholder cancels a card
- Imposing interest charges on any portion of a balance that is paid by the due date
- Charging interest on credit card transaction fees, such as late fees and overlimit fees
- Increasing interest rates on cardholders in good standing for reasons unrelated to the cardholder's behavior related to that card

Additional requirements and prohibitions are detailed within the Act. The Act also includes enhanced requirements for disclosures regarding payoff timing, late payment deadlines and penalties, as well as renewal disclosures. If credit is being extended to a person under the age of 21, additional rules would also apply. As the main focus of the CARD Act is to increase consumer protection, the Act also seeks to strengthen the applicability of the Fair Trade Commission's (FTC) Unfair or Deceptive Practices Act by requiring the federal banking agencies to jointly prescribe to the Act and consult with the FTC.

Institutions will likely need to revisit existing credit card practices and disclosures in light of the new legislation and watch for additional guidance from their primary regulator.

FinCEN'S SAR Activity Review

The Financial Crimes Enforcement Network (FinCEN) has released the fifteenth edition of its *SAR Activity Review – Trends, Tips & Issues*² (the "Review") focusing on the securities and futures industry.

The Review is published semi-annually in May and October. With each May issue a different industry or issue is discussed in more detail. The May 2009 issue of the Review emphasized the role and responsibilities of the securities and futures industries. While these industries are relatively new to SAR filing requirements – broker/dealers in securities have been required to report suspicious transactions since 2003; futures commission merchants and introducing brokers in commodities since 2004; and mutual funds since 2006 – law enforcement considers the information gained from this sector, valuable.

An assessment of suspicious activity reports filed by the securities and futures industry

The Securities and Futures Industries SAR filings (SAR-SFs) were reviewed by FinCEN. The period under review, January 1, 2003 through December 31, 2008, specifically focused on money laundering, terrorist financing and other financial crimes. FinCEN staff analyzed SAR-SFs to identify trends and patterns relating to filing volume, type of reporting institution, characterization of suspected activities, and filings by instrument type. Below is a brief discussion of the findings as described in the report.

Filing trends

The annual volume of SAR-SF filings have increased every year since required in 2003. The total number of SARs filed in 2003 was 4,267 increasing to 15,104 in 2008. The total number of SAR filings during the six-year period totaled 53,022.³

Types of reported suspicious activity

The below table depicts the top five characterizations of Suspicious Activity.

Type of Suspicious Activity	Filings	Percentage
Other	17,998	20.64%
Money Laundering/ Structuring	14,637	16.87%
Identity Theft	7,512	8.66%
Significant Wire or Other Transactions Without Economic Purpose	6,700	7.72%
Check Fraud	6,125	7.06%

These five categories represent 61% of all suspicious activity reporting in the SAR-SFs filed since 2003. Narrowed to specific activity the largest increase (95%) was attributed to Credit/Debit Card Fraud, followed by an increase of 60% associated with Mail Fraud.

Filing institutions

The majority of the institutions filing identified themselves as either clearing or introducing brokers or a securities dealer. Institutions, by type, that filed more than 1,000 SAR-SFs during 2008 were:

Type of Institution	Number of SARs Filed
Securities Brokers – Clearing	5,391
Securities Brokers – Introducing	4,626
Securities Dealer	3,469
Investment Company – Mutual Funds	1,874
Affiliate of Bank Holding Company	1,853
Investment Advisor	1,430

Instrument type reported

There was a large number of varying instrument types reported during the assessment period; the most prevalent was cash or cash equivalents. The top five characterizations of suspicious activity reported under cash or cash equivalents were: check fraud, identity theft, money laundering/structuring, significant wire or other transactions without economic purpose, and wire fraud. Where the instrument type was reported as stock, the top characterizations were: computer intrusion, identity theft, market manipulation, securities fraud, and wire fraud.

Suspicious activity review by securities regulators

The SEC and FINRA both examine broker-dealers for compliance with the Bank Secrecy Act and its implementing regulations, as well as for compliance with Rule 17a-8 under the Securities Exchange Act of 1934 and NASD Rule 3011 and NYSE Rule 445. Each year since 2002, the SEC and FINRA have conducted over 2,000 examinations of broker-dealers that have included an AML review.

The examinations focused primarily on four areas:

1. Written policies and procedures
2. Implementation of the written policies and procedures
3. Monitoring for suspicious activity
4. Reporting of suspicious activity

Some of the common examination findings included:

1. Failure to have adequate suspicious activity reporting procedures
2. Failure to identify suspicious customer activity and file SAR-SFs, where required
3. Failure of procedures to clearly set forth the process under which a SAR-SF filing should be made
4. Failure to establish a clear review program including frequency, timing, responsibility, and authority to file a SAR-SF

The complete report can be found at http://www.fincen.gov/news_room/rp/files/sar_tti_15.pdf.

Federal Agencies Propose Rule to Implement SAFE Act Mortgage Loan Originator Registration Requirements

In an effort to provide uniform licensing standards nationwide, create a comprehensive licensing database, improve accountability, track loan originators and enhance consumer protection, the Federal financial institution regulatory agencies (“the Agencies”)⁴ are issuing, for public comment, proposed rules requiring mortgage loan originators who are employees of Agency-regulated institutions to meet the registration requirements of the Secure and Fair Enforcement for Mortgage Licensing Act of 2008 (SAFE Act). The SAFE Act is part of the Housing and Economic Recovery Act of 2008. All states must have a loan originator licensing and registration system in place by July 31, 2009 or July 31, 2010 for legislatures that meet biennially. (A Federal registration system, for mortgage loan originators employed by Agency-regulated institutions, must be implemented by the Agencies by July 29, 2009.) If a state fails to meet the federally mandated minimums and the state is not participating in the Nationwide Mortgage Licensing System and Registry (NMLS&R), the U.S. Department of Housing and Urban Development (HUD) will step in and implement a licensing system for the state.

Registration requirements for Agency-regulated institutions, and the mortgage loan originators employed by them, are established by the proposal. These include the adoption of policies and procedures to ensure compliance with the SAFE Act and final rule. These mortgage loan originators must also obtain a unique identifier through the Registry that will remain with that originator regardless of changes in employment. The unique identifiers can be used by consumers to access

employment and other background information of registered mortgage loan originators when the system is fully operational. The proposal also requires these mortgage loan originators to provide their unique identifiers to consumers in certain circumstances and Agency-regulated institutions to make them available to consumers.⁵

The SAFE Act of 2008 requires all applicants registering as mortgage loan originators and employed by Agency-regulated institutions to furnish specific information such as fingerprint submission to the FBI and any other governmental agency authorized to receive such information for a state and national criminal background check. The applicant must provide personal history, experience and authorize the NMLS&R to pull credit on the applicant and obtain any other administrative, civil or criminal information.

Additionally, in order for the loan originator to obtain the license or registration, the loan originator must:

- Not have had a loan originator license revoked from any jurisdiction
- Not have any felonies within seven years of the application date
- Have no felonies related to fraud, dishonesty, breach of trust or money laundering
- Demonstrate financial responsibility, character and general fitness such as to command confidence in the community to show the loan originator will operate honestly, fairly, and efficiently under the SAFE Act
- Complete at least 20 hours of pre-licensing education
- Pass a written test with a score of 75 percent or better covering ethics, federal and state law and regulations, fraud, consumer protection, nontraditional mortgages and fair lending
- Meet either a net worth or surety bond requirement or pay into a state fund

Because modification of the Registry to accept Federal registrations involves complex technical issues, the proposed rule provides for a delay in implementation of the registration requirements until 180 days after the Registry becomes operational and available for initial federal registrations.⁶



News Bulletin: Cross-Sector (Investment Management and Securities)

SEC Reintroduces Short Sale Restrictions

On April 8, 2009 the U.S. Securities and Exchange Commission (SEC) proposed amendments to Regulation SHO⁷ in an effort to restrict current short selling practices.⁸ Short selling, (which “involves a sale of a security that the seller does not own or a sale that is consummated by the delivery of a security borrowed by, or for the account of, the seller,”⁹) has recently been the topic of numerous comments received by the SEC from the general public. The SEC proposal states that “extreme market conditions and a subsequent deterioration in investor confidence”¹⁰ have made it appropriate to consider implementing short sale restrictions. The proposal recognizes that while short selling does have its place in the market, (as it can promote pricing efficiency and liquidity), there are, however, certain aspects of short selling perceived to be abusive by some market participants. At a May 5th SEC roundtable discussion, SEC Chairman, Mary Schapiro stated that she has: “made it a priority to evaluate the issue of short selling regulation and ensure that any future policies are the result of a deliberate and thoughtful process.”¹¹

The proposed amendments to Regulation SHO contain two potential approaches, with each approach having two alternatives.

Short Sale Price Test Restriction Approach

The “Short Sale Price Test Restriction” approach would be applied on a market-wide and permanent basis and would utilize one of the following price-test based alternatives.

1. The first alternative would prevent short selling a security for a price at or below the highest national prevailing bid price for that security. The proposal refers to this alternative as the “Proposed Modified Uptick Rule” and is similar in nature to former

NASD Rule 3350 (bid-test based short sale restriction that applied to NASDAQ listed securities only). NASD Rule 3350 was in place until 2007 when the SEC prohibited Self Regulatory Organizations (SROs) from having price-test based short selling restrictions.

2. The second alternative would prohibit a short sale unless the last sale price of a shorted security ticked one penny higher. The proposal refers to this alternative as the “Uptick Rule” and is similar in nature to the former SEC Rule 10a-1 (the SEC’s first short sale restriction, adopted in 1938, to restrict short selling in a declining market) which was also eliminated in 2007.

Circuit Breaker Approach

The “Circuit Breaker” approach would apply short selling restrictions for a particular security, and only during a severe decline in its stock price. This approach would integrate one of the following alternatives,¹² and would only be in effect for the remainder of the trading day.

1. Under the first alternative, short sales for a particular security would be halted for the remainder of the trading day, following a ten percent¹³ decline in the trading price over the prior day’s closing price.
2. The second alternative is also triggered by a ten percent decline in the trading price of a particular security over the prior day’s closing price, but would involve implementing either the “Proposed Modified Uptick Rule” or “Uptick Rule” restrictions. SEC Release No. 34-59748.

As written, the proposal places a majority of the compliance responsibility on the broker-dealer community. If the SEC decides to move ahead with any of the proposed restrictions, some of the changes firms will be required to embrace involve the implementation of relevant operational and supervisory policies and procedures, modification of applicable software and trading systems, as well as update controls and surveillance mechanisms to appropriately monitor short sale activity. The SEC is proposing that the necessary controls be implemented 90 days from the effective date of the amendments, but is welcoming industry feedback on the appropriateness of this timeline.

The comment period for the proposal ended on June 19, 2009.

The complete text of the SEC proposal is available at <http://www.sec.gov/rules/proposed/2009/34-59748.pdf>. Comments received may be viewed at <http://www.sec.gov/comments/s7-08-09/s70809.shtml>.

Feature Articles: Banking

The Supervisory Capital Assessment Results ¹⁴

The Supervisory Capital Assessment Program (SCAP)¹⁵ was initiated in February 2009, and was intended to assess the capital adequacy of the 19 largest U.S. bank holding companies (BHCs). The purpose of the SCAP was to evaluate whether the BHCs had sufficient capital to withstand further substantial losses if the economy weakened more than expected. All domestic BHCs with assets exceeding \$100 billion, as of December 31, 2008, were required to participate in the SCAP. These BHCs held two-thirds of the assets and more than one-half of the loans in the U.S. banking system.

The purpose of SCAP was to answer the following question for each BHC -- how much additional capital would be needed to have the BHC's Tier 1 Capital risk-ratio in excess of six percent and a risk-based ratio in excess of four percent for Tier 1 Common Capital at year-end 2010. The SCAP was conducted as a two year 'what-if' analysis based on two scenarios:

1. Baseline scenario, e.g. analysis based on the consensus forecasts for the economy as of February 2009
2. More adverse scenario, e.g., analysis based on a deeper and more protracted downturn in the economy

The SCAP results were announced by the participating agencies on May 7, 2009;¹⁶ findings were reported at the individual BHC level and the aggregate results of the 19 BHCs. The SCAP estimated losses and loss rates for select categories of loans and securities,¹⁷ as well as measured the resources available to BHCs to absorb losses, and detailed the necessary capital buffer to withstand further losses. The main focus of SCAP was to assess the level of

Tier 1 risk-based capital ratio and the proportion of the Tier 1 capital that is common equity. SCAP stressed the Tier 1 Common Capital calculation of the participating BHCs, reflecting the notion that common equity is the first element of the capital structure to absorb losses, offering protection to more senior parts of the capital structure.¹⁸

The results indicated that the SCAP results "may not line up with BHCs internal estimates, and they may or may not line up with what the firms themselves or external analysts and researchers might have produced, even using a similar set of basic assumptions"¹⁹ as the SCAP teams²⁰ had the benefit of detailed information collected from each of the 19 BHCs and therefore may draw different conclusions.

After accounting for aggregate losses, revenues and reserve build requirements, SCAP estimated that under the "more adverse" scenario, aggregate losses at the 19 participating BHCs during 2009 and 2010 could reach \$600 billion.²¹ A large part of the estimated aggregate losses, approximately \$455 billion, were from losses on the BHCs' accrual loan portfolio²² (particularly residential mortgages). These losses are consistent with the continued projected drop in residential house prices and the effects of reduced housing prices on household wealth. Residential mortgages and consumer loans (including credit card loans) account for an estimated \$322 billion or 70 percent of the loan losses projected under the "more adverse" scenario.²³ Loss rates on commercial real estate loans, especially related to land developed are also substantially elevated in the "more adverse" scenario, further reflecting potential declines in real estate values. Potential losses from trading-related exposures and securities held in investment portfolios totaled an estimated \$135 billion. The following table details the estimated "more adverse" scenario aggregate loss data from the 19 participating BHCs²⁴:

Loans/Security Type	\$Billions
First Lien Mortgages	\$102.3
Second/Junior Lien Mortgages	\$83.2
Commercial and Industrial Loans	\$60.1
Commercial Real Estate Loans	\$53.0
Credit Card Loans	\$82.4
Securities (AFS and HTM)	\$35.2
Trading and Counterparty	\$99.3
Other	\$83.7
Total Estimated Losses	\$599.2

The SCAP results determined that nine BHCs were found to have sufficient capital levels under the “more adverse” scenario, while the remaining ten BHCs had an aggregate shortfall of \$74.6 billion.²⁵ Per the agencies, each of the ten BHCs with a capital shortfall needed to particularly focus on improving their overall capital position by increasing their Tier 1 Common Capital. At year-end 2008, capital ratios at all 19 BHCs exceeded minimum regulatory capital standards, and in many cases, by substantial margins. Tier 1 Capital at the 19 BHCs totaled approximately \$835 billion in the fourth quarter of 2008. The SCAP assessment showed that many of the BHCs already had substantial capital buffers in place to absorb their share of the estimated \$600 billion in losses. However, even though most banks had substantial capital buffers in place and met minimum regulatory capital standards, the SCAP requires BHC’s to have a significantly larger capital buffer to sustain a “more adverse” economic scenario.

As a result of SCAP, the participating federal agencies required any BHC that has estimated capital deficiencies to develop a detailed plan by June 8th, 2009 to comply with SCAP regulatory requirements. These requirements do not represent a new capital standard and are not expected to be maintained on an ongoing basis. However, to help BHCs absorb larger than expected future losses, and to support the BHC’s ability to serve their customers, regulators are requiring stricter capital standards for two years.²⁶ The plans developed by the BHCs must be approved by the BHCs’ primary regulatory supervisor, after consultation with the FDIC and the Treasury Department, and the BHC must implement the plan by November 9th, 2009. The agencies have recommended the following options for raising regulatory capital:

- Actively seek to raise new capital from outside sources
- Restructure current capital investments, sale of assets, restrictions on dividends and stock repurchases
- Apply to the U.S. Treasury Department for Mandatory Convertible (MCP) under its Capital Assistance Program (CAP), as a bridge to private capital in the future
- Exchange outstanding preferred shares sold under the Capitol Purchase Program (CPP) or Targeted Investment Program (TIP)

Many of the participating BHCs fulfilled their SCAP regulatory capital requirements by selling common

shares.²⁷ As of May 20, 2009, Secretary of the Treasury Timothy Geithner stated that banks identified in stress tests have raised \$48 billion of the \$75 billion required to fill the SCAP capital shortfall.²⁸ Some of the BHCs that were not deemed to have capital deficiencies are taking advantage of the opportunity to raise more regulatory capital by selling common shares²⁹, while other BHCs have used a combination of converting preferred shares to common shares, receiving further government aid and selling assets to meet the SCAP capital requirements.

In a recent speech at the Federal Reserve Bank of Atlanta 2009 Financial Markets Conference, Fed Chair Ben S. Bernanke discussed the results of the SCAP program and stated: “We’ve learned important lessons in the capital assessment process that will inform our supervisory efforts in the future. Notably, the process of comprehensively evaluating 19 major firms represented an important step forward in consolidated supervision, as it gave us insights into the challenges posed in understanding risks and exposures across complex organizations....Whether the objectives of the assessment program were achieved will only be known over time....We hope and expect that the public and investors will take considerable comfort from the fact that our largest financial institutions have been evaluated in a comprehensive and rigorous fashion; and that they will, as a consequence, be required to have a capital buffer adequate to weather future losses and to supply needed credit to our economy—even if the economic downturn is more severe than is currently anticipated.”³⁰

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Informed Consumers: Federal Reserve Board Enhances Early Mortgage Disclosures

The Board of Governors of the Federal Reserve System (“the Board”) recently revised and approved the disclosure requirements for mortgage loans under Regulation Z (Truth in Lending, 12 CFR Part 226). The Board was prompted to review and revise the disclosure as a result of the Housing and Economic Recovery Act of 2008 (enacted in July 2008) which included amendments to the Truth in Lending Act (TILA) known as the Mortgage Disclosure Improvement Act of 2008 (MDIA).³¹ Revisions to



Regulation Z to implement the MDIA amendments will take effect July 30, 2009.

Background on the revised disclosure

In July 2008, the Federal Reserve Board issued a final rule amending and extending the requirements of Regulation Z (Truth in Lending). As the Federal Reserve Chairman Ben S. Bernanke stated, "The proposed final rules are intended to protect consumers from unfair or deceptive acts and practices in mortgage lending, while keeping credit available to qualified borrowers and supporting sustainable homeownership."³² The Board's aim in drafting this rule was to alleviate some of the pressure consumers feel when they are rushed to close on their mortgages. The proposed final rule requires all mortgage lenders to provide early disclosures for consumer's principal dwelling as well as non-purchase closed-end loans. Among other requirements within the July 2008 final rule is a prohibition on creditors imposing any fee on consumers related to early disclosures with the exception of collecting a fee for a credit report.

On the same day the board issued the final rule on Regulation Z, the U.S. Congress passed the MDIA, making amendments to TILA. The MDIA addressed many of the same requirements that were made in the July 2008 final rule. Additionally, the MDIA expanded certain conditions and specifications that were not addressed in the rulemaking. For example, the MDIA extended the requirements that creditors must provide early disclosures for all dwelling-secured mortgage loans;³³ prior to that, early disclosures were only required for residential loans financed through purchase or initial construction of a consumer's principal dwelling.

Comments on MDIA

On December 5, 2008, the Federal Reserve Press published the revisions to TILA for public comment.³⁴ Financial institutions, as well as consumers, posted responses supporting the efforts to implement MDIA. While many recognized the benefits of the MDIA's goal of providing accurate disclosure of credit to consumer's terms in a timely manner, some were doubtful of the delays of finalizing a mortgage transaction. Specifically, there were comments noting that timing requirements needed to be flexible to accommodate all situations and circumstances, and the waiting periods could hinder such transactions.

Final regulations implementing MDIA

The Board has approved the following regulations and revisions implementing MDIA, which will take effect July 30, 2009.³⁵

Coverage of early disclosure

- Covers loans secured by dwellings other than the consumer's principal dwelling
- Creditors must give consumers early disclosures in connection with a dwelling secured mortgage loan that is subject to the Real Estate Settlement Procedures Act (RESPA), regardless of whether or not the purpose of the loan is to finance the purchase or initial construction of the consumer's principal dwelling³⁶
- Disclosure must include language informing consumers that they are not obligated to complete the transaction simply because they applied for the loan or received early disclosures

Waiting periods for disclosure

- Creditors must mail the early disclosures within three business days after receiving a consumer's application or before consummation, whichever is earlier
- Creditors must wait seven business days after they provide the early disclosures before closing the loan

Waiting period for corrected disclosure

- Creditors must provide new disclosures with a revised annual percentage rate (APR) and wait an additional three business days before settlement date, if a change occurs that makes the APR in the early disclosures inaccurate beyond a specified tolerance

Waiver of waiting period before closing

- If a consumer determines that an extension of credit is needed to meet a bona fide personal financial emergency such as foreclosure, the consumer may waive or shorten the waiting period before closing

Timeshare transactions

- The waiting period for a corrected disclosure does not apply to timeshare transactions
- Creditors must make good faith estimates of the disclosures within three business days after receiving the consumer's application.

Items pending review

- MDIA provisions regarding variable-rate transactions will not become effective until January 30, 2011
- Disclosure requirements are only for closed-end loans and not open-end credit plans secured by dwelling; the Board is currently reviewing the comments received regarding these loans
- A proposal will be underway later in 2009 to address the timing of the Home Equity Lines of Credit disclosures

The implementation of MDIA facilitates a more efficient, informed, and straightforward mortgage process. Some institutions already provide mortgage borrowers early loan disclosure; these consumers have been given time to review all documentation prior to closing. This alleviates some of the pressure consumers feel when they are rushed to close on a mortgage. The MDIA advances this goal for all consumers.

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Feature Articles: Investment Management

Private Investment Fund Regulation in a Changing Environment

The regulatory future for hedge funds, private equity funds, venture capital funds, and real estate funds (collectively, "private funds") is in flux as federal and state governments propose various legislative initiatives. As new developments occur in the economic environment, lawmakers face mounting pressure to enhance regulatory oversight of asset managers and financial markets in general. According to White House Press Secretary Robert Gibbs, the Obama Administration has "demonstrated its commitment to leadership in this endeavor by rolling out as strong a set of financial regulations as any country has proposed -- as well as a commitment to get

them through Congress this year...we won't just be speaking about this stuff, we'll be acting on it. We'll address hedge funds and derivatives as part of regulation."³⁷

Up to this point, private funds have generally been able to operate with minimal regulatory oversight.³⁸ Participation in private funds has historically been limited to experienced, wealthy, and sophisticated investors, thus seemingly justifying minimal government protection and enabling such funds to take on greater risk.³⁹ In the past, initiatives to regulate private funds were primarily directed toward hedge funds. Specifically, in 2004, the U.S. Securities and Exchange Commission (SEC) adopted the Hedge Fund Adviser Registration Rule, Rule 203(b)(3)-2 under the Investment Advisers Act of 1940 (the "Advisers Act"). The rule, which was vacated by a court decision in June 2006, required hedge funds with fifteen or more "shareholders, limited partners, members or beneficiaries" to register with the SEC.⁴⁰ As an increasing number of pension funds, university endowments, and retail investors – through fund of funds structures - invest in private funds, the impact of such funds on the overall financial system has grown, and lawmakers have broadened their focus beyond hedge funds to include all private funds.⁴¹ There has been growing concern surrounding the lack of regulation around these private investment vehicles due to their growing popularity among investors and the apparent risk that large, interconnected firms may pose to the financial system.⁴²

On January 29, 2009, U.S. Senators Charles Grassley (R-IA) and Carl Levin (D-MI) introduced the Hedge Fund Transparency Act (the "Transparency Act"). The Transparency Act, among other mandates, would require certain private funds to register with the SEC pursuant to the Investment Company Act of 1940 (the "Investment Company Act").⁴³ The Transparency Act seeks to increase the oversight and regulation of hedge funds and other private investment vehicles while also enhancing their transparency.⁴⁴

In a joint statement announcing the Transparency Act, Senators Grassley and Levin cited the lack of transparency by financial institutions as a cause of the ongoing financial crisis.⁴⁵ According to Senator Grassley, "because of their ownership, size and reach, their clientele, and the high-risk nature of their investments, the failure of a hedge fund today can imperil not only its direct investors, but also the financial institutions that own them, lent them money, or did



business with them. From there, the effects can ripple through the markets and impact the entire economy."⁴⁶

The Transparency Act would cause private funds with managed assets greater than \$50 million to register under the Investment Company Act and to become subject to specific disclosure requirements.⁴⁷ Although certain private fund managers voluntarily register as advisers with the SEC, private funds are not registered. Private funds issue securities in "private offerings" that are not subject to the registration requirements of the Investment Company Act. The funds rely upon statutory exceptions set forth in Sections 3(c)(1) and 3(c)(7) of the Investment Company Act to exempt themselves from regulatory provisions applicable to registered investment companies.⁴⁸ These definitional exceptions to the term "investment company" apply to funds with less than 100 beneficial owners and funds with only high net worth and institutional investor "qualified purchasers."

If enacted into law, the Transparency Act would subject non-exempt private funds to SEC requests for information and examinations, books and records requirements (as specified by the SEC), anti-money laundering provisions, and annual disclosure requirements. Notably, the Transparency Act would require private funds to disclose the names and addresses of the fund's beneficial owners.⁴⁹ This provision has proven especially controversial as the disclosure of passive investors in other investment vehicles is typically not required, and the provision may be revisited as part of any final legislative initiative.

In addition to the proposed Transparency Act, two other private fund-related bills have recently been introduced in Congress. On January 27, 2009, U.S. House Representatives Mike Castle (R-DE) and Mike Capuano (D-MA) introduced legislation to amend the Advisers Act.⁵⁰ Their proposed Hedge Fund Managers Registration Act would remove the exemption that allows private fund managers to avoid registering with the SEC if they have less than 15 clients.⁵¹ In a January press release, Congressman Capuano stated: "In addition to providing [investors] with basic census information on hedge funds, [manager registration] can be used to detect and deter fraudulent practices and risky behavior before it's too late."⁵² Congressman Castle also introduced legislation to require the President's Working Group on Financial Markets to conduct a study on the hedge fund industry.⁵³ The study aims to analyze the changing nature of hedge funds, the growth and role of hedge

funds within financial markets, and the potential risks that hedge funds pose to financial markets and investors.⁵⁴

Significantly, U.S. Treasury Secretary Timothy Geithner also addressed regulatory reform for private funds in a March 26, 2009, proposal aimed at a new regulatory framework directed toward systemic risk.⁵⁵ The proposal would require all advisers to private funds with assets under management above a moderate threshold to register with the SEC.⁵⁶ In announcing the proposal, Secretary Geithner stated that the current financial turmoil has made it clear that large, interconnected firms need to fall under a single independent regulator, which can oversee "systemically important firms" to ensure the stability of the overall financial system.⁵⁷ The Treasury Secretary also proposed imposing capital, liquidity, counterparty, and risk management requirements for systemically important firms,⁵⁸ which could include certain private funds. If imposed, such standards, particularly those related to minimal capital requirements, could prove burdensome to highly leveraged private funds.

Apart from pending bills in Congress and Secretary Geithner's proposal, President Obama's February 2009 *Budget Blueprint* includes a line item proposing to tax carried interests as ordinary income for federal tax purposes. Originally proposed in 2007 and again in 2008, carried interest tax legislation was re-proposed in April 2009 by Senator Levin.⁶⁰ Many private funds are organized as partnerships and the general partner, who is normally related to the manager of the fund, receives a carried interest as a significant component of their income. The carried interest is designed as an incentive to the manager to maximize performance of the fund. Proposals to modify the taxation of carried interest would re-classify carried interest income, which is sometimes subject to preferential tax rates, as ordinary income, which is subject to the highest tax rates.⁶¹ As such, some funds may be forced to reconsider their arrangements with investors depending upon the type of income generated by their funds.

The hedge fund industry has also faced mounting pressure from state legislative authorities. Connecticut lawmakers originally proposed legislation in January 2009 that extended beyond proposed federal legislation in several areas.⁶² The proposed legislation required hedge funds with certain relationships to the State of Connecticut to obtain a state license, provide for an independent annual financial

audit, and disclose fees and significant changes in management strategy.⁶³ In April 2009, Connecticut lawmakers backed away from these requirements and proposed revised legislation requiring certain advisers of hedge funds located in the State of Connecticut to disclose potential conflicts of interest.⁶⁴ This revised version of the legislation, which passed the State Senate, failed in the State House of Representatives on June 3, 2009, the final day of the House session.⁶⁵ However, the efforts on the part of Connecticut lawmakers evidence the willingness of state officials to act when the federal government has yet to pass legislation.⁶⁶

Given the proposals under consideration, enactment of new legislation may necessitate a change in the structure and scope of the operations of private funds. Depending on the outcome of any final legislation, such funds may need to incorporate new compliance, recordkeeping and/or disclosure practices to meet new regulatory requirements. The potential creation of a new systemic risk regulator, and the potential to be designated as a “systemically important firm,” may mean certain private funds may have to adjust their investment strategies and their operations. Private funds could, therefore, find it necessary to dedicate significant resources to meet the new challenges imposed in the future by new legal and regulatory requirements.

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Feature Articles: Securities

Investor Protection Reform: The SEC Approach

Investor protection has received a significant amount of media attention lately, due to recent economic

developments. As a result, there has been a debate on rethinking the current regulatory system and undertaking a regulatory reform that will offer investors more protection than the current regulatory system. During the swearing-in ceremony of Mary L. Schapiro as the 29th Chairman of the U.S. Securities and Exchange Commission (SEC or “Commission”) on January 27, 2009, the new Chairman emphasized the critical role that the SEC must play in “rebuilding investor confidence, reviving the markets, and rejuvenating the economy.”⁶⁷ Ms. Schapiro reiterated the SEC’s commitment to “reinvigorating a financial regulatory system that must protect investors and vigorously enforce the rules” while deepening the Commission’s “commitment to transparency, accountability, and disclosure.”⁶⁸

Since her appointment as chair of the SEC, Ms. Schapiro has spoken at several events around the country on the SEC’s role as the investors’ advocate, outlining the role of the SEC given the current economic conditions and proposed measures to be taken to achieve a regulatory reform that will serve the best interest of those the SEC has been entrusted to protect. In her address to the Council of Institutional Investors on April 6, 2009, Ms. Schapiro noted that “investor protection starts with fair and efficient capital markets”⁶⁹ and defined the SEC’s role in creating this type of environment. She identified four areas as areas that need to be addressed in order to have fair and efficient capital markets. She stated that the SEC needs to ensure that capital markets are:

1. Structured effectively
2. Fed by timely and reliable information
3. Well-served by financial intermediaries and other market professionals
4. Supported by a strong and focused enforcement arm⁷⁰

Proposed Measures to Enhance Investor Protection

On effective structuring of capital markets, Ms. Schapiro noted that the markets the SEC oversees have “priced, processed and cleared trillions of dollars in customer orders fairly and timely.” She further noted that the SEC is, “from an enforcement and regulatory perspective, looking at practices that may be contrary to fair and orderly markets.” (Among the latest measures taken by the SEC was a unanimous vote on April 8, 2009 to seek public comment on whether short sale price restrictions or circuit breaker restric-



tions should be imposed and whether such measures would help promote market stability and restore investor confidence.⁷¹)

Second, on ensuring that capital markets are fed by timely and reliable information, Ms. Schapiro noted that the SEC faces several challenges in this area. She pointed out that as long as gaps in regulation exist, “the market is missing important information and disclosure about these activities.”⁷² To reduce regulatory gaps, the SEC is considering the following measures to help improve disclosure of important information from public companies:

- Whether to enhance disclosure around director nominee experience, qualifications and skills
- Whether boards should disclose to shareholders their reasons for choosing their particular leadership structure
- Whether compensation disclosures accomplish the objective of providing shareholders with the most relevant information⁷³

Ms. Shapiro noted that the third area the SEC needs to address is ensuring that capital markets are served by competent, financially capable, and honest professionals; the Commission is looking at a number of reforms, some of which may require legislation. These may include:⁷⁴

- Requiring professionals with custody of client assets to undergo third party compliance audits to confirm safekeeping of assets and ensure compliance with the law
- Harmonizing responsibilities of various industry professionals, so that investors can expect uniform level of professionalism and accountability
- Requiring more disclosure from credit rating agencies and enhancing disclosures of various financial products including credit default swaps, municipal securities and asset backed securities
- Requiring registration of hedge fund advisors and potentially hedge funds themselves and enhancing standards applicable to money market funds

On the final responsibility of the SEC, Schapiro noted that the Commission is an integrated regulator of the country's capital markets with an important focus on

law enforcement. To continue strengthening enforcement, Ms. Schapiro noted that the SEC appointed its new head of Enforcement, Robert Khuzami, in February 2009, stepped up internal training programs, eliminated procedural hurdles, and began to look outside the agency for new skill sets.

In her testimony before the U.S. Senate's Committee on Banking, Housing, and Urban Affairs in March 2009, Ms. Shapiro reinforced the above outline on the SEC's role as the investor advocate.⁷⁵ In months to come, broker-dealers, hedge funds, credit rating agencies and other financial institutions may anticipate new rule proposals and amendments to existing rules as the SEC embarks on reforming the current regulatory system.

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Feature Articles: Insurance

Troubled Assets Relief Program Considerations for Insurers

In response to the global financial crisis, the U.S. Department of the Treasury (“the Treasury”) created the Troubled Assets Relief Program (TARP) to stabilize failing financial institutions. The U.S. Congress authorized the Treasury to spend \$700 billion on TARP programs and to stabilize the financial institutions through TARP. One of the TARP programs that provides short-term capital to U.S. financial institutions and encourages lending is the Capital Purchase Program.

The TARP Capital Purchase Program was originally intended for any bank, savings association, bank holding company, or savings and loan holding company to help increase the flow of financing in the markets; insurance companies were not included. In November 2008, the Treasury stated that “insurers would qualify [for TARP] only if they owned banks or thrifts, which would put their holding companies under the purview of Washington regulators such as the Office of Thrift Supervision.”⁷⁶ A few insurers, e.g., Genworth Financial, Lincoln National Corporation and



the Hartford Financial Services Group, Inc. were interested in acquiring a bank, savings thrift or savings and loan holding company (SLHC) in order to gain access to TARP funds. (An insurer would have to directly acquire more than 10% of the stock of a savings and loan association or indirectly acquire more than 10% of the stock of an existing SLHC.) The Office of Thrift Supervision would approve an insurer's application when the information provided proved that the SLHC would be adequately capitalized under the insurer's control.

On May 14, 2009, the Treasury announced that it would extend up to \$22 billion to six major life insurers however only two accepted the funds. The Hartford will take as much as \$3.4 billion of the federal bailout money and sell up to \$750 million of common stock to bolster its capital position and Lincoln National will take nearly \$1 billion of the federal bailout funds while issuing new stock and debt and selling its British insurance business.⁷⁷ Ameriprise Financial Inc., an asset management firm that sells life insurance and annuities announced that they would not take the government bailout money because they have more than \$1 billion in excess capital. Prudential Financial Inc. raised \$2.4 billion on its own through a public stock and notes offering and the Principal Financial Group Inc. will not accept the government bailout money because it has raised fresh capital through market transactions with private equity firms. And another eligible insurer elected not to take the bailout funds either. It appears that the need for federal aid has lessened during the recent months as insurers evaluated alternative methods for financing.

Implications of TARP for Insurers

Having access to government TARP funds increases an insurer's short-term capital and reduces the need to raise capital under generally challenging terms in the current market. It also helps insurers avoid further credit rating downgrades. In April 2009 the American Council of Life Insurers (ACLI) said that U.S. life insurers could benefit from having access to TARP funds because they hold about \$1 trillion in corporate debt and need the Treasury's aid to buy more bank bonds and to help inject liquidity into the nation's credit markets.⁷⁸ Although the fact that few insurers accepted the TARP funds is a counterargument to the ACLI's assertions. Nevertheless, there are strings attached with government-supplied capital.

Insurers may be subject to more government control and regulation with TARP bailout money. Chief execu-

tives in the U.S. property casualty insurance sector rejected proposals to receive federal bailout funds because it is a "slippery slope that could potentially lead to strict government regulation and control."⁷⁹ Firms who accept TARP funds come under government and public scrutiny. As a matter of fact on June 9, 2009, ten of the nation's largest banks received approval to repay \$68 billion worth of TARP bailout funds. Treasury Secretary Geithner said in a statement that "these repayments are an encouraging sign of financial repair."⁸⁰ It also appears that these banks may be rushing to pay the government back so that they will be free from restrictions on executive compensation, dividend payments and share purchases and other stringent rules.

Recipients of the TARP Capital Purchase Plan are subject to a standardized contract which requires:⁸¹

- \$500,000 executive compensation limit
- Incorporation and good standing
- Board ensures no anti-takeover provision
- Prohibition on any compensation plan that encourages manipulation of reported earnings to enhance compensation
- Prohibition on incentive compensation payments or bonuses other than certain restricted stock and payments
- For the first three years that the Treasury owns shares or warrants in the applicant, the applicant may not increase its dividend payments on common shares without the permission of the Treasury

Another implication of having access to TARP funds is TARP reporting including:

- Monthly reports on how capital is being used, including initiatives in which the monies have been deployed
- Reports on the lending activities including a breakup of mortgage lending, business and personal lending, credit card lending, student loans, corporate lending.
- Reports to demonstrate that the institution has not used the TARP funds in certain prohibited uses such as employee compensation, dividend payments, certain marketing activities and lobbying or government relations activities

- Reports on executive compensation and corporate governance

More Implications of TARP for the Life Insurance Industry

The life insurance industry is an integral part of the financial system. It is an important source of savings and wealth management for Americans. An erosion of confidence could cause customers to surrender or lapse policies and create a cash crunch for some insurers. The companies are major sources of capital throughout the economy because they invest the premiums they receive from policyholders in equities, bonds, real estate and other assets. Issuers of variable annuities with certain guarantees that promised minimum payments even if the markets fell were hurt by the financial crisis. The government aid will aid insurers with balance sheets clogged by illiquid assets and escalating liabilities to annuity contract holders.

There is concern, however, for an unfair competitive advantage to those TARP-approved life insurers who also have a property and casualty book of business. The president of the Property Casualty Insurers Association of America, David Sampson, expressed his concern in a statement urging the Treasury Department to take steps to ensure that “this funding does not give any of these insurers’ property-casualty divisions an artificial competitive advantage over fiscally sound property-casualty companies who do not need federal rescue funds.”⁸² Of the insurers approved and expected to accept the funds, only The Hartford has property and casualty operations. It remains unclear, however, precisely how the Treasury will exercise regulatory oversight over life insurers accepting TARP funds with property and casualty operations.

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End Notes

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- 42 Grassley, "Grassley and Levin Introduce Hedge Fund Transparency Bill." Hedge funds are major purchasers of complex derivatives such as credit default swaps, which played a large role in the downfall of Lehman Brothers and the current economic turmoil. In addition, private funds provide a large source of income to investment banks that act as prime brokers. See previous footnote, Marcy Gordon. "Treasury Outlines Framework for Regulatory Reform, Provides New Rules of the Road, Focuses First on Containing Systemic Risk," March 26, 2009, <http://www.treas.gov/press/releases/tg72.htm>.
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- Register with the SEC under the Investment Company Act;
 - Maintain such books and records as the SEC may require;
 - Cooperate with any request for information or examination by the SEC; and
 - File an annual information form with the SEC in an electronic, searchable format made available to the public that includes:
 - o The name and address of beneficial owners of the private fund, companies with ownership interests in the fund, and the primary accountant and the primary broker used by the fund;
 - o An explanation of the structure of ownership interests in the fund;
 - o Information on any affiliate financial institution;
 - o A statement that details the minimum investment commitment required of a limited partner, member, or other investor;

- o The total number of any limited partners, members, or other investors; and
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