

July 21, 2010

**MEMORANDUM TO CLIENTS**

**RE: Dodd-Frank Wall Street Reform and Consumer Protection Act - Impact on Plans and Plan Service Providers**

On July 21, 2010, President Obama signed into law the "Dodd-Frank Wall Street Reform and Consumer Protection Act" (the "Act").

This far-reaching regulatory reform bill will re-shape the nation's financial system. As significant participants in domestic and global financial markets, employee benefit plans (including ERISA-covered plans and governmental plans) should expect changes resulting from the Act to affect their investment activities directly, or by regulation of the financial institutions and other entities that provide plan services or are counterparties to plan financial transactions. Notably, the full scope and impact of the Act is still to be defined, because the Act requires numerous new regulations to be issued by Federal regulatory agencies, including the Securities and Exchange Commission ("SEC"), the Commodities Futures Trading Commission ("CFTC"), and the Federal Reserve and other banking regulators.

We discuss below how some key provisions may affect plans and plan service providers, including:

- Increased regulation of advisers to hedge funds and private equity funds, and others advising plans and plan investment vehicles;
- New limits on some bank investment and related activities, potentially affecting bank investment activities when acting as trustees or custodians on behalf of plans and other customers;
- A new regulatory scheme for swaps and other similar privately negotiated derivatives including special provisions intended to mitigate impact of new regulation on plans;
- New requirements on public companies enhancing shareholder rights and disclosure of executive compensation; and
- Establishment of a new Bureau of Consumer Financial Protection, which potentially may regulate certain plan services.

**A. Regulation of Advisers to Private Investment Funds**

The "Private Fund Investment Advisers Registration Act of 2010" (Title IV of the Act) amends the Investment Advisers Act of 1940 (the "Advisers Act") to eliminate (with some exceptions) the "private fund" exemption from the registration requirements of the Advisers Act.

Currently, advisers with fewer than 15 clients are not required to register or be regulated as investment advisers. For this purpose, an "investment fund" — such as a hedge fund with multiple investors — is typically treated as a single client. Accordingly, advisers to hedge funds, private equity funds and other "private funds" excepted from registration as investment companies under sections 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 ("Investment Company Act") have traditionally relied on this exemption to avoid regulation as investment advisers.

The elimination of the private fund exemption will require most advisers to private funds to register with the SEC and also subject these advisers (whether previously registered or not) to new reporting, disclosure and examination requirements. For example, many private fund advisers will be required to report to the SEC about assets under management, use of leverage, counterparty credit-risk exposure, trading and investment positions and practices, valuation policies and practices, types of assets held, side letters, and any other information the SEC deems necessary.

Elimination of the "private fund" exemption will not change requirements with respect to collective trust funds and other investment vehicles maintained solely for investment by tax-qualified plans, which are exempted by section 3(c)(11) of the Investment Company Act. In addition, the Act provides some limited exemptions from Advisers Act registration, including (among others) exemptions for venture capital fund advisers and advisers to so-called "family offices." Also exempted from Advisers Act registration will be private equity and other private fund advisers who (a) do not advise funds other than private funds and (b) have less than \$150 million in assets under management in the U.S. This provision represents a change from earlier versions of the legislation, which would have exempted even large private equity fund managers from Advisers Act registration requirements. The exact scope of these exemptions will be addressed in regulations to be issued by the SEC.

Rules governing whether an adviser may register with the SEC — or must instead register in each of the states in which it conducts business — are also changed. Current law provides that an investment adviser generally may not register with the SEC unless it has more than \$30 million in assets under management or would be required to register in 30 or more states. Under the Act, an adviser with assets between \$30 million and \$100 million may not register with the SEC (and must register in the state(s) in which it conducts business) unless the adviser would be required to register with 15 or more states.

Finally, Title IV makes some adjustments to requirements for the qualification of investors in private funds. For now, these changes primarily affect whether "natural persons" will meet "accredited investor" status, but additional adjustments may be expected. In this regard, the Act requires the SEC and Comptroller General to conduct reviews or studies of net worth thresholds to be applied to investors in private funds, and requires the SEC to adjust the "qualified client" test for the effects of inflation.

Elimination of the private fund exemption from Advisers Act registration and other changes made by Title IV of the Act could have several consequences relevant to plans, as follows.

- Many hedge fund managers and private equity managers not already registered will need to do so. Notably, even non-U.S. based advisers to foreign funds could be subject to the new registration requirements if they do not qualify as a "foreign private adviser" under the Act.
- Importantly, newly registered advisers and advisers that are currently registered will be required to maintain and file new types of information with the SEC, much of which will be of interest to the adviser's clients, including plans and plan fiduciaries.
- Plan sponsors who may themselves be in the business of advising others should consider the impact of SEC regulation with respect to the advisers' own plans. As noted above, the SEC will be required to issue rules regarding the exemption of mid-size advisers (*e.g.*, those who "solely" advise private funds and whose assets under management are less than \$150 million). (A similar rulemaking will take place with respect to "family offices" under Section 409 of the Act.) In these rulemakings, the SEC will likely be faced with the question of how to treat an adviser's own plans. For instance, should a mid-size adviser who advises the employee benefit plans it sponsors be required to register? Will a family office fail to meet the requirements of an SEC exemption merely because it sponsors and advises an employee benefit plan for employees of the family office?
- Plan sponsors that are not currently engaged in an investment advisory business (and not registered as investment advisers) but who may be deemed to "advise" the employee benefit plans they sponsor, or foundations or endowments with which they have a relationship, should consider the possible implications of the elimination of the private fund exemption and future SEC regulation on employers as advisers. The SEC staff has previously issued interpretations that plan sponsors whose employees advise the sponsor's own plans on investments could meet the definition of an "adviser" for purposes of the Advisers Act, while also indicating that plan sponsors generally need not register under the Advisers Act (based in part on the "private fund" exemption). With the private fund exemption no longer available, there is a possibility that the SEC could review whether plan sponsors remain exempted from the Advisers Act registration requirements.

Provisions under Title IV of the Act generally are effective one year after the date of enactment, although advisers may be able to register early during a one-year transition period. Fiduciaries of plans investing in hedge funds and other private funds with advisers that may be newly subject to registration requirements may wish to consider contacting these fund managers to learn about the manager's strategy for addressing new registration or recordkeeping requirements applicable to the manager. Plan sponsors and advisers may also want to review and update side letter provisions to reflect new SEC requirements, when finalized.

**B. Ban on Certain Bank Entities Investing in, or Sponsoring, Private Funds ("Volcker Rule")**

Title VI of the Act creates a new section 13 of the Bank Holding Company Act, which, during the legislative debate, became known as the "Volcker Rule." The rules, contained in Section 619 of the Act impose new requirements on any "banking entity" — including the investment and trading activities of an insured depository institution, a company that directly or indirectly controls an insured depository institution, a company treated as a bank holding company, or any subsidiary of such an institution or company ("Banking Entity"). The Volcker Rule will prohibit any Banking Entity from engaging in "proprietary trading," including transactions in stocks, bonds, options, commodities, derivatives or other financial instruments for its own trading book. However, Banking Entities will be permitted to (among other things) engage in trading on behalf of a customer and market making activities or trading "otherwise in connection with customer relationships, including risk-mitigating hedging activities related to such customer transactions."

Section 619 will also prohibit a Banking Entity from "sponsoring" or investing in a hedge fund or private equity fund (defined as any entity or fund exempt from registration under section 3(c)(1) or 3(c)(7) of the Investment Company Act or any similar fund). "Sponsoring" a fund is defined broadly to include serving as general partner, managing member, or trustee of a fund; selecting or controlling a majority of the fund's directors, trustees or managers; or sharing its own name for purposes of marketing, promotion, etc. (private labeling). The effective date for this provision is two years after regulations are issued by the federal bank regulatory agencies (required within nine months after the new Financial Stability Oversight Council completes a study of new rules affecting Banking Entities). The bank regulatory agencies could approve a maximum of three individual one-year extensions if not detrimental to the public interest.

There were concerns under the Senate version of the Act that the Volcker Rule prohibition on banks sponsoring private funds could have reached certain types of commingled benefit plan trusts, *e.g.*, VEBA's, group trusts, multi-employer plan trusts, and other investment vehicles for plans that may rely on (in part or entirely) private fund exemptions under sections 3(c)(1) and 3(c)(7) of the Investment Company Act. Many of those vehicles, in turn, have bank trustees, which might have been forced to resign under the Senate Bill. (Most "single employer" retirement plan trusts (including master trusts) are either not investment companies at all, or are exempt from registration for other reasons, *e.g.*, based on the exemption under section 3(c)(11) of the Investment Company Act, and would not have been affected. Collective trust funds and pooled separate accounts also generally rely on the section 3(c)(11) exemption.)

However, the final version of the Act contains several changes that should permit banks to continue to serve as trustee and provide other services to most commingled benefit plan trusts. First, the rule now defines a covered "banking entity" to exclude any FDIC-insured institution acting only in a fiduciary capacity (*i.e.*, a limited purpose trust company). Second, "sponsoring" a hedge or private equity fund does not include any activity engaged in by a banking entity if: the bank is acting only in the capacity of a *bona fide* trustee, fiduciary or investment adviser; it is offering the fund only to its *bona fide* fiduciary customers; it makes no more than a *de minimis* personal investment in the fund; and it satisfies certain other conditions. The full extent of this exception has yet to be determined, though it very much resembles existing law as it relates to

the investment of bank fiduciary customers in common trust funds. Federal banking agencies and the SEC are directed to adopt regulations to carry out the Volcker Rule; it will be important for financial institutions and plan fiduciaries to monitor the rulemaking process so that plan investment activities will not be disrupted.

### **C. Regulation of Over-the-Counter Swaps**

Title VII of the Act, the "Wall Street Transparency and Accountability Act," establishes a new regulatory framework for the OTC derivatives market and will impose substantial new regulation on transactions designated as "swaps" and on certain swap market participants. Transactions covered by the new regulatory framework will include a broad range of "derivative" instruments commonly referred to as swaps, puts, caps, and collars relating to commodities, currencies, securities, securities indices and other financial instruments, "synthetic" contracts and financial or economic interests of any kind based on future performance or notional amounts.

Among other things, the Act extends the jurisdiction and broadens the authority of the SEC, the CFTC and banking regulators over, and impose significant new rules on, a broad range of privately negotiated (over-the-counter) or (OTC) transactions defined as "swaps" (CFTC jurisdiction) or "securities-based swaps" (SEC jurisdiction). Generally (with limited exceptions), swaps would need to be standardized and settled through a registered clearinghouse. Swaps not settled through a clearinghouse would still be subject to reporting requirements. Persons acting as "swap dealers" and "major swap participants" will be required to register with the CFTC and/or SEC and subject to substantial new requirements regarding capital, margin deposits, disclosure (transparency), and conflicts. The Act will also prohibit future bailouts of swap dealers and major swap participants.

As investors, retirement plans and other employee benefit plans — and the pooled investment vehicles in which plans invest — use swaps and other derivatives for a range of investment purposes. Therefore, regulation of counterparties to plan transactions could substantially alter the terms and conditions, and costs, for plans engaging in swaps and other covered transactions. Accordingly, plans are likely to see the impact of the new regulation of these transactions as the new rules are implemented.

Importantly, as modified in conference, the Act substantially mitigates the potential effects of certain provisions in early versions of financial services reform that were of particular concern to the benefit plan community. Some provisions of key interest to plan fiduciaries are as follows.

- Treatment of stable value fund "wrap" contracts was a key issue for participant-directed 401(k) and similar plans. Stable value funds are a popular investment option offered to plan participants; there was concern that wrap contracts and other contracts providing a "benefit-responsive guarantee" to support stable value fund accounting could be regulated as "swaps." As modified in conference, the Act temporarily exempts stable value contracts from regulation as swaps and permanently grandfathers stable value contracts existing as of the date of enactment. The SEC and CFTC, in consultation with the Department of Labor, the Treasury Department and state insurance regulators, must determine within 15 months of enactment whether stable value contracts fall within the

definition of a "swap." If they determine that they do, they must make a further determination of whether stable value contracts should be exempted from the Act.

- Employee benefits plans generally will be exempted from the definition of "major swap participant" when engaging in swaps "for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan." The scope of this exception is unclear; for example, plans regularly engage in swaps for purposes that might be viewed as other than hedging or mitigating risk, such as certain portfolio restructurings. Also, it is not clear whether the exception applies only to plans themselves, or also to entities holding "plan assets," including master trusts and group trusts.
- One of the most controversial provisions of the Senate Bill would have imposed a "fiduciary duty" (over and above new business conduct standards) on swap dealers who provide advice to, offer to enter into swaps with, or actually enter into swaps with private or governmental retirement plans and endowment funds. There was significant concern that this provision would create insurmountable conflicts of interest for swap dealers so as to prevent them from transacting business with plans. As modified in conference, the Act instead imposes requirements on swap dealers and major swap participants who act as advisers to or counterparties to "Special Entities" (including ERISA plans, governmental plans and endowments).
  - Where a swap dealer or major swap participant advises a Special Entity, these requirements make it unlawful to defraud the Special Entity, and impose an affirmative duty on the adviser to make reasonable efforts to obtain information to determine that the recommended swap is in the Special Entity's best interest in light of the Special Entity's financial status, tax status, investment objectives.
  - Where a swap dealer or major swap participant is a counterparty to (or offers to be a counterparty to) a Special Entity, the Act requires that, prior to entering into the swap, a swap dealer must have a reasonable basis to believe that the Entity is represented by someone who (i) has sufficient knowledge to evaluate the risks of the transaction; (ii) is not "disqualified" from representing the Entity; (iii) is independent of the swap dealer; (iv) has a (fiduciary) duty to act in the best interest of the Entity; (v) makes appropriate disclosures; (vi) makes a written determination regarding fair pricing and appropriateness of the transaction; and (vii) in the case of an ERISA-governed plan, is a fiduciary. Notably, the Act's legislative history makes clear that while the person representing a Special Entity must be independent of the Special Entity's counterparty, it is not necessary for the representative to be independent of the Special Entity itself (*i.e.*, an outside manager is not required). These rules do not apply to swaps initiated by a Special Entity of its own accord via an exchange, or which are conducted as "blind" transactions.
- The full scope of transactions that will be covered by the new regulatory framework remains to be seen, and is likely to result in new uncertainty for some plan transactions. Exceptions will be available for instruments subject to regulation as securities, true debt instruments, certain bank products, and certain agreements that anticipate settlement by

actual delivery of a commodity or a security, or an agreement with an issuer designed to raise capital. For instance, it is unclear to what extent derivative contracts covered by new regulation may include common "participation" interests in loans or leases, or to guarantees. Arguably, however, the exception for capital raising should allow for typical "carried interest" or "performance fee" arrangements.

**D. Executive Compensation Provisions**

Title IX of the Act contains initiatives intended to improve investor protection, securities enforcement and securities disclosures, including, in particular, some changes to SEC rules relating to shareholder rights and disclosure of executive compensation. Key provisions would do the following:

- require that public company shareholders have a non-binding vote to approve the compensation of their top five "named executive officers" disclosed in the proxy at least once every three years, and require that shareholders vote at least once every six years to determine whether the non-binding vote on executive compensation will occur every one, two, or three years;
- require certain disclosures and a non-binding shareholder vote regarding golden parachute-type compensation (to the extent that it has not already been voted on by shareholders) in connection with any proxy involving a shareholder vote on any merger, acquisition, consolidation, sale, or disposition of substantially all of the assets of the issuer;
- require the SEC to issue rules directing the national securities exchanges and national securities associations to prohibit the listing of public companies unless all members of its board compensation committee are directors and "independent" under SEC rules that, among other things, consider the source of compensation received by a director and whether a director is affiliated with the company or any subsidiary or affiliate of the company;
- direct the SEC to identify factors that affect the independence of compensation consultants, legal counsel and other advisers to the compensation committee, require the compensation committee of a public company to consider these factors before selecting compensation consultants, legal counsel and other advisers, give the compensation committee the authority and appropriate funding to retain, compensate and oversee compensation consultants, independent legal counsel and other advisers, and require companies to disclose in their annual proxy whether the compensation committee has retained a compensation consultant and, if so, whether the compensation consultant's work has raised any conflict of interest;
- require information in the annual proxy disclosures showing the relationship between executive compensation actually paid and the financial performance of the issuer, taking into account changes in the value of the company's shares and dividends;

- amend the disclosure rules to require a public company to disclose (a) the median annual total compensation of all employees except the CEO – a potentially burdensome requirement as the SEC proxy rules for the "top 5" would need to be used, (b) the annual total compensation of the CEO, and (c) the ratio of the amount in (a) to the amount in (b);
- require public companies to develop and implement "clawback" policies (and to disclose such policies) with respect to incentive-based compensation (including stock options) in the case of accounting restatements due to material noncompliance with financial reporting requirements under the securities laws during the 3-year period prior to the date the restatement is required – at a minimum, clawbacks would be required to apply to all current and former executive officers (not just the named executive officers), and would require the return of amounts in excess of what would have been paid to the executive officer under the accounting restatement;
- require proxy disclosures by public companies regarding whether employees or members of the board of directors are permitted to purchase financial instruments (e.g., collars or equity swaps) designed to hedge or offset declines in market value of equity securities granted to or held by the employees or directors;
- direct the Federal regulators to jointly prescribe regulations requiring covered financial institutions to disclose the structures of incentive-based compensation arrangements offered by the institution – as well as regulations prohibiting any incentive-based payment arrangement that encourages inappropriate risks by covered financial institutions – by providing an executive officer, employee director or principal shareholder with excessive compensation, fees or benefits, or that could lead to material financial loss to the institution;
- prohibit brokers from voting shares with respect to the election of board members, executive compensation, or any other significant matter as determined by the SEC, unless the broker is the beneficial owner of the shares or has been instructed by the beneficial owner how to vote the shares;
- require public companies to disclose in their annual proxy statement why the company has chosen the same person to serve as CEO and chairman of the board or, alternatively, has chosen different individuals to serve in those positions; and
- permit the SEC to adopt a proxy access rule under which shareholders could nominate individuals to serve on the board of directors.

While the SEC is directed to provide guidance on many of the provisions, it is likely that many of the additional requirements and disclosures will apply for the 2011 proxy season.

#### **E. Consumer Financial Protection**

Title X of the Act, the "Consumer Financial Protection Act of 2010," will establish the Bureau of Consumer Financial Protection (the "Bureau") within the Federal Reserve System. The Bureau will gain exclusive rulemaking over a broad range of consumer protection laws

(among others, *e.g.*, the Truth in Lending Act and privacy provisions under Gramm-Leach Bliley Act) and its rulemaking may extend to persons engaged in offering or selling a "consumer financial product or service" (broadly defined) and their affiliates acting as service providers to those persons. It will have authority to prohibit practices that it finds to be unfair, deceptive or abusive, to mandate particular disclosures and to prohibit or restrict pre-dispute arbitration practices.

The key issue for the benefit plan community has been whether the Bureau will have jurisdiction to regulate services to retirement and other employee benefit plans. In this regard, Section 1002(15) defines "consumer financial product or service" broadly, including some types of activities that third party administrators and other service providers arguably could be deemed to provide to plan participants, particularly in connection with 401(k) and other participant directed plans, such as "extending credit and servicing loans" and "providing payments or other financial data processing products or services to a consumer by any technological means ..." The House Bill had specifically addressed these concerns by providing that a person would not be engaged in financial activity (subject to regulation) solely by virtue of being a "plan or arrangement" or a person that establishes or maintains a "specified plan or arrangement" for the benefit of that person's employees. For this purpose, "specified plan or arrangement" was defined (and is defined by the final version of the Act) to include any qualified retirement plan, 403(b) plan, eligible 457(b) deferred compensation plans, IRAs, 529 educational savings arrangements, or any plan subject to Title I of ERISA. However, this language did not exclude plan service providers from regulation. The Senate version provided a broader exclusion, which would have prohibited the Bureau from exercising rulemaking or enforcement authority with respect to products or services that relate to any specified plan or arrangement unless there is a joint request from the Secretaries of Treasury and Labor that describes the basis for, and scope of, consumer protection standards to be implemented with respect to services relating to a specified plan or arrangement.

The final version of the Act mostly follows the Senate version, which leaves open the possibility that the Bureau may regulate plan service providers in some respects. It provides that the authority of the Department of Labor, the Secretary of Treasury and the Internal Revenue Service to adopt regulations, initiate enforcement actions and take other actions with respect to any "specified plan or arrangement" is not affected by the Act. It also retains language providing that a person will not be treated as having engaged in the offering or provision of any consumer financial product or service (subject to regulation by the Bureau) solely because the person is a specified plan or arrangement or is engaged in the activity of establishing or maintaining a specified plan or arrangement for the benefit of the person's employees. In addition, the Bureau may exercise rulemaking or enforcement authority with respect to products or services that relate to any specified plan or arrangement only (a) in response to a joint request by the Secretaries of Treasury and Labor, or (b) if the Secretaries of Treasury and Labor grant approval of the Bureau's request to implement consumer protection standards with respect to services to a specified plan or arrangement. In addition, to the extent a person engaging in providing products and services to a specified plan or arrangement is otherwise subject to consumer laws that are within the Bureau's jurisdiction, the limit on rulemaking or enforcement does not apply. As with other provisions under the Act, the full effect (if any) on plan services is yet to be determined.

\* \* \*

If you have any questions, please contact your regular Groom contact or any of the attorneys listed below:

Jennifer E. Eller	<a href="mailto:jeller@groom.com">jeller@groom.com</a>	202-861-6604
Richard K. Matta	<a href="mailto:rmatta@groom.com">rmatta@groom.com</a>	202-861-6631
Stephen M. Saxon	<a href="mailto:ssaxon@groom.com">ssaxon@groom.com</a>	202-861-6609
Andrée M. St. Martin	<a href="mailto:astmartin@groom.com">astmartin@groom.com</a>	202-861-6642
Roberta J. Ufford	<a href="mailto:rufford@groom.com">rufford@groom.com</a>	202-861-6643
Brigen L. Winters	<a href="mailto:bwinters@groom.com">bwinters@groom.com</a>	202-861-6618
Jeff Witt	<a href="mailto:jwitt@groom.com">jwitt@groom.com</a>	202-861-6651