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The SEC Proposes Enhanced Executive Compensation Reporting for Broker-Dealers and Investment Advisers and Eliminating References to Credit Ratings Under the Investment Company Act

by William L. Tolbert, Jr., Elaine Wolff, Alexander J. May

On March 2, 2011, the Securities and Exchange Commission ("SEC") proposed executive compensation rules primarily affecting broker-dealers and investment advisers ("Proposed Compensation Rules") and credit rating rules primarily affecting money market funds and companies that register their securities under the Investment Company Act of 1940 ("Proposed Credit Rules"). The Proposed Compensation Rules would require registered broker-dealers and investment advisers with assets of at least $1 billion to file annual reports with the SEC on its incentive-based compensation arrangements and prohibit them from providing incentive-based compensation that could encourage inappropriate risk taking. The Proposed Credit Rules would eliminate the requirement that money market funds invest only in securities that receive certain credit ratings and also eliminate credit rating references from two rules and four forms under the Investment Company Act.

These rules are designed to implement sections 956 and 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Reform Act"). Section 956 of the Reform Act requires that the SEC issue rules regarding enhanced compensation reporting for certain "covered financial institutions" (in this case, broker-dealers and investment advisers)[1] to ensure that such entities do not take excessive risks in compensating their directors, officers, employees or principal shareholders.[2] Other Federal regulators, including the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision and the National Credit Union Administration Board, are issuing parallel enhanced compensation reporting regulations for banks, bank holding companies, and credit unions. Section 939A of the Reform Act requires the SEC to review its regulations for any references or requirements regarding credit ratings and substitute other standards of credit worthiness.[3]

Public comments on the Proposed Compensation Rules are due 45 days after the rules are published in the Federal Register. Public comments on the Proposed Credit Rules are due by April 25, 2011.

Enhanced Compensation Reporting for Covered Financial Institutions

The SEC's Proposed Compensation Rules would apply to broker-dealers and investment advisers registered with the SEC that have total consolidated assets of $1 billion or more. Such entities would be required to submit an annual report to the SEC that describes the structure of the entity's incentive-based compensation for directors, officers, employees or principal shareholders. The report would need to be sufficient to allow an assessment of whether the structure or features of such compensation arrangements provide or are likely to provide excessive compensation or could lead to material financial loss for such entity. Although the report need not include the actual compensation of directors, officers or employees, it would be required to include:

- A clear narrative description of the components of the compensation arrangements and to which individuals they apply;
- A succinct description of the policies and procedures regarding such compensation;
- Any material changes to the incentive-based compensation arrangements or policies and procedures since the last report; and
- The specific reasons why the entity believes the structure of its incentive-based compensation does not encourage inappropriate risks.

Broker-dealers and investment advisers would be prohibited from maintaining any compensation arrangement that encourages inappropriate risks (i) by providing a person with excessive compensation in relation to the services performed by such person or (ii) that could lead to a material financial loss to the entity. Each entity must evaluate its compensation programs in relation to its particular situation and determine that its compensation arrangements (i) balance risk and financial rewards, such as by using deferral of payments, risk adjustment of awards, and reduced sensitivity to short-term performance, (ii) are compatible with effective controls and risk management, and (iii) are supported by strong corporate governance, including active and effective oversight by the board or a committee thereof.

In addition, entities with over $50 billion in assets would be subject to additional reporting requirements. These entities would be required to (i) implement compensation deferral provisions for executive officers whereby such executive officers would be required to defer for three years at least 50% of any incentive compensation, and (ii) adjust or "claw-back" any such compensation payments to reflect losses incurred by the entity after the compensation was awarded. The board, or a committee of the board, would also be required to identify additional covered persons that would be in a position to expose the entity to outsized financial risk and approve incentive-based compensation for each such person.

Credit Ratings under the Investment Company Act

The Proposed Credit Rules would eliminate references to credit ratings in four forms under the Investment Company Act [4] and from rules related to credit ratings for securities held in money market funds and a fund's repurchase contracts. It would replace them with alternative standards of credit-worthiness that would approximate the purpose of the credit ratings, but allow for more subjective evaluation of a security. Under the Proposed Credit Rules, a fund's board (or its delegate) would be tasked with determining the credit-worthiness of a security.

Money market funds would no longer be required to consider an issuer's or a security's credit rating in selecting its holdings. Under proposed amendments to Rule 2a-7 of the Investment Company Act, the following criteria would be substituted for credit ratings:

- In determining whether a security is an "eligible security" to hold in the fund, the board must examine the credit risk surrounding the security and whether the issuer or guarantor has the "highest ability to meet its short term financial obligations";
- For securities with a conditional demand feature, the board must determine that the security is of high quality and low credit risk;
- The board must frequently monitor the securities to determine if they still present minimal credit risks; and
- The board must test the securities for adverse changes in the ability of a security issuer to meet its short-term obligations.

For funds entering repurchase transactions (whereby a party sells securities to the fund and agrees to repurchase the securities at a later date for a higher price) the SEC has proposed amendments to Rule 5b-3 of the Investment Company Act that would require a fund's board to determine that non-governmental securities that collateralize such repurchase agreements are: (i) issued by an issuer that has the highest capacity to meet its financial obligations, and (ii) sufficiently liquid that they can be sold at their carrying value within 7 days. This would replace the current requirement that the securities collateralizing repurchase agreements receive the highest credit rating or are unrated securities of comparable quality.

The SEC also proposed new Rule 6a-5 under the Investment Company Act applicable to business and industrial development companies ("BIDCOs"). BIDCOs are companies that operate under state statute that provide direct investment and loan financing, as well as managerial assistance, to state and local enterprises. Currently BIDCOs that are exempted from most provisions of the Investment Company Act are permitted to purchase debt issued by investment companies and private funds only if these debt securities are rated "investment grade" by a credit rating agency. Under the proposed new Rule, BIDCOs would be allowed to determine the credit-worthiness of certain debt securities issued by investment companies and private funds by determining that the debt security is subject to no greater than moderate credit risk and is sufficiently liquid such that it can be sold at its carrying value within a reasonably short time.

Endnotes

[1] Under the Reform Act, "covered financial institution" includes any of the following types of institutions that have $1 billion or more in assets: (A) a depository institution or depository institution holding company, as such terms are defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813); (B) a broker-dealer registered under section 15 of the Securities Exchange Act of 1934 (15 U.S.C. 78o); (C) a credit union, as described in section 19(b)(1)(A)(iv) of the Federal Reserve Act; (D) an investment adviser, as such term is defined in section 202(a)(11) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-2(a)(11)); (E) the Federal National Mortgage Association (Fannie Mae); (F) the Federal Home Loan Mortgage Corporation (Freddie Mac); and (G) any other financial institution that the appropriate Federal regulators, jointly, by rule, determine should be treated as a covered financial institution for these purposes.

[2] Incentive-based Compensation Arrangements, Draft Proposed Rules, available at http://www.sec.gov/spotlight/dodd-frank/956-proposedrule-draft.pdf.

[3] References to Credit Ratings in Certain Investment Company Act Rules and Forms, Release No. 33-9186, available at http://www.sec.gov/rules/proposed/2011/33-9193.pdf.

[4] Specifically, credit ratings references are removed from Form N-MFP (the monthly schedule of portfolio holdings of money market funds), Form N-1A (registration statements used to register shares of mutual funds), Form N-2 (registration statements used to register shares of closed-end funds) and Form N-3 (registration statements for variable annuity contracts).

For more information, please contact the following Jenner & Block attorneys:

William L. Tolbert

Partner, Corporate Practice
Tel: 202 639-6038
Email: wtolbert@jenner.com

Elaine Wolff

Partner, Corporate Practice
Tel: 202 637-6389
Email: ewolff@jenner.com

Alexander J. May

Associate, Corporate Practice
Tel: 312 840-8659
Email: amay@jenner.com