



## U.S. Congress Nears Completion of Landmark Financial Services Reform Legislation

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On June 30, 2010, the House of Representatives approved the Dodd-Frank Wall Street Reform and Consumer Protection Act, the most sweeping financial reform legislation in decades. Due to the death of Senator Robert C. Byrd, among other issues, the Senate has not yet voted on the legislation, but it is widely anticipated that the Senate will approve the legislation after it reconvenes on July 12. Once enacted, the legislation will affect virtually every segment of the financial services industry and its customers.

The core of the legislation generally follows the roadmap laid out in the White Paper released by the Treasury Department in June 2009:

- Systemic risk and the problem of “too big to fail” institutions are addressed through the creation of a ten-member Financial Stability Oversight Council, chaired by the Treasury Secretary, to identify and manage systemic risk in the financial system, and a new resolution regime under which systemically important banking and nonbank financial organizations can be placed into receivership and wound-up by the FDIC rather than reorganizing or liquidating under the supervision of a bankruptcy court. The Financial Stability Oversight Council will have authority to designate a nonbank financial company (including a foreign company) as being subject to Federal Reserve supervision and regulation if it determines that material financial distress at the company or the nature, scope, size, scale, concentration, interconnectedness or mix of its activities could pose a threat to the financial stability of the United States.
- A new Bureau of Consumer Financial Protection is created, with broad powers to enforce consumer protection laws and promulgate rules against “unfair, deceptive, or abusive” practices. The Bureau’s jurisdiction will include most financial service providers, whether or not affiliated with a depository institution. In addition, the legislation reverses years of preemption decisions by courts and the federal banking regulators, giving state authorities broad powers to adopt rules and bring enforcement actions against federally-chartered banks and thrifts under both federal and state laws.
- Risks in the secondary market for residential mortgage loans are addressed through stricter rules for securitizations of all asset types, including requirements for securitizers to generally retain at least 5% of the credit risk other than for securitizations of qualified residential mortgages (the so-called “skin in the game” requirements). In addition, the legislation (unlike the Treasury White Paper) sets out minimum underwriting standards for all residential mortgage loans, including that all such loans be fully underwritten

based on the borrower's documented ability to repay the loan, and provides additional remedies for homeowners whose loans do not meet these standards.

- Regulation of the derivative markets will be enhanced through measures that broaden the scope of derivative instruments and derivative market participants being regulated. New requirements, such as central clearing and exchange trading for derivative instruments, are introduced, as well as additional capital and margin requirements for derivative market participants.
- Credit rating agencies, which have also been blamed for contributing to the financial crisis through their ratings of subprime mortgage securities, will be subject to enhanced regulation as well as much greater exposure to litigation from investors for incorrect ratings.

The legislation also contains a number of major provisions added during the course of the Senate debate that have no direct relationship to the financial crisis but will have very significant effects on the financial services industry going forward:

- The Volcker Rule, which restricts banking organizations from engaging in proprietary trading or sponsoring or investing in hedge funds and private equity funds, subject to limited exceptions.
- The Durbin Amendment, which requires the Federal Reserve to set limits for debit card interchange fees (a major source of income for many banks) based on the cost of providing those services.
- The Lincoln Amendment, which requires banks to conduct certain kinds of derivative trading activities in separately capitalized affiliates.
- The Collins Amendment, which prohibits bank holding companies from including in regulatory capital any instruments that do not qualify as capital for banks. This provision, which will grandfather existing trust preferred securities and cumulative preferred stock as capital for banking organizations with less than \$15 billion in assets and phase-out the capital qualification of those instruments for larger organizations over a three-year period beginning in 2013, will require the refinancing of a large volume of outstanding capital instruments over the next several years and change the industry's capital costs going forward. In addition, it will subject thrift holding companies (including industrial and other companies that own grandfathered thrifts) to consolidated regulatory capital rules for the first time.

The legislation also implements a number of corporate governance requirements that will apply to all U.S. listed and, in some cases, other publicly traded companies, including requiring shareholder advisory votes on executive compensation and on golden parachutes in connection with mergers; authorizing SEC rules on "proxy access"; prohibiting broker discretionary voting of proxies on most items; and mandating clawback provisions in executive employment agreements as a condition to exchange listing.

While the legislation is broad and detailed (the published text of the House-Senate conference bill is over 2,300 pages long), very substantial portions of the legislation require rulemaking by federal government agencies to either implement the standards set out in the legislation (such as the Volcker Rule) or to adopt new standards (such as enhanced capital and liquidity levels for significant banking organizations and consumer financial protection standards). In total, the legislation requires several hundred separate rulemaking actions and numerous separate studies by different agencies. As a result, the full scope and effect of the legislation will not be known for several years.

Finally, it is important to note that the legislation is intended to, and likely will, change the competitive dynamics of the financial services industry in the United States. A number of key provisions, such as enhanced capital requirements for large banking organizations and deposit insurance premiums based on liabilities rather than deposits, are intended to favor smaller banks over larger ones. Other provisions, such as the “skin in the game” requirements for securitizations (which in recent years accounted for more than half the credit available to U.S. consumers), may reduce the amount of credit available to retail customers and increase its cost. It is also important to note that at least at this point, no other country is in the process of adopting comparable legislation. This may well affect the competitive position of U.S. banking organizations against their foreign counterparts, at least in some business lines.

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## I. REGULATION AND RESOLUTION OF FINANCIAL COMPANIES POSING SYSTEMIC RISK

In response to the severe and widespread fall-out caused by the sudden failure of some of the largest U.S. financial organizations during the 2008 crisis, including AIG and Lehman Brothers, the Act includes among its key features numerous provisions designed to identify and mitigate “systemic risk” at an earlier stage and to impose a new regulatory scheme on companies deemed to pose systemic risk that could jeopardize the nation’s financial stability. These provisions are intended to address some of the perceived major failings of the current regulatory system. One such perceived failing relates to the “shadow banking system”: the fact that, due to gaps in the regulatory structure, many players in the financial system (including investment bank holding companies, large hedge funds, money market funds and large nonbank financial services companies), and key financial markets (including the over-the-counter market for derivatives and the tri-party repo market) were subject to little or no regulation. The regulators lacked the authority to even obtain information regarding many significant players and systems in the shadow banking system. Another perceived failing was the lack of focus on “macroprudential regulation.” Regulators focused on the risks faced by an individual firm, but neither regulators nor market participants had a comprehensive understanding of how changes in market conditions could simultaneously render ineffective risk management practices used by many firms, particularly with respect to liquidity. A third perceived failing, referred to as “too big to fail,” was the inability of the regulatory system to manage the failure of a large financial institution. Due to the complexity and interconnectedness of the financial system, the lack of information regarding the extent of those interconnections and the lack of an insolvency regime that would enable regulators to rapidly resolve the failure of a large financial institution, the regulators were left to choose between the moral hazard of “bailing out” the shareholders and creditors of such a failing institution, and the unknown, and possibly disastrous, consequences to other financial institutions and to the financial system as a whole of allowing the institution to fail.

The systemic risk provisions in the Act include:

- the creation of a Financial Stability Oversight Council, a new governmental agency comprised of representatives of all the major U.S. financial regulators. The Council is charged with identifying and mitigating sources of systemic risk, filling regulatory gaps created by the existing system of separate functional regulation, and designating certain financial companies, whether or not currently regulated under federal banking laws, as subject to enhanced regulation based on a finding that such institutions pose significant risk to the U.S. financial system;
- provisions to increase the Federal Reserve’s regulatory authority over, and enhance substantive prudential requirements applicable to, large bank holding companies and financial companies identified by the Council as posing risk to financial stability;
- imposing additional regulatory requirements on systemically important payment, clearing and settlement systems; and
- creating a new resolution authority for systemically important institutions as an alternative to the bankruptcy process. This resolution authority, which will be exercised

by the FDIC and is similar to the resolution process currently applicable to insured depository institutions, is intended to allow the FDIC to take over a failing organization and wind it down on an orderly basis (although the funds needed to do so will not be available to the FDIC until after it takes over a failing organization).

#### A. Establishment of Financial Stability Oversight Council

One of the central features of the Act is the creation of a Financial Stability Oversight Council (the “Council”), which has a general mandate to identify and respond to risks and emerging threats to the financial stability of the U.S. that could arise from the financial distress, failure or activities of large, interconnected bank holding companies and nonbank financial companies. The Council is also mandated to eliminate expectations of shareholders, creditors and counterparties of such companies that the U.S. government will shield them from losses from failures of those companies. “Nonbank financial companies” under the Act are defined as companies, other than insured depository institutions, that are substantially (*i.e.*, 85% of revenues or assets) engaged in activities considered to be “financial in nature” under the Bank Holding Company Act of 1956 (the “Bank Holding Company Act”), which include various activities currently conducted by firms that have not previously been subject to the purview of federal banking regulators, such as insurance companies, broker-dealers and asset management companies.

Chaired by the Treasury Secretary, the Council will include ten voting members, comprised of top-ranking representatives of the Board of Governors of the Federal Reserve System (the “Federal Reserve”), the Office of the Comptroller of the Currency (the “OCC”), the new Bureau of Consumer Financial Protection, the Securities and Exchange Commission (the “SEC”), the Federal Deposit Insurance Corporation (the “FDIC”), the Commodity Futures Trading Commission (the “CFTC”), the Federal Housing Finance Agency, the National Credit Union Administration and an independent member appointed by the President having insurance expertise. The Council will also have five non-voting members, including the Director of the Office of Financial Research, a new body designed to gather information necessary to inform regulatory decisions of the Council; the Director of the newly-created Federal Insurance Office; and a state insurance commissioner, bank regulator and securities commissioner. Although the Council generally acts by majority vote of its voting members, on most key decisions a two-thirds vote is required. The ten voting members (only four of whom are from bank regulatory agencies) represent agencies with differing missions and jurisdictions, which may affect the Council’s decision-making process.

The Council will have various information gathering, advisory and reporting duties, including:

- collecting information from regulatory agencies, from the new Office of Financial Research and from bank holding companies and nonbank financial companies;
- facilitating information sharing among agencies regarding financial services policy development; and
- identifying gaps in regulation and making recommendations to the Federal Reserve and other regulatory agencies designed to heighten standards and reduce systemic risk

posed by large interconnected bank holding companies and nonbank financial companies.

The Council is given broad powers to gather information from bank holding companies and nonbank financial companies, including foreign-based companies.

The Council may, by the affirmative vote of two-thirds of its members, including the chairperson, require a U.S. nonbank financial company or a foreign nonbank financial company that has substantial operations in the United States to be supervised by, and registered with, the Federal Reserve (with respect to its U.S. operations) if it determines, based on criteria prescribed in the Act, that material financial distress at the company or the nature, scope, size, scale, concentration, interconnectedness or mix of its activities could pose a threat to the nation's financial stability. While such a company would have the opportunity to request a hearing and judicial review to challenge such a determination, the Council's final determination is binding unless arbitrary and capricious. Once made, the Council's determination will be reevaluated on an annual basis and, upon the same supermajority vote of the Council (including the vote of the chairperson), the Council may rescind such a determination.

To mitigate risks posed by large, interconnected financial institutions, the Council may also, by an affirmative vote of two-thirds of its members, including its chairperson, recommend that the Federal Reserve require more stringent prudential standards and reporting and disclosure requirements for nonbank financial companies subject to its supervision and large bank holding companies. Such heightened standards, which are discussed below, may include heightened capital requirements, leverage and concentration limits, liquidity requirements, requirements to submit resolution plans and credit exposure reports, contingent capital requirements, enhanced public disclosures and heightened risk management requirements. As part of these contemplated heightened standards, the Act mandates that the Council conduct a study of the feasibility and costs and benefits of requiring nonbank financial companies and large bank holding companies to issue contingent capital securities. The Act does not define "large" bank holding companies. Although the version of the legislation initially passed by the Senate in May limited the applicability of heightened prudential standards to institutions with assets of \$50 billion or greater, the Act does not limit the Council's authority based on a particular size threshold, but gives the Council discretion to exempt institutions based on particular size thresholds and applies many of the specific requirements and limitations of the Act to bank holding companies above such threshold.

The Act contains "anti-evasion" provisions, which allow the Council, by the affirmative vote of two-thirds of its members, including its chairperson, to subject financial activities of any U.S. or foreign company to regulation by the Federal Reserve. In such a case, the company may create an intermediate holding company to house such activities, and such intermediate holding company would be subject to regulation as if it were a nonbank financial company supervised by the Federal Reserve. In what has come to be referred to as the "Hotel California" provision, the Act provides that any company that was a bank holding company with more than \$50 billion of assets as of January 1, 2010 and that received TARP assistance will be treated as a nonbank financial company supervised by the Federal Reserve even if the company subsequently ceases to be a bank holding company. Although a nonbank financial company that is supervised by the Federal Reserve is subject to substantial regulation and supervision, it

is of a lesser degree than that to which bank holding companies are subject. In particular, while the Federal Reserve may subject the proprietary trading and private funds activities of such a nonbank company to capital requirements and other restrictions, such activities are not subject to the statutory prohibition that applies to such activities in the case of bank holding companies.

In cases where the Federal Reserve determines that a nonbank financial company subject to supervision by the Federal Reserve or a bank holding company with assets of \$50 billion or more presents a “grave threat” to U.S. financial stability, the Council may, by the affirmative vote of two-thirds of its members authorize the Federal Reserve to limit the ability of the company to acquire, merge or affiliate with other companies, restrict its ability to offer financial products, terminate one or more of its activities or order a divestiture of assets to parties unaffiliated with the institution. Companies subject to such a directive may request a hearing to challenge the decision, but the decision following such hearing remains with the Federal Reserve. This provision of the Act initially applies to U.S. institutions, but the Act authorizes the Federal Reserve to prescribe regulations regarding application of the provisions to foreign entities, provided that such regulations give due regard for national treatment and competitive opportunity and take into account comparable home country standards.

The Act establishes an Office of Financial Research to be headed by a Presidential appointee for a six-year term and funded by the Treasury Department. The office is charged with supporting the Council in fulfilling its purposes, including by collecting data from agencies and financial companies, conducting research, sharing data with regulatory agencies and making reports to Congress.

#### **B. Additional Authority of Federal Reserve Over Bank Holding Companies and Nonbank Financial Companies**

The Act grants the Federal Reserve additional authority to require nonbank financial companies supervised by the Federal Reserve and these companies’ subsidiaries (other than insured depository institutions) to submit to regulatory reporting and examination requirements. It also subjects these entities to the enforcement provisions of the Federal Deposit Insurance Act as if they were bank holding companies. However, in the case of banks and other subsidiaries subject to primary regulation by another regulator, this Federal Reserve authority is a “back-up” authority pursuant to which the Federal Reserve may recommend action to the entity’s primary regulator if the Federal Reserve determines that the regulated entity poses a threat to U.S. financial stability. If the primary regulator fails to take supervisory or enforcement action acceptable to the Federal Reserve within 60 days of that recommendation, the Federal Reserve may take such action as if the subsidiary were a bank holding company.

The Act requires that any nonbank financial company regulated by the Federal Reserve or any bank holding company with assets of \$50 billion or more that is seeking to acquire another company engaged in financial activities with total consolidated assets of \$10 billion or more (other than an insured depository institution, a securities underwriter or dealer, or a company engaged in activities permitted under Section 4(c) of the Bank Holding Company Act) must provide notice to the Federal Reserve before completing any such acquisition and follow the procedures set forth in the Bank Holding Company Act for nonbanking acquisitions. In addition to the grounds for disapproval currently set forth in the Bank Holding Company Act,

the Federal Reserve may also disallow such a proposed transaction if it would result in greater or more concentrated risks to the U.S. economy or to financial stability generally. The Act also treats nonbank financial companies regulated by the Federal Reserve as if they were bank holding companies in the case of bank acquisitions (which effectively means prior Federal Reserve approval would be needed to acquire more than 5% of the voting stock of another bank or bank holding company) and for purposes of prohibiting management interlocks among those firms and other non-affiliated institutions.

The Act provides that the Federal Reserve will, on its own or upon recommendation by the Council, require that nonbank financial companies regulated by it or bank holding companies with consolidated assets in excess of \$50 billion meet heightened prudential standards based on a consideration of their capital structure, riskiness, complexity, financial activities, size and other risk-related factors as compared with other companies that do not present similar risks. The Act requires heightened prudential requirements of the following types:

- risk-based capital requirements;
- leverage limits, including maintenance of a debt-to-equity ratio of not more than 15-to-1 if the Council determines that the company poses a grave risk to U.S. financial stability and such requirement is necessary to mitigate the risk;
- liquidity requirements;
- overall risk management requirements;
- the so-called “living will” requirement to periodically submit resolution plans, which will be subject to review by the Federal Reserve and which must be amended if deemed deficient; if a satisfactory plan is not provided to the Federal Reserve and the FDIC, the entity will be required to divest assets or operations to the extent necessary to facilitate an orderly resolution of the entity in the event of material financial distress or failure;
- required reports on credit exposure and limits on having credit exposure to any unaffiliated company in excess of 25% of capital and surplus (or such lower amount as the Federal Reserve may determine); and
- concentration limits.

The Federal Reserve may establish contingent capital requirements (subject to and following the Council’s study and report to Congress on this subject to be undertaken pursuant to the Act), enhanced public disclosure requirements and short-term debt limits and such other standards as the Federal Reserve may determine to implement.

The Federal Reserve may apply the foregoing heightened standards to foreign institutions as well as U.S. institutions, but is instructed to give due regard to national treatment and home country standards.

The Federal Reserve is mandated to require publicly traded nonbank financial companies that it regulates and publicly-traded bank holding companies with assets in excess of \$10 billion, and is authorized to require smaller bank holding companies, to establish a risk committee responsible for oversight of enterprise-wide risk. The committee must include such number of

independent directors as the Federal Reserve may determine to be appropriate (based on the nature of operations, size of assets, etc.) and at least one risk management expert.

In addition, the Federal Reserve is mandated to conduct annual “stress tests” on nonbank financial companies it regulates and bank holding companies with more than \$50 billion in assets to determine whether they have enough capital, on a consolidated basis, to absorb losses as a result of adverse economic conditions. Nonbank financial companies regulated by the Federal Reserve and bank holding companies with more than \$10 billion of assets are also required to conduct semi-annual stress tests on their own operations.

The Act requires the Federal Reserve, in consultation with the Council and the FDIC, to establish regulations providing for the early remediation of financial distress of nonbank financial companies supervised by the Federal Reserve or bank holding companies with assets in excess of \$50 billion. The purpose of the requirement is to establish specific remedial steps that can be taken in order to minimize the probability that such an institution experiencing financial distress will become insolvent. These regulations would presumably be in addition to the prompt corrective action rules to which all banks and thrifts are currently subject.

### C. Payment, Clearing and Settlement Supervision

The Act applies some of the same principles applicable to nonbank financial companies to systemically important payment, clearing and settlement activities. These provisions were enacted in light of Congress’s findings that while payment, clearing and settlement activities may reduce risks for the financial system, they may also concentrate and create risks. The Act enhances the Federal Reserve’s supervisory role over systemically important payment, clearing and settlement activities, whether conducted by financial institutions or “financial market utilities,” which are defined as persons that manage or operate a multilateral system for the purpose of transferring, clearing or settling payments, securities or other financial transactions among financial institutions or between financial institutions and the managers or operators of such systems.

The Act permits the Council, by an affirmative vote of two-thirds of its members, including its chairperson, to designate particular financial market utilities or payment, clearing or settlement activities as “systemically important” or likely to become systemically important, meaning that a failure or disruption of the function of such utility or activity could create or increase the risk of significant liquidity or credit problems spreading among financial institutions or markets and thereby threaten the stability of the financial system of the United States. In making such designation, the Council must consider, among other factors, the monetary value of transactions processed, the aggregate exposure of the financial market utility or financial institution, and the relationship and interdependencies among such utility or activities with other such utilities or activities.

The Act requires the Federal Reserve, by rule or order, and in consultation with other supervisory agencies, to prescribe risk management standards governing financial market utilities and activities as to which a determination of systemic importance has been made. The Act provides for special rules applicable to clearing agencies and financial institutions regulated by the CFTC or the SEC. With respect to such institutions, the CFTC and SEC are charged with

formulating risk management standards, but if the Federal Reserve determines that such standards are insufficient to prevent or mitigate risks to U.S. financial stability, the Federal Reserve may report such findings to such regulators and to the Council, and the Council may, by the affirmative vote of two-thirds of its members, including its chairperson, require changes to those regulations deemed to be insufficient.

The Act requires the supervisory agency for a financial market utility or for the activities of a financial institution as to which a finding of systemic importance has been made to conduct, in consultation with the Federal Reserve, annual examinations of those institutions and subjects those institutions to the enforcement provisions of the Federal Deposit Insurance Act as if they were insured depository institutions. The Act also permits the Federal Reserve to recommend enforcement action to the applicable supervisory agency and to submit any disputes as to enforcement decisions between those agencies and the Federal Reserve to the Council for final determination. The Federal Reserve is empowered to take direct enforcement action upon a majority vote by the Council if the Federal Reserve has reasonable cause to believe that actions by, or the condition of, a systemically important financial market utility will pose an imminent risk of financial harm to financial institutions or the U.S. financial system. In addition, the appropriate financial regulator will have direct enforcement powers, as set forth in the Federal Deposit Insurance Act, over activities of a financial institution as to which a finding of systemic importance has been made as if such financial institution were an insured depository institution.

The standards that may be prescribed pursuant to the Act include risk management policies and procedures, margin and collateral requirements, participant and counterparty default policies and procedures and capital and financial resource requirements, among others.

The Act requires systemically important financial market utilities to provide advance notice of changes to rules, policies and procedures that could impact their risk (unless the immediate implementation of the change is necessary to permit the financial utility to continue to provide its services in a safe and sound manner, in which case such changes are subject to regulatory rescission) and prohibits such utilities from implementing changes objected to by their supervising regulators.

The Act permits the Federal Reserve to authorize a Federal Reserve Bank to provide discount and borrowing privileges to financial market utilities as to which a systemic importance determination has been made, and to exempt them from reserve requirements under the Federal Reserve Act, but only upon majority vote of the Federal Reserve members and after consultation with the Treasury Secretary.

#### **D. The Orderly Liquidation of Systemically Important Financial Companies**

##### *1. Liquidation Procedures for Systemically Important Financial Companies*

One aspect of the existing regulatory system that became a key issue in the financial crisis was the inability of any single regulator to take possession of, stabilize and wind-down a diversified financial services company. Under existing law, the FDIC could only be appointed receiver for insured depository institutions; all other U.S. companies in a failing group (with some specialized exceptions, such as insurance companies) would be subject to the Bankruptcy Code.

Bankruptcy procedures are generally focused on the reorganization of companies where possible, and the protection of creditor rights (rather than the stability of the U.S. financial system). Moreover, bankruptcy proceedings do not allow immediate decision-making by any single party, unlike an FDIC-managed receivership of an insured depository institution.

The Act addresses these issues by adopting a framework for the resolution of failing financial organizations (*i.e.*, bank holding companies, nonbank financial companies supervised by the Federal Reserve, other companies predominantly engaged in financial activities and all subsidiaries thereof other than insured depository institutions) that pose significant risks to the financial stability of the United States. The new framework incorporates much of the extensive statutory and regulatory framework that exists for the resolution of failed or failing insured depository institutions under the Federal Deposit Insurance Act. The FDIC will be appointed receiver for such a failed or failing financial company and its subsidiaries (other than those, such as insurance and broker-dealer subsidiaries, that are subject to a separate insolvency regime). The new framework, however, is not intended to replace bankruptcy procedures in most situations. Instead, it is intended to be available only in extraordinary circumstances affecting U.S. financial stability and where no viable private sector alternative is available to prevent the default of the financial company. One obvious concern is the unpredictability, for shareholders, creditors and customers of financial companies, as to whether their claims might ultimately be subject to the Bankruptcy Code or to the insolvency procedures established by the Act. Potentially, any company that obtains 85% or more of its consolidated revenues from financial activities could become subject to such procedures. It seems likely that a bank holding company with \$50 billion or more in assets, and any nonbank financial company that is supervised by the Federal Reserve will be viewed as systemically important. However, the status of other nonbank financial companies will be less clear, particularly if the Council designates few companies as nonbank financial companies that require supervision by the Federal Reserve. As the Act also severely restricts the ability of the Federal Reserve to extend credit to failing nonbank companies on an individual basis, as it did in the recent crisis, a severe financial crisis may result in a number of nonbank financial companies becoming subject to the new procedures.

In addition, large, complex nonbank financial companies typically operate in many countries. The Act does not (and, of course, could not) provide for a means to deal with the cross-border aspects of such insolvencies, beyond calling for several studies of the issue.

The orderly resolution authority provisions of the Act address, among other matters:

- the valuation and priority of claims for distribution purposes;
- limitations on court actions;
- the repudiation of contracts;
- the right to transfer assets and liabilities of the covered financial company without regard to contractual or other restrictions;
- the liability of directors and officers of the subject company for gross negligence, and expedited consideration of claims against officers, directors, employees and experts;

- clawback provisions regarding the recoupment of compensation from senior executives and directors;
- funding sources and post-receivership financing; and
- the establishment and operation of “bridge financial companies.”

The new orderly liquidation procedures apply only to “financial companies.” A “financial company” is defined as any company that is incorporated under U.S. federal law or the law of any state and is:

- a bank holding company;
- a nonbank financial company supervised by the Federal Reserve;
- a company predominantly engaged in activities that are financial in nature (as defined in Section 4(k) of the Bank Holding Company Act), which includes insurance companies and broker-dealers; or
- any subsidiary of any company described above (other than an insured depository institution or insurance company) that is predominantly engaged in activities that are financial in nature.

Companies are deemed to be “predominantly engaged” in financial activities if 85% or more of their annual gross revenues are attributed to those activities. The Act specifically exempts from the definition of financial company Farm Credit System institutions and government sponsored entities.

The Act vests the authority to invoke the new resolution authority with respect to any financial company with the Treasury Secretary following recommendation by the Federal Reserve and the FDIC (or the Federal Reserve and the SEC in the case of broker-dealers). Such recommendation must be made by a vote of two-thirds of the Board of Governors of the Federal Reserve and two-thirds of the board of directors of the FDIC (or two-thirds of the Commissioners of the SEC, as applicable).

In order to invoke the resolution authority, the Treasury Secretary must determine that:

- the company is a financial company and in default or danger of default;
- the failure of the company and its resolution under otherwise applicable federal or state law would have serious adverse effects on financial stability in the United States;
- no private sector alternative is available to prevent the default;
- any effects on creditors, counterparties and shareholders under the new resolution authority are appropriate given the impact on financial stability;
- the application of the authority would mitigate the adverse effects on financial stability; and
- a federal agency has ordered the conversion of all of the financial company’s convertible debt instruments.

A determination to appoint the FDIC pursuant to the Act's orderly resolution authority is initially made confidentially and may be immediately challenged by the financial company, in which case the Treasury Secretary must petition the U.S. District Court for the District of Columbia for an order authorizing the appointment of the receiver. The petition must be made under seal and a decision must be made within 24 hours (or if no such decision is made, the petition will be deemed granted). The Act provides that the District Court must issue the order appointing the FDIC unless it determines that the Treasury Secretary's determination was arbitrary and capricious. The Act imposes criminal penalties for disclosure of the Treasury Secretary's decision or any petition or pendency of District Court proceedings. Once the initial appeal to the District Court has been decided, the order appointing the FDIC may not be stayed or enjoined. However, any such order is subject to expedited appeal to the Court of Appeals of the District of Columbia and to the United States Supreme Court.

## 2. Purpose and Intent of the Orderly Liquidation Provisions

The purpose of the new resolution authority is to provide necessary authority to liquidate failing financial companies that pose a significant risk to the financial stability of the United States in a manner that mitigates that risk and ensures that (i) creditors and shareholders bear the losses of the institution, (ii) management responsible for the condition of the company will not be retained and (iii) those responsible for the condition of the company bear losses consistent with their responsibility, including paying damages, restitution and recoupment of compensation and other gains.

Unlike a bankruptcy proceeding to preserve the company and/or maximize payments to creditors, the Act provides that the FDIC's actions should be intended to preserve the financial stability of the United States, instead of the particular company. The Act prohibits the FDIC from taking an equity interest in or becoming a shareholder of any company or its subsidiaries for which it is appointed the receiver.

The Act also provides that all institutions put into receivership under the Act must be liquidated and that taxpayers may not bear any losses from the exercise of the resolution authority under the Act.

## 3. Jurisdiction Issues Relating to the Orderly Liquidation Authority Procedures

Proceedings initiated under the Act will cause the subject companies to be removed from any previously commenced bankruptcy case.<sup>1</sup> In the event that the FDIC is appointed as receiver for a financial company, or the Securities Investor Protection Corporation is appointed as trustee over a covered broker or dealer, on that same day, any case or proceeding with respect to such entity under the Bankruptcy Code or the Securities Investor Protection Act of 1970 is dismissed upon proper notice, and no case or proceeding can be commenced with respect to such entity at any time while proceedings are pending. However, the legislation does not stretch as far as to invalidate any order entered or other relief granted by a bankruptcy court prior to the date the FDIC became a receiver.

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<sup>1</sup> Because an entity is not required to be insolvent or in default to be eligible to file a bankruptcy petition, a financial company could conceivably have filed for bankruptcy before the process under the Act (which requires a "default" or "danger of default") was initiated.

The Act requires the FDIC as receiver to consult with the primary financial regulatory agencies for the financial company and its subsidiaries. The FDIC is also specifically required to consult with the SEC and the Securities Investor Protection Corporation in the case of resolutions of broker-dealers and is required to appoint the Securities Investor Protection Corporation as trustee for the liquidation of any broker-dealer subject to the orderly resolution process. The FDIC is required to apply subchapter III of chapter 7 of the Bankruptcy Code (with respect to distributing customer name securities and property) when liquidating a financial company or bridge financial company (as described below) that is or has a broker-dealer subsidiary, but is not a member of the Securities Investor Protection Corporation. Likewise, the FDIC is instructed to follow subchapter IV of chapter 7 of the Bankruptcy Code (with respect to distributing customer name securities and property) when liquidating such companies that are commodity brokers. In both cases, the financial company or bridge financial company is liquidated as if it were a debtor under the Bankruptcy Code.

#### 4. Role and Powers of the FDIC

As receiver, the FDIC has authority to liquidate the financial company and its nonbanking financial subsidiaries, including through the use of a “bridge financial company.” The FDIC will have three days to transfer the company’s assets, including “qualified financial contracts,” to a successor and is authorized to act as the receiver for all of the financial company’s U.S. subsidiaries (other than insurance companies, broker-dealers and insured banks). The legislation provides that the FDIC as receiver must liquidate and wind up the affairs of the covered financial company.

As the Bankruptcy Code allows a debtor to reject (*i.e.*, breach), assign (*i.e.*, transfer) or assume (*i.e.*, retain) either executory contracts or leases that were entered into before filing for bankruptcy, the Act similarly empowers the FDIC as receiver. Furthermore, the legislation expressly provides that the FDIC’s authority to recover, transfer or avoid an obligation is superior to the rights a trustee and any other party (other than a federal agency) has under the Bankruptcy Code.

In its treatment of certain qualified financial contracts, the Act takes the same approach as the Federal Deposit Insurance Act with respect to such contracts in the case of the receivership of an insured depository institution, which is substantially but not completely similar to the Bankruptcy Code approach. Under the Act, in a manner substantially similar to federal bankruptcy law, no person may be stayed or prohibited from exercising any right to terminate, liquidate or accelerate any qualified financial contract with a subject financial company which arises at any time after the FDIC is appointed.

However, the Act provides that a party to a qualified financial contract cannot exercise any right to terminate, liquidate, or net such contract due to the sole reason of or incidental to the FDIC being appointed as receiver until 5:00 p.m. Eastern Time on the business day after the FDIC was appointed, or until after the person receives notice that the contract was transferred under the Act. By contrast, under the safe harbor provision of the Bankruptcy Code, the counterparty has the immediate right to terminate such contract upon a bankruptcy filing. However, the Act makes unenforceable any “walkaway” clause purporting to eliminate, upon

appointment of a receiver for a company, any payment obligation of a counterparty to such company.

The Act limits the FDIC's ability to disaffirm or repudiate or to transfer qualified financial contracts of the subject company. The FDIC must either: (1) disaffirm or repudiate or transfer all the qualified financial contracts of the company with a counterparty, or (2) choose not to disaffirm or repudiate or transfer any of them. By contrast, the Bankruptcy Code does not contain this "all or none" rule, but rather allows the debtor to reject, assign, or assume executory contracts or leases that were entered into before filing for bankruptcy on a case by case basis that enables it to "cherry-pick" the best contracts and reject the worst.

#### 5. Bridge Financial Companies

The Federal Deposit Insurance Act provides for the creation of bridge banks by the FDIC. Such banks are typically used when the FDIC needs to close a bank and is not able to immediately transfer its deposits and assets to another banking organization. In some cases, this is because the value of the failing bank is difficult for potential buyers to assess or because the failing bank deteriorates too quickly for the FDIC to locate a buyer. The FDIC will then put the failing bank in receivership, transfer its insured deposits and most of its assets to a newly chartered bank controlled by the FDIC. Shareholders and unsecured creditors of the failed bank have claims only against the receivership, which in turn will realize value from its claim against the bridge bank only in the unlikely event that the value of the assets transferred exceeds that value of the deposits assumed by the bridge bank. Former customers of the failed bank make an essentially seamless transition to the bridge bank and greater value is generally preserved and less disruption caused than if the FDIC simply closed the failing bank, liquidated its assets and paid claims to the extent possible. Such banks are not required to have capital and they are funded, to the extent necessary, by the FDIC.

Given the likely complexity of any nonbank financial company or bank holding company that is determined to be systemically important, it seems likely that the FDIC will need to use a bridge institution as a step in the resolution of such a company, and the Act provides for "bridge financial companies" that will operate in a manner that is similar to bridge banks.

#### 6. Avoidable Transfers, Setoffs and Recoupment of Executive Compensation

In its capacity as receiver under the Act, the FDIC is authorized to avoid fraudulent and preferential transfers. The new legislation also implements harsher provisions covering senior executives and directors.

With respect to fraudulent transfers, the FDIC can avoid a subject company's transfer of property or any obligation incurred within two years prior to the time the FDIC was appointed as receiver if:

- (1) the company voluntarily or involuntarily:
  - made the transfer or incurred the obligation with actual intent to hinder, delay or defraud, or

- received less than a reasonably equivalent value in exchange for such obligation; and
- (2) the company:
  - was insolvent on the date of the transaction or became insolvent due to the transaction,
  - was engaged or about to be engaged in business or a transaction, where the company had unreasonably small capital,
  - intended to incur or believed it would incur debts that exceeded its ability to pay, or
  - made such transfer to or for the benefit of an insider (or incurred such obligation to or for the benefit of an insider) under an employment contract and not in the ordinary course of business.

Except for the last bullet under item 2 (regarding transfers to insiders under an employment contract and not in the ordinary course of business), which is new, this mirrors the Bankruptcy Code's fraudulent transfer provisions. The legislation also mirrors the Bankruptcy Code's provisions for preferential transfers, and the FDIC's avoidance powers are subject to the same defenses as in the Bankruptcy Code. This provision is notable because, unlike the Bankruptcy Code, bank insolvency laws do not provide for the avoidance of preferential transfers other than fraudulent transfers. The reason for this is that such provisions accentuate the tendency of financial distress at a bank to lead to a "run" on the bank, as depositors and lenders seek to withdraw their funds before the bank closes, thereby making it much more likely that the bank will need to close. Depositors would need to assess not just whether the bank is likely to close immediately, but whether it may close within the preference period (90 days).

Under the Act, setoff rights have similar treatment as under the Bankruptcy Code, with some qualifications to allow the FDIC to transfer liabilities to a third party or bridge financial company even if the transfer destroys the mutuality of offsetting claims.

#### 7. Priority of Claims

Under the Act, unsecured claims are ranked in priority as follows:

1. the FDIC's claims for administrative expenses as receiver;
2. amounts owed to the United States, unless it agrees or consents otherwise;
3. wages, salaries or commissions to those other than senior executives and directors (up to \$11,725 each);
4. claims for certain contributions to employee benefit plans;
5. claims under other general or senior liabilities of the company;
6. any other obligations subordinated to general creditors;
7. claims of senior executives and directors for wages, salaries or commissions; and

8. obligations to shareholders, members, partners or other similar persons.

While there is substantial similarity to the priority of claims under the Bankruptcy Code, the Act departs from the priority of claims afforded under the Bankruptcy Code to make the unsecured claims of senior executives and directors (for wages, salaries or commissions) junior to all debts, even subordinated debt, and senior to only shareholder claims.

The Act generally requires that similarly situated unsecured claimants must be treated similarly; however, the FDIC may take any action that it determines necessary to maximize the value of the company subject to liquidation proceedings, continue essential operations and maximize return or minimize loss from disruption. In addition, with the approval of the Treasury Secretary, the FDIC may authorize payments to any claimant if the FDIC determines the payment is necessary to minimize losses to the FDIC, provided that no claimant may receive more than the face value of its claim.

8. Provisions Applicable to Management and Other Responsible Parties

The Act requires the FDIC to promulgate regulations designed to prevent various benefits to specified persons, including persons who defaulted on obligations to the failed institution, persons who engaged in fraudulent conduct, officers and directors and other persons who participated in transactions causing substantial losses to the failed institution.

Notably, the legislation authorizes the FDIC or Federal Reserve, subject to due process and other procedures, to prohibit culpable senior executives and directors from working in the financial services industry for a period of no less than two years if they violated certain laws or conditions, engaged in unsafe or unsound financial practices, or breached their fiduciary duty by virtue of any act or omission. The Act gives the FDIC authority to recoup compensation paid to current or former senior executives and directors of a subject company who are "substantially responsible for the failed condition" of the resolved company. The FDIC can seek to recoup compensation paid within two years of the agency's appointment as receiver for the company, but there is no time limit in the case of fraud. There are no comparable provisions in the Bankruptcy Code.

9. Post-Receivership Financing and Funding Sources

The Act establishes a separate fund in the U.S. Treasury called the "Orderly Liquidation Fund," which is available to the FDIC to carry out its responsibilities under the resolution provisions of the Act, including, among others, paying the costs of liquidation, administrative expenses, and principal and interest on obligations issued by the FDIC pursuant to the Act.

The Orderly Liquidation Fund will not be funded until a financial company is placed in receivership under the orderly liquidation provisions of the Act. At that point, it will be funded by proceeds of obligations that may be issued by the FDIC to the Treasury Secretary subject to limits prescribed in the Act, interest and other investment earnings and risk-based assessments imposed on financial institutions and proceeds received from liquidations under the Act.

The Act authorizes the FDIC to issue debt securities to the Treasury Department, up to a maximum amount for each covered financial company equal to: (a) during the 30-day period

immediately following the appointment of the receiver, 10% of the book value of the covered financial company's total consolidated assets (based on its most recent financial statements available), and (b) after such 30-day period, 90% of the fair value of such company's total consolidated assets.

In order to obtain amounts from the Orderly Liquidation Fund to pay expenses in connection with any particular resolution, the FDIC must develop an orderly liquidation plan for that entity that is acceptable to the Treasury Secretary. The liquidation plan must provide for a specific plan for the repayment of any obligations issued by the FDIC. The Treasury Secretary and the FDIC are required to consult with the Congressional banking committees regarding that repayment plan.

The FDIC may impose risk-based assessments to the extent necessary to permit the FDIC to repay the Treasury all amounts owed pursuant to obligations issued by the FDIC to the Treasury within 60 months after the issuance of such obligations (as such period may be extended by agreement of the FDIC and the Treasury Secretary). Assessments will be charged first against claimants who receive more than the amount to which they are entitled solely from the proceeds of an institution liquidated pursuant to the Act (for example, creditors whose claims were transferred for full consideration to a third party). If those recoupment payments are not sufficient, the FDIC is required to charge risk-based assessments against bank holding companies with more than \$50 billion in assets, nonbank financial companies supervised by the Federal Reserve and other financial companies with more than \$50 billion in assets. The assessments will be charged at a graduated rate based on the level of assets and risk of the institutions against which the assessments are charged. Risk levels of those institutions will be determined by the FDIC based on numerous factors outlined in the Act, including the assets, activities, market share, leverage, liquidity and risk history of the institutions subject to the assessment and such other factors as the FDIC may determine appropriate.

## II. KEY BANK REGULATORY REFORMS

The Act brings important changes to existing bank regulations, including the imposition of new bank capital requirements, the abolishment of the Office of Thrift Supervision, the Volcker Rule restrictions on proprietary trading and private funds activities by bank holding companies, and deposit insurance reforms. Among other provisions, the Act includes:

- new minimum leverage and risk-based capital requirements, and limitations on the inclusion of hybrid capital securities and cumulative preferred securities in Tier 1 capital for bank and thrift holding companies;
- a ban on proprietary trading by banking organizations and restrictions on their investments in and sponsorship of hedge funds and private equity funds;
- the abolishment of the Office of Thrift Supervision and the related transfer of its functions and powers to the Federal Reserve, the OCC and the FDIC;
- a new concentration cap on the growth of large financial firms;
- broader powers for all banks and thrifts to branch across state lines on a *de novo* basis;

- a permanent increase in the level of federal deposit insurance coverage to \$250,000 and the repeal of a prohibition on banks paying interest on “business checking” accounts;
- limitations on the Federal Reserve’s emergency authority under Section 13(3) of the Federal Reserve Act;
- limitations applicable to certain nonbank “banks” under the Bank Holding Company Act; and
- a requirement that interchange fees, or “swipe” fees, on debit card transactions be “reasonable and proportional” to the cost of processing such transactions.

#### A. New Bank Capital Requirements and Other Changes

##### 1. Minimum Leverage and Risk-Based Capital Requirements

During the reconciliation process, the so-called “Collins Amendment” was the subject of some of the most intense negotiations by House and Senate conferees. As incorporated into the Act, the Collins Amendment requires the federal banking regulators, including the Federal Reserve, to establish new minimum leverage and risk-based capital requirements for insured depository institutions, bank and thrift holding companies and nonbank financial companies supervised by the Federal Reserve. These new requirements cannot be (i) less stringent than those requirements applicable to insured depository institutions under the prompt corrective action regulations of the Federal Deposit Insurance Act, regardless of “total consolidated asset size or foreign financial exposure,” or (ii) quantitatively lower than the requirements that were in effect for insured depository institutions as of the date the Act became law. It is these two conditions, or floors, that give the Collins Amendment its importance.

The Collins Amendment will have major implications for large banks, bank holding companies, thrift holding companies and nonbank financial companies that are supervised by the Federal Reserve. First, thrift holding companies were not previously subject to any capital requirements. The Act not only authorizes the Federal Reserve, which replaces the OTS as the regulator of thrift holding companies, to impose capital requirements on them, but in the Collins Amendment the Act specifies that such capital requirements must be no less stringent than those generally applicable to insured depository institutions. This requirement is especially significant for industrial and other nonbank companies that have controlled a thrift institution since 1999 without being subject to consolidated holding company capital requirements. Now they will be subject to the same capital requirements as insured depository institutions after a five-year grace period.<sup>2</sup>

Second, in the case of large banks, the significance of the Collins Amendment is based on the definition of the capital floors in terms of those applicable to insured depository institutions under the prompt corrective action guidelines, “regardless of total consolidated asset size or foreign financial exposure.” As adopted in the United States, the Basel II capital rules, which

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<sup>2</sup> Separately, under the Act such grandfathered thrift holding companies will be required to serve as a source of strength for their thrift subsidiaries and may be required to establish regulated intermediate holding companies that contain all their financial activities (other than certain internal activities) and that would be regulated by the Federal Reserve.

require the use of highly sophisticated financial models, are available only to a small number of very large banking organizations (and to a few, not quite so large, that have substantial international exposures). For some time, concerns have been expressed in Congress and among smaller banking organizations that the Basel II capital guidelines would enable large banking organizations to reduce the amount of capital that they held, providing them with a competitive advantage and, as some see it, leaving them with capital levels that are too low. The Collins Amendment will address these concerns.

Third, the Collins Amendment effectively ends the use of cumulative preferred stock and certain hybrid securities, such as trust preferred securities, as a component of Tier 1 capital. Currently, the Federal Reserve permits bank holding companies to include cumulative preferred stock and certain hybrid securities in their Tier 1 capital, subject to quantitative limits and qualitative standards. However, banks and thrifts are not permitted to do so. As described below, the Collins Amendment disallows any cumulative preferred stock and hybrid capital instruments issued on or after May 19, 2010 from counting as Tier 1 capital; permanently grandfathered such instruments issued before that date by organizations with less than \$15 billion in consolidated assets; and requires a three-year phase-out, beginning in 2013, of such instruments issued before that date for larger organizations:

- Effective retroactively to May 19, 2010, non-Tier 1 qualifying debt or equity instruments issued *on or after* May 19, 2010 by “depository institution holding companies” (defined as a domestic bank or thrift holding company, including any bank or thrift holding company that is owned or controlled by a foreign organization, but does not include the foreign organization itself) or nonbank financial companies supervised by the Federal Reserve must be excluded from Tier 1 capital. All institutions covered by the Collins Amendment are immediately affected by this provision.
- Effective “incrementally” over a three-year period from January 1, 2013 to January 1, 2016, non-Tier 1 qualifying debt or equity instruments issued *before* May 19, 2010 by depository institution holding companies with more than \$15 billion of consolidated assets or nonbank financial companies supervised by the Federal Reserve must be excluded from Tier 1 capital. For depository institution holding companies that issued trust preferred securities with the right to redeem upon a “regulatory capital event” (*i.e.*, a change in law or regulation that affects the Tier 1 capital treatment of such security), consideration will need to be given to the timing of any redemption notice, to obtaining Federal Reserve approval prior to any such redemption and, most importantly, to finding any necessary Tier 1 capital replacement. Following implementation of the new requirements, only common stock, noncumulative perpetual preferred stock and qualifying minority interests in consolidated subsidiaries (including potentially REIT preferred securities) will qualify as Tier 1 capital instruments.
- For depository institution holding companies with total consolidated assets of under \$15 billion as of December 31, 2009, as well as for mutual holding companies in existence on May 19, 2010, there are no required regulatory capital deductions for non-Tier 1 qualifying debt or equity instruments issued *before* May 19, 2010.
- For intermediate bank holding company subsidiaries of foreign banking organizations that have relied on the exemption from the Federal Reserve’s capital adequacy

guidelines pursuant to Supervision and Regulation Letter SR-01-1 (dated January 5, 2001), non-Tier 1 qualifying debt or equity instruments issued *before* May 19, 2010 do not have to be excluded from Tier 1 capital until five years from the date of enactment.

- The Collins Amendment does not apply to: (i) certain small bank holding companies with less than \$500 million in consolidated assets, (ii) securities issued under TARP or (iii) any Federal Home Loan Bank.

## 2. Capital Requirements to Address Certain Activities that Pose Systemic Risks

Subject to the recommendation of the Council, the federal banking regulators must issue a separate set of capital requirements applicable to insured depository institutions, their holding companies and nonbank financial companies supervised by the Federal Reserve that address the risks that the activities of such institutions pose to “private and public stakeholders” in the event of the disruption or failure of the institution or activity.

At a minimum, these rules are to address risks arising from:

- significant volumes of activity in derivatives, securitized products, financial guarantees, securities borrowing and lending, repurchase and reverse repurchase agreements;
- concentrations in assets for which the values presented in financial reports are based on models, rather than historical cost or prices derived from deep and liquid two-way markets; and
- concentrations in market share for any activity that would substantially disrupt financial markets if the institution is forced to unexpectedly cease the activity.

## 3. Other Key Bank Regulatory Changes in the Act

The Act also contains several other miscellaneous provisions reflecting the Act’s heightened emphasis on the capital adequacy and financial strength of financial institutions. These provisions include the following:

- *Countercyclical capital requirements*—The Act requires the Federal Reserve and the other federal banking regulators to establish capital requirements that are countercyclical with the economy, so that higher capital levels are required in times of economic growth and lower levels are required in times of economic contraction.
- *Capital requirements for financial holding companies*—As a special subset of bank holding companies, financial holding companies may engage in a broader range of activities than other bank holding companies, provided, among other things, that all of their bank subsidiaries are “well capitalized” (under the prompt corrective action guidelines) and “well managed.” The Act amends the Bank Holding Company Act to further require that a financial holding company itself (and not only its bank subsidiaries) be well capitalized and well managed as a condition to engaging in any expanded financial activities. For foreign banks, this will not represent a change in practice. Such a requirement currently applies (both in regulation and in practice) to foreign bank holding companies that have elected to become financial holding companies.

- *Clarified “source of strength” obligation*—The Act statutorily requires what the Federal Reserve has long expected of bank holding companies: that they serve as a source of financial strength to their bank subsidiaries during times of financial distress. Although some form of a source of strength doctrine has been part of the Federal Reserve’s Regulation Y for decades, this explicit codification removes any doubt that has emerged from case law on the Federal Reserve’s authority to require certain actions of bank holding companies. The Act also clarifies that this source of strength obligation extends to thrift holding companies as well as to any other company that is not a bank or thrift holding company but nevertheless directly or indirectly controls an insured depository institution. Amendments necessary to effect the codification would become effective one year from enactment.

## B. Enactment of the “Volcker Rule”

The Act will generally prohibit banks, their holding companies and any of their subsidiaries and affiliates from (i) engaging in proprietary trading and (ii) investing in or sponsoring private equity funds or hedge funds. The prohibition is embodied in what has come to be known as the “Volcker Rule,” named after Paul Volcker, the former chairman of the Federal Reserve and current head of the President’s Economic Recovery Advisory Board, who was the initial advocate for banning banking organizations from engaging in such activities. The Volcker Rule prohibitions were not included in either the Treasury White Paper or the financial reform bill approved by the House on December 11, 2009, and were only raised in January of this year as the Senate began work on the legislation. The proposal initially met with skepticism in Congress, but it gained considerable momentum during Congressional hearings and was eventually incorporated into the legislation passed by the Senate. During the reconciliation process, the Volcker Rule underwent significant changes and clarifications; what emerged raises a multitude of interpretive questions and promises to be complex in application. Below is a summary of some of the key provisions of the Volcker Rule.

### 1. The Basic Prohibition

Under the Volcker Rule, the Bank Holding Company Act is amended to provide that “a banking entity shall not (A) engage in proprietary trading; or (B) acquire or retain any equity, partnership, or other ownership interest in or sponsor a hedge fund or a private equity fund.”

For purposes of the Volcker Rule:

- A “banking entity” is any (i) insured depository institution (other than certain limited purpose trust companies), (ii) company that controls an insured depository institution (*i.e.*, bank and thrift holding companies, but also any company that directly or indirectly controls a nonbank bank, such as a credit card bank or industrial loan company), (iii) company that is treated as a bank holding company under the International Banking Act (*i.e.*, foreign banks that have a branch, agency or commercial lending subsidiary in the United States) and (iv) affiliate or subsidiary of such insured depository institution or company.
- A “hedge fund” or “private equity fund” is an issuer that would be an investment company but for the exemption from registration under Sections 3(c)(1) or 3(c)(7) of the

Investment Company Act of 1940 (the “Investment Company Act”) or “such similar funds” as the appropriate federal banking regulators, the SEC and the CFTC may determine.

- “Proprietary trading” means engaging as principal for the “trading account” (generally, an account used for acquiring or taking positions principally for the purposes of selling in the short term) of the banking entity in any transaction to purchase or sell any security, any derivative or any other security or financial instrument that the federal banking regulators, the SEC and the CFTC may determine by rule.
- “Sponsor” means serving as a general partner, managing member or trustee of a fund; selecting or controlling a majority of the directors, trustees or management of a fund in any manner; or sharing with the fund the same name or a variation of the same name for corporate, marketing, promotional or other purposes.

## 2. Exclusions From the Basic Prohibition

The Volcker Rule does not apply to “permitted activities,” subject to any restrictions and limitations that the federal banking regulators, the SEC and the CFTC may determine. The federal banking regulators, the SEC and the CFTC are authorized under the Act to determine by regulation that an activity should be considered a “permissible activity” if it would promote and protect the safety and soundness of the banking entity and the financial stability of the United States.

Apart from determinations by regulators, a number of activities are statutorily deemed to be “permissible activities” under the Act, and therefore expressly excluded from the Volcker Rule’s prohibitions, including:

- buying and selling securities issued by the U.S. government and certain government-sponsored enterprises;
- buying and selling securities in connection with underwriting or market-making activities to the extent such activities are reasonably designed not to exceed the reasonably expected near term demands of clients, customers or counterparties;
- certain risk-mitigating hedging activities in connection with positions, contracts or other holdings of the banking entity that are designed to reduce the specific risks to the banking entity in connection with such positions, contracts or other holdings;
- purchases and sales on behalf of customers;
- certain insurance company investments for the general account of the company; and
- proprietary trading conducted solely outside of the United States by a non-U.S. banking entity (not directly or indirectly controlled by a banking entity organized under U.S. law) pursuant to Sections 4(c)(9) or (13) of the Bank Holding Company Act.

As a general matter, no transaction or activity may continue to qualify as a permitted activity if it would (i) involve or result in a material conflict of interest (to be defined by the regulators) between the banking entity and its clients, customers or counterparties; (ii) result in a material exposure of the banking entity to high-risk assets or trading strategies (to be defined by the

regulators); (iii) pose a threat to the safety and soundness of the banking entity; or (iv) pose a threat to the financial stability of the United States.

3. The Volcker Rule and Hedge Funds and Private Equity Funds

Certain sponsorships of and investments in hedge funds and private equity funds are also considered “permissible activities” under the Volcker Rule. In addition to an exemption for certain actions by non-U.S. banking entities not involving sales to U.S. residents, the most significant permissible activity exemption allows banking entities to organize and offer a hedge fund or private equity fund, including by serving as general partner and in any manner controlling the fund’s management if certain conditions are met, including:

- the fund is organized and offered only in connection with the provision of bona fide trust, fiduciary or investment advisory services and only to persons that are customers of such services of the banking entity;
- the banking entity’s investment in the fund is for the purpose of making a *de minimis* investment or providing seed money; provided that (i) not later than one year after the fund’s establishment, the investment is reduced to no more than 3% of the fund’s total ownership interests; (ii) the investment is immaterial to the banking entity (to be defined by the regulators) and in aggregate all such investments do not exceed 3% of the banking entity’s Tier 1 capital; and (iii) the aggregate amount of such investments is deducted from both the assets and the tangible equity of the banking entity, with the amount of the deduction increasing “commensurate with the leverage of the hedge fund or private equity fund”;
- no director or employee of the banking entity (other than those who are “directly engaged in providing investment advisory or other services to the fund”) takes or retains an ownership interest in the fund; and
- the banking entity (i) does not directly or indirectly guarantee the obligations or performance of the fund or share its name or a variation of its name with the fund, and (ii) informs investors that any fund losses will be borne by investors, and complies with any regulations issued to ensure that it is the case.

The same requirements described above regarding the absence of conflicts of interest, material exposure to high-risk assets or trading strategies and threats to the entity or the financial stability of the United States would apply. In addition to these conditions, a banking entity must comply with restrictions that the Volcker Rule imposes on transactions with hedge and private equity funds that the bank entity sponsors, manages, advises, organizes or offers. The Volcker Rule prohibits any banking entity (including its affiliates) from engaging in a “covered transaction,” as defined in Section 23A of the Federal Reserve Act, with a hedge fund or private equity fund (or with another hedge fund or private equity fund that is controlled by such fund) if the banking entity serves, directly or indirectly, as the investment manager, investment adviser or sponsor of that fund, or if it organizes and offers the fund as a permitted activity in connection with bona fide trust, fiduciary or investment advisory services.

Section 23A is intended to protect an insured depository institution (and, indirectly, the FDIC’s Deposit Insurance Fund) from transactions with its parent and cross-stream affiliates that are

disadvantageous to the insured depository institution. Section 23A applies to specified “covered transactions,” including loans, extensions of credit, purchases of assets and affiliate securities, and issuance of guarantees by the insured depository institution. (As described later in this memorandum, the Act also amends Section 23A to include credit exposure from derivative transactions as covered transactions.) Normally, these transactions are subject to, among other limitations, a quantitative restriction that, in aggregate, such transactions with all affiliates may not exceed 20% of the capital of the depository institution, but the Volcker Rule instead applies a flat prohibition.

The Volcker Rule also requires that transactions between a hedge fund or private equity fund and a banking entity that serves as the investment manager, investment adviser or sponsor, or that organizes and offers the fund, satisfy the qualitative standard set forth in Section 23B of the Federal Reserve Act. Section 23B of the Federal Reserve Act requires all transactions between an insured depository institution and its affiliates to be on an arm’s length basis or on better terms from the perspective of the insured depository institution. Section 23B is broader than Section 23A in that it applies not only to “covered transactions,” but to most commercial transactions between affiliates.

Notwithstanding the prohibition on covered transactions under Section 23A, the Federal Reserve may permit “any prime brokerage transaction” with such a hedge fund or private equity fund if the Federal Reserve determines that it is consistent with the safe and sound operation of the banking entity or a nonbank financial company supervised by the Federal Reserve. (The Act does not indicate whether such determinations are to be made by rule or on a case-by-case basis.) Any exemption of prime brokerage arrangements from the Section 23A covered transactions ban does not exempt them from any Section 23B requirement that otherwise applies to the transactions.

#### 4. The Volcker Rule and Systemically Important Nonbank Financial Companies

Nonbank financial companies that are supervised by the Federal Reserve under the Act are not subject to the ban on proprietary trading or on investing in or sponsoring hedge funds or private equity funds, or on covered transactions with hedge funds or private equity funds that they advise or in which they invest or the application of Section 23B to those transactions. However, the regulations to be adopted pursuant to the Volcker Rule must include “additional capital requirements or other restrictions” on those companies to address “the risks to and conflicts of interest of banking entities described in” the provisions imposing those restrictions on banking entities.

#### 5. Implementation and Transition Matters

Within six months of enactment, the Council is required to study and issue recommendations on implementing the Volcker Rule addressing, among other things, conflicts of interest, financial stability concerns, the cost and availability of financial services, and appropriate timing for certain divestitures to be required under the Volcker Rule. Within nine months of completion of that study, the federal banking, securities and commodities regulators are to issue regulations implementing the Volcker Rule’s provisions. The Volcker Rule’s prohibitions will

then become effective on the earlier of (i) 12 months after the final regulations are issued or (ii) two years from enactment.

The Act provides a period for divestiture of non-conforming investments and activities, with rules regarding the conformance period to be issued by the Federal Reserve within six months of enactment. Under the Act, the general rule is that a banking entity or nonbank financial company supervised by the Federal Reserve needs to conform by no longer sponsoring or making or retaining investments in hedge funds or private equity funds or engaging in proprietary trading within the later of two years from the effective date of the rules (*i.e.*, not more than four years from enactment) and the date on which it became a bank holding company or was designated a systemically important nonbank financial company subject to supervision by the Federal Reserve. This transition period may be extended under certain circumstances. The Federal Reserve, by rule or order, may extend the transition period, one year at a time, for up to three additional years (*i.e.*, seven years from enactment) if it determines such extensions to be consistent with the purposes of the Volcker Rule and not detrimental to the public interest.

The Federal Reserve may also grant extensions for “illiquid funds,” a term that refers to certain funds that, as of May 1, 2010, were principally invested in or were invested in and contractually committed to principally invest in, illiquid assets, such as portfolio companies, real estate investments and venture capital investments. With respect to such funds, the Federal Reserve may, upon application by a banking entity, approve one five-year extension to the period during which the banking entity may “take or retain its equity, partnership, or other ownership interest in, or otherwise provide additional capital to” such fund, but only “to the extent necessary to fulfill a contractual obligation that was in effect on May 1, 2010.” Divestiture is required once “the contractual obligation to invest” in the illiquid fund terminates. The five-year extension for illiquid investments appears to be in addition to the basic five-year period for divestitures.

### C. Abolishment of the Office of Thrift Supervision

As expected, the Office of Thrift Supervision (the “OTS”), the primary regulator for thrifts and thrift holding companies, will be abolished. As the primary regulator for AIG, Countrywide, Washington Mutual and IndyMac, the OTS was cited frequently for its perceived insufficient regulatory oversight and as part of the larger debate on “regulatory arbitrage.” Under the Act, the OTS’s functions and powers will be transferred within one year of enactment (or within 18 months, if extended by the Treasury Secretary).

The OTS’s functions and powers will be transferred to, and divided among, the Federal Reserve, the OCC and the FDIC. The Federal Reserve will assume all functions relating to the supervision of thrift holding companies and their nonbank subsidiaries, as well as all rulemaking authority over thrift holding companies. The Federal Reserve will also assume rulemaking authority relating to thrift transactions with affiliates, loans to insiders and tying arrangements. The OCC will assume all functions and powers of the OTS relating to federally-chartered thrifts, while the FDIC will assume all of the OTS’s powers and functions relating to state-chartered thrifts. Generally, existing thrifts and thrift holding companies will continue to

operate under current laws (including the Home Owners' Loan Act) and OTS regulations and interpretations, which will be administered by the applicable banking agency.

Congress did not eliminate the federal thrift charter itself or prohibit the granting of thrift charters in the future. As a result, the OCC, at least in theory, can continue chartering new federal thrifts after the OTS's functions and powers are transferred to it. However, the Act does call for a study that includes consideration of whether to eliminate the exception to the definition of "bank" that is currently available to thrifts, so that thrift holding companies would be required to register and be regulated as bank holding companies.

#### **D. Interstate Bank Acquisitions and De Novo Branching**

The Act includes several provisions affecting bank regulatory approvals of proposed acquisitions of insured depository institutions. For acquisitions requiring the approval of the Federal Reserve, Section 3(c) of the Bank Holding Company Act is amended to require that the Federal Reserve take into consideration, in every case, the extent to which a proposed transaction would result in "greater or more concentrated risks to the stability of the United States banking or financial system." Similarly, the "convenience and needs" test applicable to transactions covered under the Bank Merger Act is broadened to include considerations relating to "the risk to the stability of the United States banking or financial system."

In addition to financial stability concerns, the Act imposes heightened standards with regard to capital and management for interstate bank acquisitions and mergers. Currently, an acquiring bank holding company (in the case of a transaction requiring Federal Reserve approval for the acquisition of a bank located in a state other than the home state of the acquiring bank holding company) or a resulting bank (in the case of a transaction requiring the applicable federal banking regulator to approve a merger transaction between insured banks with different home states) must be "adequately capitalized" and "adequately managed." The Act changes this by requiring the highest capital rating that a financial institution can attain under the prompt corrective statute. Effective one year from the date of enactment, "well capitalized" status, as well as "well managed" status, will generally be required for interstate merger and acquisition transactions to be approved.

The Act also alters the state "opt-in" election that has been necessary to permit interstate branching through *de novo* branches of national and FDIC-insured state-chartered banks. Under the Act, national banks and state-chartered banks may establish branches in any state if that state would permit the establishment of the branch by a state bank chartered in that state. As a result, both national and state-chartered banks will now generally be able to branch freely across state lines.

#### **E. Changes to Affiliate and Insider Transaction Restrictions and Lending Limits**

The Act imposes a number of new restrictions on transactions with affiliates and insiders, with related amendments to Sections 23A and 23B of the Federal Reserve Act generally becoming effective one year from enactment. Following is a list of some of the more significant changes:

- any investment fund that is advised by a member bank or its affiliate will be treated as an affiliate for purposes of Section 23A, consistent with the Volcker Rule;

- credit exposures (not defined) on a derivative transaction with an affiliate or any transaction with an affiliate that involves the borrowing or lending of securities will, to the extent such a transaction causes a credit exposure to the affiliate, be treated as a “covered transaction” for purposes of Section 23A and subject to its collateral requirements;
- credit extensions and guarantees that are outstanding will continue to be subject to the collateral requirements of Section 23A, and not simply at the inception of such transactions;
- exceptions for transactions with financial subsidiaries under Section 23A will be eliminated (and eliminated immediately with regard to such transactions entered into on or after the date of enactment); and
- the Federal Reserve’s authority to grant Section 23A exemptions is substantially restricted because, prior to granting any exemption, it will have to provide the FDIC with 60-day notice, during which time the FDIC may object to the Federal Reserve’s finding that the exemption is in the public interest, based on a determination by the FDIC that the exemption presents an “unacceptable risk” to the Deposit Insurance Fund.

Consistent with the heightened regulatory focus on derivative transactions, the Act also amends the lending limits applicable to national banks and federally-chartered thrifts by including within such limits any credit exposure from a “derivative transaction” with another person, including an insider. The term “derivative transaction” is defined broadly to include any transaction that is a contract, agreement, swap, warrant, note or option that is based on the value of, any interest in or any quantitative measure or the occurrence of any event relating to, one or more commodities, securities, currencies, interest or other rates, indices or other assets. The limits also include credit exposures from a repurchase agreement, reverse repurchase agreement, securities lending transaction or securities borrowing transaction between a national bank or federally-chartered thrift and another person. These changes will take effect one year from enactment.

#### F. Prohibiting Charter Conversions by Troubled Institutions

The Act immediately prohibits a national bank from converting its charter to a state charter if it is subject to a cease-and-desist order, memorandum of understanding or other enforcement order by the OCC with respect to a significant supervisory matter. Likewise, a state-chartered bank or thrift is prohibited from converting to a national bank or federal thrift if it is subject to a cease-and-desist order, memorandum of understanding or other enforcement order by its state banking regulator or state attorney general. Federally-chartered thrifts are also subject to prohibitions with regard to conversions to a state charter. The Act provides for a limited exception if the existing regulator does not object to the conversion after having been notified and after having received an acceptable plan by the post-conversion regulator to address the significant supervisory matters which were the subject of the existing regulator’s enforcement action.

## G. Limiting the Growth of Large Financial Firms

Since 1994, U.S. banking law has limited the expansion of banks and bank holding companies by prohibiting transactions that would result in a bank holding company acquiring, on a consolidated basis, more than 10% of the total insured deposits in the United States. The Act alters this cap by prohibiting any “financial company” from merging or acquiring control of another company if the acquiring financial company, on a consolidated basis, would hold more than 10% of the aggregate consolidated “liabilities” of all financial companies at the end of the prior calendar year. As a result, the new “concentration limit” will encompass a wider range of liabilities than the cap currently in place and potentially affect a broader range of companies.

The concentration limit provision applies to “financial companies,” a term that is defined for purposes of this provision to include insured depository institutions, bank and thrift holding companies (as well as any other company that controls a bank or thrift), nonbank financial companies supervised by the Federal Reserve and any foreign bank or company that is treated as a bank holding company under the Bank Holding Company Act. For U.S. financial companies, liabilities are to be calculated by reference to total risk-weighted assets, as adjusted to reflect exposures that are deducted from regulatory capital, less total regulatory capital under the risk-based capital rules applicable to bank holding companies. For foreign-based financial companies, the calculation is different, focusing principally on the total risk-weighted assets of their U.S. operations, as determined pursuant to risk-based capital rules. For insurance companies or other nonbank financial companies supervised by the Federal Reserve, the calculation will be based on those assets specified in regulations to be issued by the Federal Reserve.

The new concentration limit does not take effect immediately. The Council has six months to study the extent to which it would affect financial stability and the efficiency and the competitiveness of U.S. financial firms and financial markets and to recommend modifications. The Federal Reserve then has nine months to issue final regulations reflecting the recommendations of the Council.

## H. Deposit Insurance and Other Reforms

The Act also contains a number of deposit insurance reforms. Significantly, the Act directs the FDIC to depart from the long-standing practice of charging deposit premiums based on the amount of deposits held by an insured depository institution. Instead, regulations under the Federal Deposit Insurance Act must be amended to define the term “assessment base” by reference to an institution’s total assets. An insured depository institution’s assessment base would generally be an amount equal to its average consolidated total assets during an assessment period *minus* its average tangible equity during such period.<sup>3</sup>

The Act increases the minimum reserve ratio for the Deposit Insurance Fund from 1.15% to 1.35% of estimated insured deposits (or the comparable percentage of the assessment base) and requires the FDIC to take necessary steps for the reserve ratio to reach the new minimum

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<sup>3</sup> Note that, whether intentional or not, this provision penalizes institutions that have generated significant goodwill from acquisitions, since assessments will effectively have to be paid on that goodwill.

reserve ratio by September 30, 2020. The Act also gives the FDIC sole discretion to suspend or limit the payment of dividends from the Deposit Insurance Fund even after the minimum reserve ratio has been reached.

The Act also permanently increases the level of federal deposit insurance coverage to \$250,000, retroactive to January 1, 2008. The standard limit was temporarily raised from \$100,000 to \$250,000 per depositor with the enactment of the Emergency Economic Stabilization Act of 2008. On May 20, 2009, this temporary limit was extended through December 31, 2013. The Act makes permanent the level of federal deposit insurance applicable to depositors of banks, thrifts and credit unions that had been in place since the start of the financial crisis in 2008. The retroactive application will result in the repayment of additional deposits to customers of the failed IndyMac Bank (and several other smaller banks), with an estimated cost of \$180 million.

The Transaction Account Guarantee Program, a component of the FDIC's Temporary Liquidity Guarantee Program adopted in October 2008, will be extended through 2012. Under the program, funds held in noninterest-bearing transaction accounts above the existing deposit insurance limit are guaranteed by the FDIC.

Apart from deposit insurance, the Act also repeals provisions that have prohibited insured depository institutions from paying interest on "business checking" accounts. The repeal is effective one year from enactment.

## I. Federal Reserve System Reforms

### 1. Transparency and Governance

A number of provisions in the Act are designed to enhance the transparency of the Federal Reserve System. The Act provides for a one-time audit by the Government Accountability Office ("GAO") of all emergency loans and other financial assistance provided by the Federal Reserve under Section 13(3) of the Federal Reserve Act between December 1, 2007 and the date of enactment. The audit would also include open market transactions and transactions made pursuant to the Federal Reserve's discount window. The Act also requires the Federal Reserve to publish by December 1, 2010 the details on all loans and other financial assistance (including identities of borrowers and recipients, specific terms of repayment, interest charges, collateral information, limitations on executive compensation and other material terms) provided under the various emergency lending facilities that were in place during this 2007 to 2010 period. In addition, the Federal Reserve must disclose, on an ongoing basis and with specified time delays, the identities of borrowers and participants and information regarding amounts, terms and conditions of emergency lending facilities, discount window programs and other open market operations of the Federal Reserve—all information that the Federal Reserve traditionally has not made publicly available.

Other provisions in the Act relate to the Federal Reserve System's governance. Directors of each of the twelve Federal Reserve Banks who are elected by member banks (other than those elected to represent the public) will now be ineligible to vote for the election of the president of a Federal Reserve Bank. Instead, Federal Reserve Bank presidents will be elected by those directors who are appointed by the Federal Reserve or by district member banks to represent the public. The Act requires the GAO to conduct a study on the current system for electing

directors of Federal Reserve Banks, and specifically whether there are actual or potential conflicts of interest created when such directors are elected by member banks. The Act's requirement of a GAO study, instead of an outright ban on election of Federal Reserve Bank directors by member banks, reflects a compromise between the House and Senate conferees. Under the Senate version of the legislation, no company (including its subsidiaries and affiliates and any current, director or employee of such company or its subsidiaries and affiliates) supervised by the Federal Reserve would have been permitted to vote for Federal Reserve Bank directors.

A new position of Vice Chairman for Supervision is also established, consistent with the new financial stability function given to the Federal Reserve under the Act to "identify, measure, monitor, and mitigate risks to the financial stability of the United States." The Vice Chairman for Supervision is to be appointed by the President, with the advice and consent of the Senate. A proposal to also empower the President to appoint the president of the Federal Reserve Bank of New York was ultimately rejected during the reconciliation process.

## 2. Limitations on Authority

The Act addresses the Federal Reserve's authority under Section 13(3) of the Federal Reserve Act, the "emergency" statute from 1932 under which the Federal Reserve had lent a total of \$1.5 million to businesses during the Great Depression. Until the collapse of Bear Stearns, the Federal Reserve had rarely, if ever, invoked its authority under this statute. As the financial crisis unfolded in 2008, the Federal Reserve relied on this statute to a degree that it never had before, exposing it to criticism and leading even its former chairman to characterize some of the Federal Reserve's actions as extending "to the very edge of its lawful and implied powers."<sup>4</sup> The Federal Reserve also used this statute to authorize the Federal Reserve Bank of New York to facilitate transactions and financial support benefitting specific financial institutions, including Bear Stearns and AIG.

Under the Act, Section 13(3) of the Federal Reserve Act is amended to strip the Federal Reserve of its authority to provide assistance to any "individual, partnership, or corporation." Such assistance must be given only to participants in a "program or facility with broad-based eligibility." The Treasury Secretary must also approve any lending program or facility established by the Federal Reserve under Section 13(3). In addition, the Act amends the Federal Reserve Act to prohibit the Federal Reserve from delegating to a Federal Reserve Bank president any financial stability authority and from delegating to a Federal Reserve Bank any functions relating to the establishment of supervision and regulatory policy.

## J. Addressing Regulatory "Blind Spots"—Banks that Are Technically Not "Banks"

The Treasury White Paper proposals announced in June 2009 noted the goal of eliminating regulatory "blindspots" related to companies that have been permitted to control certain types of insured depository institutions without the corresponding supervisory and regulatory burdens imposed on bank holding companies under the Bank Holding Company Act. While

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<sup>4</sup> Paul A. Volcker, Remarks at the 395th Meeting of The Economic Club of New York (Apr. 8, 2008).

the Act does not eliminate the exceptions provided in Section 2(c)(2) of the Bank Holding Company Act pursuant to which companies that control “credit card” banks, industrial banks and trust banks are not regulated under the Bank Holding Company Act, it does impose a three-year moratorium immediately upon enactment.

Under the moratorium, the FDIC is prohibited from approving any application for deposit insurance received after November 23, 2009 for a credit card bank, industrial bank or trust bank that is directly or indirectly owned or controlled by a “commercial firm,” which is defined as a company that derives less than 15% of its consolidated gross revenues from activities that are considered “financial in nature” under the Bank Holding Company Act. The moratorium also applies to change in control transactions. The federal banking regulators are required to disapprove a change in control of any credit card bank, industrial bank or trust bank if the transaction would result in direct or indirect control of the institution by a commercial firm. There are exceptions for a change in control of a failing institution, for a change in control resulting from the merger or whole acquisition of the controlling commercial firm itself, and for a change in control resulting from an acquisition of less than 25% of the voting shares of a publicly traded company that controls a credit card bank, industrial bank or trust bank.

The Act also directs the GAO to conduct a study to determine whether it is necessary to eliminate the Bank Holding Company Act exceptions that allow companies to own credit card banks, industrial loan companies and industrial banks, trust banks and certain other companies without becoming a bank holding company. A report detailing the study’s findings is due to the Senate Banking Committee within 18 months of enactment.

#### K. New Rules for Interchange Fees

A late addition to the financial reform legislation is the so-called “Durbin Amendment” on interchange fees. Interchange fees, or “swipe” fees, are charges that merchants pay to credit card companies and card-issuing banks for processing electronic debit transactions. Typically ranging between 1% to 2% per transaction, these fees represent significant revenues for banks, but come at a cost to businesses in highly competitive sectors.

Under the Durbin Amendment, the Federal Reserve must issue rules within nine months that require interchange fees for debit card transactions to be “reasonable and proportional” to the cost of processing such transactions. In issuing regulations, the Federal Reserve must take into consideration the functional similarity between debit card transactions and traditional checking transactions, as well as the incremental costs incurred by a card issuer in processing a particular debit card transaction. The Federal Reserve may also allow for upward adjustments to interchange fees to reflect costs incurred in connection with fraud prevention efforts.

The “reasonable and proportional” requirements would not apply to interchange fees charged or received in a debit transaction made with government-issued debit or general-use prepaid cards (such as through unemployment or food stamp programs). Similarly, these requirements would not apply to reloadable prepaid cards that do not access or debit a cardholder’s bank account, are redeemable at multiple unaffiliated merchants and are not marketed or labeled as gift cards.

Although the Durbin Amendment specifies that banking organizations with less than \$10 billion in consolidated assets will not be subject to these fee limitations, as a practical matter most organizations will have to reduce their fees to match the Federal Reserve mandated rates for larger organizations in order to remain competitive.

In a significant win for credit card companies, the Act does not restrict the “network fees” they charge to card issuers for processing debit transactions. The Federal Reserve’s authority regarding such fees is limited to ensuring that they are not used to circumvent or evade the “reasonable and proportional” requirements for debit card interchange fees and are not used to indirectly or directly compensate a card issuer for reduced interchange fees. However, the Durbin Amendment affects credit card companies in other ways. Within one year of enactment, the Federal Reserve is required to issue regulations prohibiting credit card companies from restricting the number of “payment card networks” on which a credit or debit card transaction may be processed. Also, credit card companies will generally be prohibited from restricting the ability of merchants to offer discounts based on the method of payment (such as cash) or set minimum dollar amounts on credit and debit card transactions (as long as the minimum amount does not exceed \$10).

### **III. CONSUMER PROTECTION AND MORTGAGE REFORMS**

The Act creates a new body, called the Bureau of Consumer Financial Protection, within the Federal Reserve with rulemaking and enforcement powers over large banks and non-banks that offer consumer financial products and services, such as credit cards, mortgages and loan modification services. Under certain circumstances, national banks may also be subject to stricter consumer protection laws enacted at the state level than those currently applicable to them.

There are also a number of mortgage-related reforms. Among other things, the Act imposes new minimum underwriting standards for home mortgages and limitations on mortgage origination fees.

#### **A. Bureau of Consumer Financial Protection**

##### **1. Authority of the Bureau**

The Act establishes a new Bureau of Consumer Financial Protection (the “Bureau”) as an autonomous unit within the Federal Reserve System with broad powers to regulate consumer financial products and services. The definition of consumer financial products and services covers a wide range of activities, including lending, loan servicing, check cashing, credit counseling, certain financial data processing services and any activity permissible for a bank or financial holding company that is likely to have a material impact on consumers. Specifically excluded, however, is the provision of insurance products. The Bureau will be an independent agency within the Federal Reserve, with its own budget, and headed by a single director appointed by the President. The Director of the Bureau will succeed to the OTS’s seat on the board of directors of the FDIC and will be a voting member of the Council.

The Bureau is charged with supervising, with respect to federal consumer financial law, (1) banks, savings associations and credit unions with total assets of more than \$10 billion, and

their affiliates, and (2) a range of non-bank providers of consumer financial products and services (and affiliated service providers), including mortgage originators, brokers and servicers, providers of foreclosure relief or loan modification services, providers of private education loans, payday lenders, and any person who is a “larger participant of a market for other consumer financial products or services,” which concept will be defined by rules to be adopted by the Bureau in consultation with the Federal Trade Commission. The Bureau will have exclusive rulemaking, supervision and enforcement authority within its assigned role with respect to large depository institutions, and will share authority with the Federal Trade Commission with respect to non-bank providers.

Notable exclusions from the federal consumer financial laws within the Bureau’s purview include the Community Reinvestment Act and the Federal Trade Commission Act. The Bureau will have limited authority with respect to banks, savings associations and credit unions with total assets of less than \$10 billion (but not with respect to their affiliates), but in general the supervision of these smaller depository institutions with respect to federal consumer financial law will remain with their primary bank regulator. Service providers to persons subject to supervision by the Bureau may also be subject to the Bureau’s authority to the same extent as service providers under the Bank Service Company Act. The SEC and the CFTC are required to consult and coordinate with the Bureau (in the case of the SEC, only “where feasible”) with respect to any rule regarding overlapping investment products or services. The Council can stay or set aside rules adopted by the Bureau, but only through a complicated and time-consuming process, with the requirement that the Council determine that the rule would “put the safety and soundness of the United States banking system or the stability of the financial system of the United States at risk.”

The following persons, among others, are generally excluded from the Bureau’s authority (in some cases, the exclusion relates to “any rulemaking, supervisory, enforcement or other authority” and in other cases a subset of those categories, such as enforcement), but subject to a variety of caveats and conditions:

- sellers of nonfinancial goods or services, with potentially meaningful exceptions (among others) for sellers who extend credit to customers and assign non-delinquent debt to a third party or assess a finance charge;
- small businesses, but again subject to exceptions if the small business extends credit to customers and then assigns non-delinquent debt to a third party;
- real estate brokers;
- accountants and lawyers;
- persons regulated by state insurance authorities;
- employee benefit plans;
- persons regulated by the SEC, the CFTC or a state securities commission; and
- auto dealers.

## 2. Preemption and Other State Powers

An area of significant concern for national banks has been the Act's treatment of federal preemption of state consumer protection laws. The Act provides a narrow standard of preemption, specifying that a state consumer financial law is preempted only if:

- it directly or indirectly discriminates against national banks;
- its application would have a discriminatory effect on national banks as compared to a bank chartered under the laws of the applicable state;
- it prevents or significantly interferes with the exercise by a national bank of its powers (adopting the Supreme Court's standard set forth in *Barnett Bank of Marion County, N.A. v. Nelson, Florida Insurance Commissioner, et al.*); or
- it is preempted by a provision of federal law other than the Act.

Subsidiaries and affiliates of national banks that are not themselves national banks are not entitled to preemption. The Comptroller of the Currency must make any determination of preemption on a case-by-case basis, addressing each particular law (together with any law of another state with "substantively equivalent terms") individually, and must take into account the views of the Bureau. The Comptroller cannot delegate a determination of preemption to any other officer or employee of the OCC, can make such a determination only if there is "substantial evidence" that preemption is warranted under the *Barnett Bank* standard summarized above, and must review prior determinations at least once every five years and report to Congress on such review. The Act clarifies that the same standards apply to federal savings associations.

State attorneys general can bring a civil action to enforce provisions of, and regulations issued under, the consumer financial protection provisions of the Act, except that such actions may be brought against national banks and federal savings associations only with respect to enforcement of regulations. The Act also adopts the Supreme Court's decision in *Cuomo v. Clearing House Assn., L.L.C.* that the Act's provisions on visitorial powers do not limit the power of a state attorney general to bring an action against a national bank or federal savings association to enforce a law.

## 3. Independence of the Bureau

The independence of the Bureau within the Federal Reserve System is protected in several ways, including that:

- the director of the Bureau is appointed by the President, subject to Senate confirmation;
- funding for the Bureau is specified by the Act, and the Bureau director may obtain additional funds from Congress; and
- the Federal Reserve is prohibited from interfering with the Bureau's operations (*i.e.*, the Federal Reserve cannot intervene in any matter or proceeding before the Director, unless specifically provided by law; appoint, direct or remove any of the Bureau's officers or

employees; or merge or consolidate the Bureau or any of its functions or responsibilities with any division or office of the Federal Reserve or the Federal Reserve Banks).

The Council's ability to set aside any regulation issued by the Bureau is the only check on its rulemaking authority by the federal banking regulators.

#### B. Residential Mortgage Reforms

The Act provides for a number of new requirements relating to residential mortgage lending practices, many of which will be developed further through implementing regulations to be adopted within 18 months after the date on which authority is transferred to the Bureau (which should be between six and 12 months after enactment, with the possibility of an extension up to 18 months from enactment) and to take effect within 12 months after their issuance. These include:

- minimum standards for mortgages, including prohibiting a lender from making a mortgage loan unless it has made a reasonable and good faith determination, based on “verified and documented” information, that the consumer can repay the loan, based on full amortization (and subject to a safe harbor provision, which will require rulemaking, for certain “plain vanilla” mortgages that, among other things, comply with promulgated regulations specifying minimum debt-to-income or other ratios);
- limitations on mortgage origination fees and a prohibition on tying compensation to the terms of the loan (other than principal amount);
- providing borrowers a partial defense in a foreclosure proceeding, allowing a set-off equal to all finance charges and fees, plus the costs of the action, in the event of a violation by a lender of the limitations on mortgage origination fees or the minimum standards for mortgages;
- limits on prepayment penalties, including a prohibition of such penalties in connection with any loan that is not a “plain vanilla” fixed-rate loan, and the requirement to offer a consumer a comparable no-penalty option; and
- limits on “high cost” mortgages, and a requirement that before issuing any such mortgage the consumer receive counseling from a HUD-approved provider.

The Act also establishes a new Office of Housing Counseling within HUD, requires a study of the root causes of defaults and foreclosures and provides \$1 billion for an Emergency Mortgage Relief Fund through HUD and \$1 billion to HUD for redevelopment of abandoned and foreclosed homes.

### IV. INVESTOR PROTECTION AND SECURITIES LAW REFORMS

The Act contains a wide array of investor protection and securities law reforms, from the establishment of a new Investor Advisory Committee to broadened anti-manipulation provisions to increased protections for whistleblowers. In addition, the Act requires the SEC to limit the use of the Regulation D exemption for certain private offerings by “bad actors” and to issue new rules that will result in the increased regulation of credit rating agencies. A number

of reforms applicable to the securitization market, as well as new standards for executive compensation and corporate governance practices, are also contained in the Act.

#### A. Securities Investor Protections

The Act seeks to increase investor protections by establishing an Investor Advisory Committee and an Investor Advocate within the SEC, and by amending the Securities Exchange Act of 1934 (the “Exchange Act”) to authorize the SEC to promulgate rules to harmonize the standard of care applicable to broker-dealers and investment advisers.

The Act establishes within the SEC a new Investor Advisory Committee. The Investor Advisory Committee will advise and consult with the SEC on, among other things, regulatory priorities of the SEC; issues relating to the regulation of securities products, trading strategies and fee structures and the effectiveness of disclosure; and initiatives to promote the integrity of the securities marketplace. The Investor Advisory Committee will be composed of the head of the newly created Office of the Investor Advocate, a representative of the state securities commissions, a representative of “the interests of senior citizens” and between 10 and 20 individuals appointed by the SEC who would represent the interests of individual and institutional investors. The SEC will be required publicly to disclose any Investor Advisory Committee finding or recommendation that it receives and the action the SEC plans to take in response to the finding or recommendation.

The Investor Advocate will report to the Chairman of the SEC and will serve a range of functions associated with investor protection matters, including assisting retail investors in resolving significant problems they have with the SEC or self-regulatory organizations (“SROs”); identifying areas in which investors would benefit from SEC or SRO rule changes; and proposing legal, administrative or personnel changes to mitigate any identified investor protection concerns. The Investor Advocate will appoint an ombudsman as a liaison between the SEC and retail investors.

The Act authorizes the SEC to promulgate rules, after performing a study, which may provide that the standard of care for broker-dealers and investment advisers, when providing personalized investment advice about securities to retail customers, be in the best interest of the customer without regard to the financial or other interest of the broker-dealer or investment adviser. For these purposes, a “retail customer” is a natural person who (1) receives personalized investment advice about securities from a broker, dealer, or investment adviser; and (2) uses such advice primarily for personal, family, or household purposes. The Act makes clear that a “customer” does not include an investor in a private fund that is managed by an investment adviser pursuant to an advisory contract with that adviser.

The Act requires a number of studies related to investor protection, including, among others, relating to the effectiveness of the existing legal and regulatory standards of care imposed on broker-dealers and investment advisers; mutual fund advertising; and potential conflicts of interest between investment banking and research analyst functions at securities firms. The latter study is required to include consideration of whether and to what extent the undertakings agreed to by the firms subject to the Global Analyst Research Settlements in 2003 should be

codified and applied to securities firms generally or whether the SEC should adopt rules applying the undertakings to securities firms.

The Act allows the SEC to adopt restrictions on the use of mandatory arbitration clauses in broker-dealer and municipal securities dealer contracts with customers or clients.

## B. Increasing Regulatory Enforcement and Remedies

The Act contains a variety of provisions designed to expand and enhance the enforcement powers of the SEC and to promote compliance with the securities laws, including the following:

### 1. Aiding and Abetting Liabilities

The Act expands the SEC's ability to bring "aiding and abetting" cases. Under current law, the SEC's ability to bring such cases is limited to aiding and abetting violations of the Exchange Act. The Act allows the SEC to bring actions for aiding and abetting liability under the Securities Act of 1933 (the "Securities Act") and the Investment Company Act against any person that knowingly or recklessly provides substantial assistance to another person in violation of those Acts to the same extent as against the person that committed the violation. The Act adds a similar provision to the Investment Advisers Act of 1940 (the "Investment Advisers Act"). The Act also changes the *scienter* standard for aiding and abetting liability under the Exchange Act from "knowingly" to "knowingly or recklessly." The Act also requires a study regarding the advisability of providing a private right of action against persons who aid or abet another person in violation of the securities laws.

### 2. Broadens Anti-Manipulation Provisions

The Act broadens the application of the anti-manipulation provisions of Section 9 of the Exchange Act to any security other than a government security. Previously, Section 9 applied only to securities registered on a national securities exchange.

### 3. Extraterritorial Jurisdiction of Antifraud Provisions of the Federal Securities Laws

The Act broadens the jurisdiction of U.S. district courts for actions brought by the SEC or the United States for violations of the antifraud provisions of the Securities Act and the Exchange Act to (1) conduct within the United States that constitutes significant steps in furtherance of a violation, even if the securities transaction occurs outside the United States and involves only foreign investors; or (2) conduct occurring outside the United States that has a foreseeable substantial effect within the United States. In so doing, the Act would exempt the SEC and the United States from the restrictions on extraterritorial jurisdiction established just weeks ago by the Supreme Court in *Morrison v. National Australia Bank*. The Act also requires a study of whether to provide private rights of action under the antifraud provisions of the Exchange Act for certain conduct involving foreign securities transactions.

4. Civil Monetary Penalties in Administrative Proceedings

The Act expands the SEC's powers by authorizing it to seek monetary penalties in administrative proceedings, including against public companies and their directors and officers, in contrast to the SEC's current authority to seek such civil penalties only in federal district court cases or in administrative proceedings against broker-dealers and investment advisers.

5. Whistleblowers

The Act amends the Exchange Act to compensate and protect whistleblowers who voluntarily provide original information to the SEC derived from the independent knowledge or analysis of the whistleblower. The Act establishes a "Securities and Exchange Commission Investor Protection Fund" to be used to pay whistleblowers whose information leads to a successful civil or criminal enforcement action under the securities laws resulting in monetary sanctions exceeding \$1 million. The fund will also be financed, in part, by these monetary penalties. Subject to certain disqualifications, whistleblowers will be entitled to receive a payment equal to between 10% and 30% of the monetary sanctions imposed in a successful government action resulting from the information provided by the whistleblower, with the amount within that range to be determined by the SEC.

The Act also creates a private right of action for whistleblowers against employers who discharge, demote, suspend, threaten, harass or discriminate against whistleblowers.

6. Other Provisions

The Act contains a number of other important provisions relating to the federal securities laws:

- The Act provides the Enforcement Division of the SEC with a number of new tools that have been on the Division's legislative wish list for many years. For example, the Act expands enforcement powers and remedies, including by: allowing for the imposition of collateral bars under the Exchange Act and the Investment Advisers Act (such bars would prohibit offenders from associating with a broad range of SEC-regulated entities rather than only those entities regulated under the particular statutory provisions under which the violation occurred); permitting nationwide service of process in any action or proceeding instituted by the SEC (enabling SEC trial lawyers to use more live witnesses at trial and be less dependent on presentation of evidence through deposition testimony of non-party witnesses); and requiring production of audit workpapers and other documents of any foreign audit firm that performs material services upon which a registered public accounting firm relies on the conduct of an audit or interim review. The Act did not, however, provide the SEC with access to grand jury materials, which was one item on the SEC wish list that Congress did not grant.
- In response to high-profile securities frauds like the Madoff case, the Act also directs the U.S. Sentencing Commission to amend the Federal Sentencing Guidelines and policy statements (1) relating to securities fraud to reflect the intent of Congress that penalties for these offenses should "appropriately account for the potential and actual harm to the public and financial markets from the offenses," and (2) relating to substantial bank fraud or other frauds relating to financial institutions to "ensure appropriate terms of

imprisonment for offenders.” The Act also extends the statute of limitations for criminal securities fraud violations from five years to six years.

### C. Limitation on Use of Regulation D by “Bad Actors”

The Act requires the SEC to promulgate rules, within one year after the enactment of the Act, disqualifying persons determined to be “bad actors” from eligibility to use Rule 506 of Regulation D under the Securities Act. Rule 506 under the Securities Act provides an exemption from registration for certain private offerings and sales of securities without regard to the size of the offering.

A “bad actor” includes any person:

- who is subject to a final order by a state securities, banking or insurance authority, a federal banking regulator or the National Credit Union Administration that:
  - bars the person from (1) association with any entity regulated by such authority, (2) engaging in the business of securities, insurance or banking, or (3) engaging in savings association or credit union activities; or
  - constitutes a final order based on a violation of any law or regulation that prohibits fraudulent, manipulative or deceptive conduct within the 10-year period ending on the date of the filing of the Form D relating to the offer or sale; or
- who has been convicted of any felony or misdemeanor in connection with the purchase or sale of any security or involving the making of any false filing with the SEC.

The Act mandates that the new rules be substantially similar to the disqualification provisions in Rule 262 under the Securities Act that are applicable to the exemption for small issues under Regulation A.

### D. Increased Regulation of Credit Rating Agencies

Recognizing the systemic importance of credit ratings and the role credit rating agencies play as gatekeepers to the financial markets, the Act sets forth a number of new standards and requirements designed to enhance oversight of, and increase accountability on the part of, credit rating agencies. The Act creates within the SEC a new federal Office of Credit Ratings that will conduct an annual examination of each nationally recognized statistical rating organization (“NRSRO”), focusing on the NRSRO’s compliance with regulatory requirements as well as its internal control procedures and methodologies, and make its findings available to the public. Also, the SEC will have the authority to impose fines and other penalties for violations by NRSROs and, upon a determination that an NRSRO does not have adequate financial and managerial resources to consistently produce credit ratings with integrity, to temporarily suspend or permanently revoke the registration of such NRSRO with respect to a particular class or subclass of securities.

The SEC is required by the Act to promulgate rules regarding the procedures and methodologies used by NRSROs in determining credit ratings, and to ensure changes in those procedures and methodologies are applied consistently. The SEC is also required to promulgate rules requiring each NRSRO to publicly disclose its credit ratings, credit rating methodologies, changes in these methodologies, potential limitations and uncertainties of the credit ratings, information used to determine credit ratings, potential volatility of credit ratings and information on ratings track records. The Act also requires the SEC to eliminate the credit rating agency exemption from Regulation FD, which allows issuers to provide material non-public information to rating agencies for the purpose of determining or monitoring credit ratings without providing public disclosure of such information.

In producing a credit rating, an NRSRO will be required to consider information from sources other than the issuer or underwriter if it finds such information credible and potentially significant to a rating decision.

The Act also contains several provisions that address concerns regarding conflicts of interest and governance. For example, it requires the SEC to promulgate rules to prevent sales and marketing considerations of an NRSRO from influencing the determination of ratings and requires re-rating or reporting to the SEC in certain circumstances when an employee of an NRSRO is hired by an obligor, issuer, underwriter or sponsor of a security or money market instrument subject to a rating by that NRSRO. Each NRSRO will have to include an attestation with any credit rating it issues that no part of the rating was influenced by its other business activities. In addition, at least half of an NRSRO's board of directors must be comprised of independent directors, and NRSROs must establish and maintain an effective internal control structure. The Act also provides standards for the responsibilities and compensation of compliance officers of an NRSRO.

In addition, the Act will impose broader liability on NRSROs and other credit rating agencies under the securities laws. The Act amends Section 15E(m) of the Exchange Act to provide that the enforcement and penalty provisions of the Exchange Act will apply to statements made by a credit rating agency in the same manner and to the same extent as such provisions apply to statements made by a registered public accounting firm or a securities analyst, and that statements made by a credit rating agency will not be entitled to protection as "forward-looking statements" under Section 21E of the Exchange Act. Further, the Act immediately rescinds Rule 436(g) under the Securities Act, which rescission effectively requires the consent of an NRSRO to be filed with a registration statement if a credit rating issued by such NRSRO is included in the registration statement or in a prospectus in connection with a registered offering of securities. This provision will expose an NRSRO to potential liability as an expert in any registered securities offering in which it allows its credit rating to be used.

Section 21D(b)(2) of the Exchange Act is amended to allow investors to bring a private right of action against a credit rating agency if the credit rating agency knowingly or recklessly failed to conduct a reasonable investigation of the security being rated, or to obtain reasonable verification of the facts from an independent source. The Act will also require each NRSRO to refer to law enforcement allegations of material violations of law by issuers of rated securities that it finds credible.

The Act requires the substitution in the Exchange Act, the Federal Deposit Insurance Act, the Investment Company Act and other federal statutes of any references to “investment grade” categories of credit ratings with “such standards of creditworthiness” as the applicable federal agency shall adopt. The Act also requires each federal agency to review over the next year any of its regulations that include any references to credit ratings and to similarly substitute such references.

#### E. Securitization Market Reforms

In order to ensure high quality underwriting standards of mortgage loans and other financial assets that are securitized and encourage appropriate risk management practices by securitizers and originators of such financial assets, the Act establishes risk retention and other requirements for securitizations.

Most significantly, the Act requires that securitizers, which include asset-backed issuers, securitization sponsors and originators of financial assets underlying asset-backed securities, retain at least 5% of the credit risk (and prohibits hedging such risk), thereby keeping some “skin in the game” in the form of continued loss exposure. The Act amends the Exchange Act by adding a new Section 15G, which directs the SEC, the federal banking regulators and certain other federal agencies to jointly issue regulations by asset class that require any securitizer to retain credit risk for any asset that is transferred, sold or conveyed to a third party through the issuance of an asset-backed security. The Act exempts securitizations of qualified residential mortgages and allows a smaller retention requirement if the assets being securitized meet underwriting standards to be established by asset class by the federal banking regulators and the SEC. Regulators may jointly grant exemptions from the risk retention requirement, or require less than 5% risk retention, with respect to certain classes of assets or institutions.

Other key provisions of the Act relating to the reform of the securitization market include the following:

- *Heightened disclosure obligations for asset-backed securities*—The SEC is required to adopt regulations requiring standard data disclosure formats and asset-level or loan-level data disclosure necessary for investors to perform due diligence independently.
- *Representations and warranties in asset-backed offerings*—The SEC is required to adopt regulations that require NRSROs to include evaluations of representations and warranties in their ratings of asset-backed securities and require securitizers to disclose fulfilled or unfulfilled repurchase obligations in past securitizations.
- *Elimination of exemption from registration*—Transactions involving certain mortgage-backed securities will no longer be exempt from registration under Section 4 of the Securities Act.
- *Due diligence analysis and disclosure*—The SEC is required to adopt regulations requiring any issuer of asset-backed securities filing a registration statement to perform a review of the assets underlying its asset-backed securities and to disclose the nature of that review.

- *Conflicts of interest* – The Act requires the SEC to adopt rules to prohibit any sponsor or distributor of asset-backed securities (including a synthetic asset-backed security) from engaging in any transactions during a one-year period after issuance “that would involve or result in any material conflict of interest” with an investor in the transaction.

#### F. New Standards for Executive Compensation and Corporate Governance

The Act sets new standards relating to executive compensation and corporate governance. In some cases, the reach of the Act is limited to companies that have listed their securities on a national securities exchange, such as the NYSE or the NASDAQ Stock Market, but in other cases it extends to companies that are otherwise subject to specified SEC reporting requirements, such as the requirement to deliver to shareholders a proxy or information statement. The Act also authorizes the SEC to exempt companies from certain requirements, in particular with respect to compensation committee independence, compensation-related shareholder voting and shareholder proxy access, based on the size of the issuer and other relevant factors.

- *Compensation Committee independence* – The Act requires that the SEC issue rules directing the national securities exchanges to prohibit the listing of any equity security of a company that fails to have a compensation committee comprised entirely of independent directors, subject to a number of limited exceptions, including an exception for “controlled companies” and for foreign private issuers that provide annual disclosure of their reasons for not maintaining an independent compensation committee. This legislative mandate tracks the Sarbanes-Oxley requirement that audit committees of listed companies be comprised entirely of independent directors. The Act imposes additional requirements relating to the retention and independence of compensation consultants and legal and other advisers, and disclosure regarding the use of such consultants and advisers.
- *Shareholder “say on pay” and “golden parachute” votes* – The Act requires that all public reporting companies, beginning with the first shareholder meeting after the six-month period following the enactment of the Act, have a separate, non-binding shareholder vote, not less frequently than once every three years, on compensation paid to certain executive officers, and a separate resolution, at least once every six years, to determine whether the “say on pay” vote should be held every one, two or three years. The say on pay resolution must be included in a proxy or consent or authorization for an annual or other meeting of the shareholders for which the proxy solicitation rules require compensation disclosure. In addition, to the extent that any “golden parachute”-related compensation is not approved at a say on pay vote, the Act requires a separate, non-binding shareholder vote on such golden parachute compensation at any meeting at which shareholders are asked to approve a merger, acquisition or other extraordinary transaction that would trigger payments under such golden parachutes. The Act also includes a requirement that every institutional investor subject to the reporting requirements under Section 13(f) of the Exchange Act disclose how it voted on any say on pay or golden parachute vote. The Act also includes a requirement that the national securities exchanges prohibit broker discretionary voting in connection with the election of directors, executive compensation or any other significant matter (as determined by the SEC), which would ensure that discretionary voting by brokers would not be permitted in say on pay or golden parachute votes.

- *Additional compensation disclosures* – Under the Act, the SEC is directed to issue rules requiring companies to disclose in annual proxy statements a clear description of executive officer compensation, including:
  - information that shows, graphically or otherwise, the relationship between executive compensation actually paid and the financial performance of the issuer, taking into account any change in the value of the shares of stock and dividends of the issuer and any distributions;
  - disclosure regarding the internal pay disparity between the CEO's compensation and median annual total compensation of all other employees; and
  - disclosure regarding whether directors and employees of the companies are permitted to hedge the equity they own in their companies.
- *Clawback of "erroneously awarded" compensation* – Under the Act, the SEC is also required to cause national securities exchanges to prohibit the listing of any security issued by a company that fails to adopt and implement a policy (i) providing for disclosure of the policy of the issuer on incentive-based compensation that is based on financial information required to be reported under the securities laws and (ii) providing that the issuer, in the event of an accounting restatement due to material non-compliance with financial reporting requirements, will recover from any current or former executive officer any incentive-based compensation received during the three-year period preceding the date on which the issuer is required to prepare a restatement on the basis of inaccurate financial statements, based on the erroneous data, in excess of what would have been paid to the executive officer under the accounting restatement. This provision reaches further than Section 304 of the Sarbanes-Oxley Act of 2002 (the "Sarbanes-Oxley Act"), in that it extends to all executive officers and not just the CEO and CFO, and applies in the event of any accounting restatement because of the material noncompliance of the issuer with any financial reporting requirement under the federal securities laws, whether or not as a result of misconduct.
- *Sound compensation plans for financial institutions* – Under the Act, federal financial regulators are directed to establish joint compensation rules for bank holding companies and savings and loan holding companies prohibiting any plan that provides "excessive" compensation to executives, employees, directors or principal shareholders or that could lead to material financial loss to the company.
- *Proxy access for shareholder nominees* – The Act authorizes the SEC to promulgate rules, often referred to as proxy access rules, permitting shareholders to use a company's annual proxy materials to solicit other shareholders for the shareholders' director nominees. Currently, such activist shareholders must pay for the preparation and mailing of materials to campaign for their own nominees. Although the SEC has already proposed proxy access rules,<sup>5</sup> the legislation would resolve the questions that have been

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<sup>5</sup> For further information on the SEC's proposed proxy access rules, please refer to our earlier memos on that topic. See *SEC Signals that New Proxy Access Rules Will Likely Not Be Effective for 2010 Proxy Season* (Oct. 2, 2009); *Simpson Thacher Urges Caution with Respect to the SEC's New Proxy Access Proposal* (Aug. 17, 2009); *The SEC's New Proxy Access Proposal: Thoughtful Reform to Promote Better Corporate Governance or Rushed Response*

raised as to whether the rules exceed the SEC's statutory authority under current law. Indeed, commentators have speculated that the SEC has deferred adoption of final proxy access rules pending adoption of legislation explicitly authorizing such rules. Most practitioners expect proxy access rules will be adopted this summer following the Act's enactment, and SEC Chair Mary Schapiro has indicated that she expects proxy access will be adopted in time for the 2011 proxy season.

- *Disclosure on dual CEO/Chairman roles* – The Act requires that the SEC promulgate rules not later than 180 days following enactment of the Act requiring public companies to disclose in their annual proxy statements the reasons why they have chosen to either have one person to serve in the dual roles of chairman of the board of directors and chief executive officer or to have different individuals serve in such roles.

#### **G. Expansion of Authority of Public Company Accounting Oversight Board**

The Act expands the authority of the Public Company Accounting Oversight Board ("PCAOB") under the Sarbanes-Oxley Act to govern auditors of broker-dealers in addition to auditors of issuers. All such auditors must now register with the PCAOB and be subject to its investigation.

The Act further grants the PCAOB broadened authority to share information with a foreign auditor oversight authority, to require public accounting firms to follow a specified inspection schedule and to authorize an SRO to investigate auditors.

#### **H. Other Matters**

##### **1. Beneficial Ownership Reporting**

The Act allows the SEC to establish a shorter time frame for Section 13 reporting and for filing initial Section 16(a) reports after becoming a beneficial owner, director or officer.

##### **2. Short Sales**

The Act mandates that the SEC promulgate rules that provide for the public disclosure of short sales by institutional investment managers subject to Section 13(f) of the Exchange Act at least monthly, prohibit manipulative short sales and require that broker-dealers provide notices to their customers that they may elect not to allow the use of their securities for short sales.

##### **3. Securities Investor Protections in Portfolio Margining Accounts**

The Act extends the protections of the Securities Investor Protection Act of 1970 to customers who have claims against the debtor in futures contracts and options on futures contracts held in a portfolio margining account.

##### **4. Securities Lending or Borrowing**

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*to Political Pressure?* (June 26, 2009); and *SEC Re-Proposes Proxy Access* (May 20, 2009). The memos are available at <http://www.stblaw.com/publicationSearch.cfm?list=Memos>.

The Act requires the SEC to create rules that promote greater transparency in available information concerning lending and borrowing of securities. The Act makes it unlawful for any person to participate in the lending or borrowing of securities in contravention of any rules designed by the SEC to promote the public interest or to protect investors.

5. Change to the Individual Accredited Investor Definition

The Act contains a provision that adjusts the individual accredited investor test for private placement purposes. Effective immediately upon enactment, and for four years thereafter, the net worth threshold will be \$1 million, excluding the value of the investor's primary residence. In addition, the Act authorizes the SEC to adjust the individual accredited investor thresholds that do not relate to net worth (*i.e.*, the net income test) and to adjust dollar thresholds for inflation every five years. The Act also requires the SEC, four years after the enactment of the legislation and every four years thereafter, to review the individual accredited investor definition and modify the definition as appropriate for the protection of investors. As a result, private funds and other issuers currently engaged in private placement offerings will need to move rapidly to revise their subscription documents to incorporate the new net worth test for individual accredited investors, distribute new forms of subscription documents to prospective investors and make sure that going forward they only accept subscription documents containing the new test.

## V. REGULATION OF THE OVER-THE-COUNTER DERIVATIVES MARKET

The Act introduces sweeping changes in the regulation of derivative transactions and of the participants in the over-the-counter derivatives markets, including, among other things:

- the expansion of the types of derivatives regulated under U.S. commodities and securities laws;
- the allocation of regulatory authority over derivatives among the CFTC, the SEC and other government regulators;
- the identification of certain derivative dealers and major derivative participants, such as swap dealers and major swap participants, as well as derivative clearing and trading facilities, that will be subject to significantly enhanced regulation;
- the introduction of the Lincoln Amendment, or "dealer push-out" rule, which will significantly limit the derivatives-related activities that can be conducted within an insured depository institution;
- the imposition of mandatory central clearing and exchange trading requirements on many derivative transactions; and
- the expansion of anti-fraud and anti-manipulation regulations with respect to derivatives.

Unless otherwise noted, the provisions of the Act described in this section will be effective one year from enactment or, to the extent a provision requires rulemaking, the later of one year from enactment and a date not less than 60 days following publication of the final rule.

## A. The Regulatory Regime for Swaps, Security-Based Swaps and Mixed Swaps

The Act gives the CFTC authority to regulate derivatives that are “swaps.” A “swap” is defined as any derivative transaction referencing assets, securities, financial indicators, conditions and/or events and any transaction commonly known as a derivative transaction (e.g., a total return swap, an equity swap, a weather swap), excluding, among others:

- any “security-based swap” that is not a “mixed swap” (as defined below);
- any option on any security, certificate of deposit, or group or index of securities that is subject to the Securities Act and the Exchange Act;
- any agreement as to the sale of one or more securities on a fixed basis or contingent basis that is subject to the Securities Act and the Exchange Act;
- any commodity forward (or option on such a contract);
- any physically-settled forward or future on a non-financial commodity or security;
- any security futures product;
- any debt security;
- any security-based agreement entered into by an issuer directly or through an underwriter for capital raising purposes (other than to manage a risk associated with the capital raising);
- any foreign exchange option entered into on a national securities exchange; and
- any agreement with the U.S. government or a Federal Reserve Bank or a U.S. government-backed federal agency.

The issue of whether foreign exchange swaps and foreign exchange forwards should be regulated as “swaps” has been hotly debated throughout the legislative process. These derivative products were excluded from the version of the legislation initially passed by the House, but are covered as “swaps” under the Act. However, the Act grants the Treasury Secretary authority to make a written determination that foreign exchange swaps or forwards (or both) should not be regulated as “swaps” and are not structured to evade any rules promulgated by the CFTC to further define the term “swap.” Notwithstanding any such future determination, foreign exchange swaps and forwards will continue to be subject to the reporting requirements, and, if centrally cleared or exchange traded, the anti-fraud and anti-manipulation provisions, of the Commodity Exchange Act. In addition, swap dealers and major swap participants (defined below) party to such transactions must conform to the business conduct standards applicable to them under the Act.

The Act grants the SEC authority to regulate derivatives that are “security-based swaps.” A “security-based swap” is a “swap” (as defined without the exclusion) based on a narrow-based security index, a single security or loan or the occurrence or nonoccurrence of an event relating to a single issuer of a security or the issuers of securities in a narrow-based security index. “Security-based swaps” include, among others, single-name cash-settled equity swaps and credit default swaps referencing corporate bonds and narrowly-based cash-settled equity index swaps.

The Act grants joint authority to the CFTC and the SEC (who will consult with the Federal Reserve in this regard), to regulate derivatives that are “mixed swaps.” A “mixed swap” is covered under the definitions of both “swap” and “security-based swap” and possesses characteristics of both types of derivatives.

The Act also preempts the application of state gaming law and bucket shop laws to (i) options or other security (except any security that has a pari-mutuel payout or is otherwise identified by the SEC) or (ii) any “security-based swap” between eligible contract participants or traded on a national securities exchange. The Act provides that no state law governing the offering, sale or distribution of securities (other than any state antifraud law) will apply to any “security-based swap” or security futures product.

There has been much public discussion about whether derivative products, particularly credit default swaps, are in essence insurance products and thus should be regulated as such. The Act amends Section 12 of the Commodity Exchange Act and Section 28(a) of the Exchange Act to make clear that “swaps” and “security-based swaps” will not be considered insurance and may not be regulated as an insurance contract under state law.

## B. Regulation of Dealers and Major Participants

The Act creates four main categories of dealers and major participants who will be subject to additional scrutiny and regulation: swap dealers, major swap participants, securities-based swap dealers and major security-based swap participants. Swap dealers and major swap participants will be regulated by the CFTC, whereas security-based swap dealers and major security-based swap participants will be regulated by the SEC. The Act requires each such dealer and major participant to register with the applicable agency.

### 1. Swap Dealer and Security-Based Swap Dealer

The Act defines a “swap dealer” as any person who (i) holds itself out as a dealer in swaps, (ii) makes a market in swaps, (iii) regularly enters into swaps with counterparties as an ordinary course of business for its own account or (iv) engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps.

The Act carves out the following entities from the definition of a swap dealer:

- an insured depository institution to the extent it offers to enter into a swap transaction in connection with originating a loan with that customer;
- a typical “end user,” a person that enters into swaps for their own account, but not as a part of a regular business; and
- an entity that engages in a *de minimis* quantity of “swap” dealing, as determined by the applicable agency, will not be a swap dealer.

The definition of “security-based swap dealer” is identical to the definition of “swap dealer” except that it references “security-based swaps” instead of “swaps” and does not contain an exception for insured depository institutions.

## 2. Major Swap Participant and Major Security-Based Swap Participant

A “major swap participant” is a person other than a swap dealer who:

- maintains a substantial position for any of the major categories of swaps (other than positions held for hedging or mitigating commercial risk and positions maintained by certain employee benefit plans for hedging or mitigating its risks);
- has outstanding swaps that create substantial counterparty exposure that could have serious adverse effects on the financial stability of the U.S. banking system or financial market; or
- is a financial entity that is highly leveraged relative to the amount of capital it holds and maintains a substantial position in any category of swaps.

Excluded from the definition of a “major swap participant” is a financing vehicle that uses derivatives for the purpose of hedging interest rate and foreign currency exposures arising primarily from financing that facilitates the purchase or lease of products manufactured by its parent company or another subsidiary of its parent company.

The Act delegates to the applicable agency the task of defining key concepts in the definition of “major swap participant”: “substantial position” and “commercial risk.” The Act provides that a “substantial position” shall be at the level such agency determines to be prudent for the effective monitoring, management and oversight of entities that are systemically important or can significantly impact the financial system of the United States. The Act also requires such agency to consider the person’s relative position in uncleared derivatives, and allows the agency to consider the value and quality of collateral held, in setting such definition. The Act does not further clarify or set standards for defining other key concepts such as “serious adverse effect,” “substantial counterparty exposure” and “highly leveraged.”

The definition of “major security-based swap participant” is identical to the definition of “major swap participant,” except that it references “security-based swaps” instead of “swaps” and does not contain the exception for employee benefit plans or financing vehicles described above.

## 3. Capital and Margin Requirements

For a swap dealer or major swap participant that is a bank, its prudential regulator, jointly with the CFTC and the SEC, will establish minimum capital requirements. For a security-based swap dealer or major security-based swap participant that is a bank, its prudential regulator will establish minimum capital requirements (in consultation with the CFTC and the SEC). For all dealers and major participants that are not banks, the CFTC or the SEC, as the case may be, will establish minimum capital requirements. In establishing capital requirements for a swap dealer or major swap participant for a single type, class or category of swap or activities, the regulators will be required to take into account the risks associated with other swaps and activities of such entity with respect to which such entity would not otherwise be considered a swap dealer or major swap participant.

The same regulator setting the capital requirements for a dealer or major participant will also set both initial and variation margin requirements for such dealer or participant with respect to

uncleared “swaps” and “security-based swaps.” The Act provides that non-cash collateral will be permitted. The Act, however, does not contain the important exemption to the margin requirements for uncleared derivatives that had been included in the Senate version of the bill for transactions where one of the parties is a commercial end-user. The Act also does not appear to provide for grandfathering of existing transactions with respect to any such margin requirement, except that in the sections of the Act addressing mandatory central clearing of “swaps” and “security-based swaps,” the Act provides that, for at least the first two years following the date of enactment, an affiliate, subsidiary or a wholly-owned entity of a person that qualifies for the non-financial entity exemption to the mandatory clearing requirement that is predominantly a financing vehicle for the non-financial entity will be exempt from any margin requirements that would otherwise be applicable to a dealer or major participant with regard to derivatives entered into to hedge the risk of financing activities.

4. Recordkeeping and Business Conduct Requirements

Each dealer and major participant will be required to maintain daily trading records of its “swaps” and “security-based swaps” and all related records and recorded communications. These will include electronic mail, instant messages and recordings of telephone calls. Further, these entities must maintain daily trading records for each counterparty in a manner and form that is identifiable with the relevant transaction. A complete audit trail must be maintained for conducting comprehensive and accurate trade reconstructions.

The Act mandates the CFTC and the SEC to establish business conduct requirements for dealers and major participants that will (i) establish a duty to verify that any counterparty meets the appropriate standards for an eligible contract participant; (ii) require disclosure of material risks and characteristics of the swap and any material incentives or conflicts of interest the dealer or major participant may have; and (iii) ensure receipt of the daily mark of the transaction from either the clearinghouse or the dealer, depending on whether the transaction is cleared. The Act also imposes heightened standards on dealers and major participants acting as advisers to government entities, any employee benefit plan, any governmental plan or any endowment. Furthermore, the Act empowers the CFTC and the SEC to prescribe rules that limit the activities of dealers and major participants.

**C. Prohibition on “Bailouts” of Derivative Dealers and Major Derivative Participants**

Under the Act, the so-called “Lincoln Amendment,” or “dealer push-out” rule, prohibits federal assistance to registered dealers and major participants. Prohibited federal assistance would include, among other things, FDIC insurance, use of guarantees, including guarantees of loans to registered dealers and major participants and any loss sharing arrangement, “tax breaks” and access to advances from Federal Reserve credit facilities or the Federal Reserve’s discount window, unless such access is part of a program with broad based eligibility as described beginning on page 28 under “Key Bank Regulatory Reforms—Federal Reserve System Reforms—Limitations on Authority.” Any funds expended in connection with the termination of derivatives activities after the failure of any registered dealer or major participant are to be recovered by sale of the entity’s assets or through assessments, including on the “financial sector,” but not through taxpayer resources.

The Act limits the “swap” and “security-based swap” activities in which a depository institution may engage while remaining eligible for FDIC insurance. These activities are restricted to activities to hedge the depository institution’s own risks and acting as a dealer or major participant for derivatives referencing rates or assets that are permissible for investment by a national bank, provided that it may act as a dealer or participant for credit default swaps only if the credit default swaps are centrally cleared. An insured depository institution is permitted to have an affiliate that is a registered dealer or major participant, but the depository institution must be part of a bank holding company or savings and loan holding company that is supervised by the Federal Reserve and the registered dealer or major participant must comply with Sections 23A and 23B of the Federal Reserve Act. Note that the proprietary trading and other provisions of the Volcker Rule, as discussed above, will also apply. The Act leaves open the possibility that even these permitted activities may be banned in the future, allowing the Council to make such a determination on an institution-specific basis and by the affirmative vote of two-thirds of its members, including the chairperson.

The bar on federal assistance to registered dealers and major participants will be effective two years following the effective date of Title VII of the Act. An insured depository institution will have up to two years (this appears to be an additional two-year period after the effectiveness date, and the period may be extended by the applicable federal bank regulator by up to one additional year) to divest the part of its business that engages in disqualified derivative activities (including by transferring it to an affiliate) or cease these activities. Transactions entered into by an insured depository institution prior to the end of the transition period will be grandfathered.

#### D. Certain Requirements for “Swaps” and “Security-based Swaps”

##### 1. Mandatory Central Clearing

Other than where an exemption applies, a “swap” or a “security-based swap” must be cleared by a registered clearinghouse if it is (i) accepted by a registered clearinghouse and (ii) determined by the applicable agency (the CFTC and/or the SEC, as the case may be) as requiring central clearing.<sup>6</sup>

The Act requires the applicable agency to review “swaps” or “security-based swaps,” as the case may be, to make a determination as to whether such derivative should be centrally cleared. Such review and determination may be made on an individual basis or an aggregate basis for a group, category, type or class of such derivatives. Each registered clearinghouse is required to submit to the applicable agency for review “swaps” or “security-based swaps” it plans to accept for clearing (either individually or as a group, category, type or class). Any derivative listed for clearing by a registered clearinghouse as of the enactment date is automatically deemed to have been submitted to the appropriate agency for review. Each agency may also initiate such a review on its own. In either case, once the agency makes a determination that a derivative must

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<sup>6</sup> The Act uses terms “uncleared swaps” and “uncleared security-based swaps” in several sections including the sections on segregation of funds, however it does not appear to define “uncleared security-based swaps.” The definition of “unclear swaps” refers to such derivative that is “directly or indirectly” submitted to and cleared by a registered clearinghouse, but does not provide any examples of transactions that would be deemed to have been indirectly cleared.

be cleared, a 30-day public comment period will follow. The Act mandates the agencies to establish within one year of enactment rules for the submission and review of derivatives accepted by clearinghouses for clearing. Agency review of a derivative submitted by a clearinghouse should be completed within 90 days of submission. However, the reviewing agency may stay the clearing requirement on its own initiative or on application of a counterparty and extend the review period by up to 90 days (or longer if agreed by the clearinghouse).

In conducting a review of derivatives for clearing, the Act directs the agency to take into account (i) the existence of significant outstanding notional exposure, trading liquidity and adequate pricing data, (ii) the availability of operational and credit support infrastructure for proper clearing, (iii) the effect on the mitigation of systemic risk (balanced against the size of the relevant market and the capacity of the clearinghouse to clear the derivative), (iv) the effect on competition and (v) the existence of reasonable legal certainty in the treatment of customer and counterparty positions, funds and property in the event of the insolvency of the clearinghouse.

If either the CFTC or the SEC determines that a derivative or a group thereof should be centrally cleared, but no registered clearinghouse has listed such derivative or group for clearing, the applicable agency will (i) investigate the relevant facts and publicly report the results of such investigation within 30 days and (ii) take such action as the agency determines to be necessary and in the public interest, including imposing margin and capital requirements on the parties to such derivative; provided that the CFTC or the SEC may never require a clearinghouse to clear a derivative that would threaten the financial integrity of the clearinghouse. The reference to "parties" in this particular provision of the Act presents the possibility that end-users may be subject to margin and capital requirements in connection with an uncleared derivative.

A derivative is exempt from the mandatory clearing requirement if at least one of the parties to the derivative (i) is not a "financial entity," (ii) is using the derivative to hedge or mitigate commercial risk and (iii) notifies the applicable agency how it generally meets its financial obligations associated with entering into non-cleared derivatives. A "financial entity" is defined as a swap dealer, a security-based swap dealer, a major swap participant, a major security-based swap participant, a commodity pool, certain types of private funds, an employee benefit plan or a person predominantly engaged in banking or other financial activities. The CFTC and the SEC have discretion to exempt small banks, savings associations, Farm Credit System institutions and credit unions. In addition, the non-financial entity exemption does apply to a financing vehicle that uses derivatives for the purpose of hedging interest rate and foreign currency exposures arising primarily from financing that facilitates the purchase or lease of products manufactured by its parent company or another subsidiary of its parent company.

An affiliate of a non-financial entity that is exempt from the mandatory clearing requirement may also be exempt if it uses the derivative to hedge or mitigate the commercial risk of such non-financial entity or other affiliate of such non-financial entity that is not a "financial entity." However, the exemption does not apply if the affiliate itself is a dealer or major participant, an investment company, a commodity pool or a bank holding company with more than \$50 billion in consolidated assets.

In addition, the Act provides that, for at least the first two years following the date of enactment, an affiliate, subsidiary or a wholly-owned entity of a person that qualifies for the non-financial entity exemption and that is predominantly a financing vehicle for the exempt person will be exempt from the mandatory clearing requirement with regard to derivatives entered into to hedge the risk of financing activities.

The Act mandates the CFTC and the SEC to prescribe reporting rules for “swaps” and “security-based swaps” to a registered data repository or the applicable agency. The Act provides that any such derivative entered into before enactment of the Act must be reported within 180 days of the effective date of the Act, and any such derivative entered into on or after the enactment must be reported no later than 90 days after such effective date or, if later, such other time as the applicable agency may require.

A “swap” or “security-based swap” will be grandfathered with respect to the mandatory clearing requirement if:

- it is entered into before the enactment of the Act and reported within 180 days after the effective date of the Act; or
- it is entered into before application of the clearing requirement and reported within 90 days after the effective date or, if later, such time as the applicable agency may prescribe by rule or regulation.

## 2. Exchange Trading Requirement

“Swaps” and “security-based swaps” must be executed either on a regulated exchange or swap execution facility unless (i) no exchange, board of trade or swap execution facility lists the derivative for trading or (ii) the transaction is exempt from the mandatory clearing requirement. If a “swap” or “security-based swap” is with a party that is not an eligible contract participant,<sup>7</sup> it must be entered into on, or subject to the rules of, a board of trade designated as a contract market.

It should be noted that the exemptions to the mandatory clearing and exchange trading requirements described above with respect to “security-based swaps” are available to a public company only if the appropriate committee of such company’s board of directors or governing body has approved the use by such company of such “security-based swaps.”

## 3. Reporting of Transaction Data

The Act requires real-time public reporting of transaction data for “swaps” and “security-based swaps” and directs the CFTC and to the SEC to establish a rule providing for such public

<sup>7</sup> An “eligible contract participant” includes, among others and with limitations, financial institutions, insurance companies, investment companies, commodity pools, employee benefit plans, government entities, brokers, dealers, futures commissions merchants and high net worth individuals. Certain of these entities are considered “eligible contract participants” only if they (1) have total assets or net worth exceeding specified amounts and (2) among other things, are managed by persons subject to regulation by various securities laws or governmental entities.

reporting. The rule will contain provisions to (i) ensure the anonymity of derivative participants; (ii) specify the criteria for determining what constitutes a large notional derivative transaction; (iii) specify the appropriate time delay for reporting large notional derivative transactions to the public and (iv) take into account whether the public disclosure will materially reduce market liquidity. The Act also requires the CFTC and SEC to issue semiannual and annual written reports to the public regarding the trading and clearing in the major derivative categories, the market participants and developments in new products. In preparing the reports, the CFTC and the SEC will use information from derivative data repositories and registered clearinghouses, and will consult with other regulatory bodies as necessary.

Any uncleared “swap” or “security-based swap” must be reported to a derivative data repository (a swap data repository or a security-based swap data repository, as the case may be). If no derivative data repository accepts the trade, the trade will be reported to the applicable agency. In an uncleared “swap” or “security-based swap” where only one party is a dealer or major participant, such dealer or major participant will make the required reporting. In a transaction where one party is a dealer and the other party is a major participant, the dealer will report. In all other cases, the parties will decide which party will report. The reporting party must maintain books and records regarding the transaction which shall be open to inspection by regulators. The Act directs the CFTC and the SEC to each promulgate an interim final rule within 90 days of enactment for the reporting of uncleared “swaps” or “security-based swaps,” as the case may be, entered into before the Act was enacted. The Act requires such transactions to be reported no later than 30 days after issuance of the interim final rule, or such other period as such agency determines to be appropriate.

#### 4. Position Limits and Large Trader Reporting

The CFTC will establish position limits on certain commodity derivatives and underlying commodities, with an exception for bona fide hedge positions. The SEC and SROs will also establish position limits and related hedge exemption provisions with respect any “security-based swaps” and underlying positions.

The Act prohibits any person from directly or indirectly entering into a large “swap” transaction on any day equal to or in excess of a cap established periodically by the CFTC if the CFTC determines that such “swap” performs a significant price discovery function with respect to registered entities and the person has or obtains, directly or indirectly, a position in the “swap” equal to or in excess of an amount established periodically by the CFTC, except if the person files with a properly designated officer of the applicable agency appropriate reports regarding any transactions or positions with respect to such “swap.” The books and records of the large swap trader must show complete details concerning all transactions and positions as the applicable agency may prescribe by rule or regulation and be open at all times to inspection by regulators. The Act also grants the SEC authority to require reporting of any large position in “security-based swaps,” securities, loans or group thereof or any narrowly-based index of securities or loans underlying such “security-based swaps” and/or any instrument related thereto.

**E. Regulation of Certain Derivative Market Participants and Data Repositories****1. Registered Clearinghouses**

The Act requires central registered clearinghouses (derivative clearing organizations for swaps and clearing agencies for security-based swaps) to register with the CFTC and the SEC, respectively, and abide by certain core principles. Each registered clearinghouse must have adequate financial, operational and managerial resources to discharge its responsibilities. A registered clearinghouse must possess financial resources that would enable the organization to meet its financial obligations to its members and participants even in the event its largest exposure defaults. In particular, a registered clearinghouse must possess enough funds to cover the operating costs of the clearinghouse for a period of one year, calculated on a rolling basis.

The Act requires registered clearinghouses to set eligibility standards for participants and products. On an ongoing basis, the clearinghouse will verify that its members are in compliance with the organization's membership requirements. Registered clearinghouses are required to manage risk, maintain margin requirements and report information on trades they clear, including the terms and conditions of each contract, daily settlement prices and volume, and any other relevant matters. Each registered clearinghouse is also required to designate a chief compliance officer. The CFTC and the SEC will adopt data collection and maintenance requirements for registered clearinghouses.

**2. Derivative Execution Facilities**

A derivative execution facility (a swap execution facility or a security-based swap execution facility) is a facility trading system or platform in which multiple participants have the ability to execute or trade "swaps" or "security-based swaps" by accepting bids and offers made by other participants that are open to multiple participants in the facility or system, including any trading facility that (i) facilitates the execution of derivatives between persons and (ii) is not a designated contract market or a national securities exchange. The Act requires each derivative execution facility to be registered with the CFTC or the SEC, as the case may be. Like registered clearinghouses, registered derivative execution facilities must abide by certain core principles. A derivative execution facility must monitor trading and trade processing, position limits and the financial integrity of the transactions. Similar to clearinghouses, derivative execution facilities must publish trading information in a timely manner, with reporting requirements comparable to registered clearinghouses and derivative data repositories. The applicable agency may promulgate rules defining the universe of "swaps" or "security-based swaps," as the case may be, that can be executed on a derivative execution facility.

**3. Derivative Data Repositories**

A derivative data repository (swap data repository or security-based swap repository) must also be registered with the applicable agency. The duties of a derivative data repository include, among others, (i) accepting data prescribed by the applicable agency; (ii) confirming with both parties to the derivative the accuracy of the data submitted; (iii) maintaining the data in a form as prescribed by the applicable agency; (iv) establishing automated systems for monitoring, screening and analyzing derivative data and (v) maintaining privacy of all derivative transaction information received. Derivative data repositories will be held to the

same standards of reporting and recordkeeping similar to the registered clearinghouses and derivative execution facilities.

#### F. Segregation of Funds

Only an entity registered with the CFTC as a futures commission merchant or registered with the SEC as a broker, dealer, or security-based swap dealer may accept any money, securities, or property from, for, or on behalf of a customer to margin, guarantee, or secure a derivative that is centrally cleared.

For cleared derivatives, funds of a customer may not be commingled with the funds of the futures commission merchant or used to margin, secure or guarantee any trades or contracts of any customer or person other than the customer.

The Act provides that, for convenience, money, securities and property of different customers may be commingled and deposited in the same account with any bank or trust company or with a registered clearinghouse, and withdrawals may be made from such account if necessary to the execution, maintenance or settlement of the derivative as in the normal course of business.

For uncleared derivatives, the swap dealer, major swap participant, security-based swap dealer or major security-based swap participant, as the case may be, is required to notify its counterparty at the beginning of the transaction that the counterparty has the right to require segregation of the funds supplied to margin, guarantee, or secure the obligations of the counterparty. If requested by the counterparty, the dealer or participant must segregate the funds for the benefit of the counterparty and maintain the funds in a segregated account separate from the assets of the dealer or participant.

#### G. Expansion of the CFTC's Regulatory Authority over Swaps

The Act contains significant amendments to the Commodity Exchange Act which introduce, among others, new insider trading, anti-disruption and anti-fraud provisions, as well as provisions on remedies and whistleblower protection.

##### 1. Insider Trading

The Act adds to the Commodity Exchange Act new insider trading provisions that generally prohibit any employee or agent of the U.S. Government from using nonpublic information acquired by virtue of his or her employment or position that may affect or tend to affect the price of any commodity or "swap" and from entering into any "swap," any commodity forward or option on such forward or any option not executed or traded on a national exchange. These provisions also prohibit such employees and agents from imparting such information in their personal capacity and for personal gain with intent to directly or indirectly to assist another person to enter into any such derivative transaction. Furthermore, these provisions generally prohibit any person from stealing, converting or misappropriating such material nonpublic information or using such information or imparting it to others as described above.

2. *Anti-Disruptive Practices and Anti-Fraud Authority*

The Act adds to the Commodity Exchange Act anti-disruption and anti-fraud provisions which prohibit any person from engaging in any disruptive trading practices such as violating a bid or offer, demonstrating intentional or reckless disregard for the orderly trade execution during the closing period or what is commonly known in the industry as “spoofing” (bidding or offering with the intent to cancel the bid or offer before execution). The Act also makes it illegal for any person to enter into a “swap” either with knowledge of or with reckless disregard of the fact that its counterparty will use the “swap” to defraud a third party.

3. *Anti-Manipulation Authority*

The Act adds to the Commodity Exchange Act provisions prohibiting the use of any manipulative or deceptive device in connection with any “swap” or contract of sale of any commodity in interstate commerce or for future delivery. Specifically, the Act prohibits (1) any false reporting concerning crop or market information or conditions that affect the price of any commodity and (2) any false or misleading statement of material fact (or omission thereof) to the CFTC, including in any registration application or report filed with the CFTC under the Commodity Exchange Act or any other information relating to any “swap” or contract of sale of any commodity in interstate commerce or for future delivery.

4. *Equitable Remedies*

The Act adds to the Commodity Exchange Act equitable remedies provisions pursuant to which the CFTC may seek, among other remedies, restitution for persons who have sustained losses as a result of any violation, as well as disgorgement of gains received in connection with a violation.

5. *Whistleblower Incentives and Protections*

The Act provides incentives and protections for whistleblowers by requiring the payment of an award to whistleblowers who voluntarily provide original information to the CFTC that leads to the successful enforcement of a judicial or administrative action brought by the CFTC for more than \$1 million. The Act also protects whistleblowers from retaliation by employers. A whistleblower that prevails in an action brought under this section may receive relief by reinstatement, back pay and compensation for special damages.

**H. Expansion of the SEC’s Regulatory Authority over Derivatives**

The Act contains a number of amendments to the U.S. securities law which significantly expand the SEC’s regulatory authority over derivatives.

The Act repeals several of the provisions of the Gramm-Leach-Bliley Act and adds “security-based swaps” to the definition of “security” in the Securities Act and the Exchange Act. In addition, the Act requires the offer or sale of any security-based swap offered to a person who is not an eligible contract participant to be registered with the SEC without exception.

Another significant amendment is the expansion of the concepts of purchase and sale of a security under the Securities Act and the Exchange Act to cover a broad set of occurrences with respect to a security-based swap. For example, the purchase or sale of a security for U.S. securities law purposes may be deemed to occur upon each of the execution, early termination and assignment of a “security-based swap” and also upon the extinguishment of rights or obligations under such derivative. In addition, for purposes of the Securities Act, any offer or sale of a security-based swap by or on behalf of the issuer of the underlying securities, an affiliate of such issuer or an underwriter, shall constitute an offer or sale of the underlying securities. Such amendments have significant implications on other provisions of the Securities Act and the Exchange Act, such as the registration and anti-fraud provisions of the Securities Act and the beneficial ownership reporting requirements, short-swing profit rules and anti-manipulation provisions of the Exchange Act.

The Act broadens the terms of Sections 13(d) and 13(g) of the Exchange Act to include “security-based swaps” for the purposes of determining beneficial ownership. As amended, the purchase or sale of a “security-based swap” may confer beneficial ownership for purposes of Section 13 of the Exchange Act to the extent that the SEC, after consulting with the prudential regulators and the Treasury Secretary, determines that the purchase or sale of the “security-based swap” is comparable to direct ownership of the underlying equity security.

The Act also amends Section 9 of the Exchange Act to prohibit purchases and sales of any “security-based swap” or “security-based agreement”<sup>8</sup> to manipulate the price of any security (whether traded on an exchange or in the over-the counter markets), “security-based swap” or “security-based agreement.”

## I. The Rulemaking Process

The Act leaves a significant number of rulemaking items in this area to the CFTC and the SEC. For example, the Act provides that the CFTC and the SEC, in consultation with the Board of Governors, shall further define key terms such as “swaps” and “security-based swaps,” “swap dealer,” “security-based swap dealer,” “major swap participant” and “security-based major swap participant,” as well as any other term they determine to be necessary and appropriate in the public interest and for the protection of investors. The Act also mandates joint rulemaking by the CFTC and the SEC (in consultation with the Federal Reserve) regarding mixed swaps.

The Act requires the CFTC and the SEC to:

- generally complete their rulemaking process within 360 days of the enactment;<sup>9</sup>

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<sup>8</sup> “Security-based swap agreements” are security-based derivative transactions that are not “security-based swaps.” “Security-based swap agreements” are not subject to the registration requirements of the Securities Act but are still subject to the anti-fraud and anti-manipulation provisions of the Securities Act and the Exchange Act.

<sup>9</sup> The Act clarifies that none of the regulatory actions taken by the CFTC and the SEC, such as promulgation of rules or orders, registrations of regulated persons and issuances of exemptions, will be effective prior to the effective date of the Act.

- coordinate with each other and consult with the prudential regulators to the extent possible to ensure regulatory consistency; and
- treat functionally or economically similar products or entities in a similar manner.

If either the CFTC or the SEC objects to a rule, regulation or order of the other agency on the grounds that it violates the division of regulatory authority mandated by the Act or the requirement with respect to similar products or entities, the complaining agency may petition for a review by the Court of Appeals of the District of Columbia within 60 days after the publication of the final rule, regulation or order. Upon the filing of such petition, such rule, regulation, or order will be stayed until the date such court reaches final determination (including any appeal).

## VI. INSURANCE REFORMS

The Act creates, for the first time ever, a federal insurance regulator with the authority to monitor all aspects of the insurance industry (except health insurance). In addition, under the Act, any insurance company whose financial distress would pose a systemic risk to the financial stability of the U.S. can be subjected to regulation and supervision by the Federal Reserve as a nonbank financial company. The Act also dramatically changes the regulatory framework for nonadmitted insurance and reinsurance.

### A. Establishment of the Federal Insurance Office

The Act creates a new Federal Insurance Office to be located within the Treasury Department and headed by a director appointed by the Treasury Secretary.

Pursuant to the direction of the Treasury Secretary, and in addition to other powers and functions assigned to it by the Treasury Secretary, the Federal Insurance Office will have the following powers and functions:

- to monitor all aspects of the insurance industry (except health insurance);
- to identify issues or gaps in the regulation of insurers that could contribute to a systemic crisis in the insurance industry or the U.S. financial system;
- to recommend to the Council that it designate an insurer as a nonbank financial company to be supervised by the Federal Reserve;
- to assist in administering the Terrorism Insurance Program;
- to coordinate federal policy on international insurance matters and represent the United States in the International Association of Insurance Supervisors; and
- to determine whether state insurance measures are preempted by international agreements.

The scope of these powers and functions extends to all lines of insurance except health insurance, and the Treasury must coordinate with the Secretary of Health & Human Services to determine which lines of insurance are health insurance and therefore excluded from Federal Insurance Office authority. To carry out its functions, the Federal Insurance Office has the

power to require an insurer, or any affiliate of an insurer, to submit any data or information it may reasonably require. In addition, the Federal Insurance Office is authorized to enter into information-sharing agreements with state insurance regulators, analyze and disseminate data and information, and issue reports regarding all lines of insurance under its authority.

The Act authorizes the Federal Insurance Office to preempt any state insurance measure to the extent it is inconsistent with an international insurance agreement or results in less favorable treatment to a non-U.S. insurer that is subject to such an agreement than to a U.S. insurer domiciled or licensed in that state. To do so, the Federal Insurance Office must first notify and consult with the relevant state regulator and engage in a notice and comment process with potentially interested parties.

Importantly, the Federal Insurance Office explicitly is not provided with general supervisory or regulatory authority over the business of insurance (*i.e.*, dealings between insurers and policyholders).

## B. State-Based Insurance Reforms

The Act contains a number of measures primarily designed to streamline the regulation of nonadmitted insurance and reinsurance.

### 1. Nonadmitted Insurance

Nonadmitted insurance is property or casualty insurance permitted to be placed from an insurer not licensed to engage in the business of insurance in a state but otherwise eligible to accept such insurance. The Act limits regulation of the placement of nonadmitted insurance solely to the home state of the insured. In addition, the Act:

- prohibits states other than the home state of the insured from requiring any premium tax payment for nonadmitted insurance;
- encourages states to enter into a nationwide compact to establish procedures for payment, collection and allocation of such premium taxes for nonadmitted insurance;
- prohibits states from imposing eligibility requirements on nonadmitted insurers domiciled in the U.S. except in conformance with the National Association of Insurance Commissioners' model law;
- prohibits states from disallowing surplus lines brokers from placing insurance from non-U.S. nonadmitted insurers who are included on the National Association of Insurance Commissioners' list;
- prohibits states, other than an insured's home state, from requiring a surplus lines broker to be licensed in order to sell nonadmitted insurance; and
- requires the Comptroller General to conduct a study to determine how enactment of the ACT affected the size and market share of the nonadmitted insurance market for providing coverage typically provided by the admitted insurance market.

In addition, the Act substantially softens the requirement with regard to large commercial policyholders that a surplus lines broker must first attempt to place coverage in the admitted market.

2. Reinsurance

Under the Act, if the domiciliary state of a ceding company is accredited by the National Association of Insurance Commissioners or has financial solvency requirements substantially similar to those required for accreditation by the National Association of Insurance Commissioners, then no other state may deny credit for reinsurance for the ceded risk if the domiciliary state recognizes such credit for reinsurance. Moreover, if the domiciliary state of a reinsurer is accredited by the National Association of Insurance Commissioners or has financial solvency requirements substantially similar to those required for accreditation by the National Association of Insurance Commissioners, then that state is solely responsible for regulating the financial solvency of the reinsurer and no other state may require the reinsurer to provide financial information other than that information provided to the domiciliary state.

C. **Miscellaneous Insurance Reforms**

Other key highlights of the Act include the following:

- *Representation on the Council* – One voting member of the Council will be an independent member with insurance expertise. The director of the Federal Insurance Office will serve as a non-voting member of the Council, and an additional non-voting member of the Council will be a state insurance commissioner selected by a process to be determined by the state insurance commissioners.
- *Carve-Outs* – Insurance company subsidiaries of companies defined as financial companies for purposes of the new orderly liquidation authority are themselves excluded from the new liquidation authority. Persons regulated by a state insurance regulator are carved-out from the authority of the Bureau of Consumer Financial Protection.

**VII. REGULATION OF PRIVATE FUNDS AND THEIR ADVISERS**

The Act significantly alters the registration, reporting and recordkeeping obligations applicable to private fund advisers. Previously, private equity and hedge fund advisers generally avoided registration with the SEC (and related reporting, record keeping and other compliance burdens) in reliance on the “private investment adviser” exemption under the Investment Advisers Act. Under the Act, however, private equity and hedge fund advisers will be required to register with the SEC if their advisee funds and other client accounts have \$150 million in assets or more under management. Advisers solely to “venture capital funds,” regardless of their size, are not required to register, although they will be subject to certain reporting requirements. The registration, reporting and recordkeeping obligations become effective one year after the Act is enacted.

## A. Registration of Investment Advisers to Private Funds

Under current regulations, many private fund advisers—including advisers to what are colloquially referred to as hedge funds, private equity funds and venture capital funds—are exempted from registration with the SEC, regardless of the amount of their assets under management, in reliance on the “private investment adviser” exemption in the Investment Advisers Act.<sup>10</sup> The Act significantly changes the private investment adviser exemptive framework.

Most notably, the Act eliminates the private investment adviser exemption contained in Section 203(b)(3) of the Investment Advisers Act and thereby generally requires (subject to the exceptions noted below) the registration of all advisers to “private funds.” The Act defines a “private fund” as an issuer that would be an “investment company” under Section 3 of the Investment Company Act but for the exemptions provided in Sections 3(c)(1) or 3(c)(7) of the Investment Company Act.<sup>11</sup> As a result, investment advisers to most private funds, subject to certain exceptions, will now be required to register with the SEC. Private equity and hedge fund advisers will be required to register with the SEC if their advisee funds and other client accounts have over \$150 million in assets under management. Advisers solely to “venture capital funds,” regardless of their size, are not required to register, although they will be subject to certain reporting requirements. The term “venture capital funds” is not defined in the Act, but the Act directs the SEC to issue rules, within one year of the effectiveness of the Act, providing for a definition.<sup>12</sup>

Investment advisers solely to venture capital funds (as well as investment advisers to other private funds with assets under management below the \$150 million threshold) are exempt from the Act’s registration requirements, but will still be subject to certain reporting requirements. In each case, the SEC will at some point in the future specify the reports to be maintained and provided to the SEC based on what it deems “necessary and appropriate in the public interest or for the protection of investors.”

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<sup>10</sup> Section 203(b)(3) of the Investment Advisers Act provides an exemption for an investment adviser that (i) has had fewer than fifteen clients during the preceding twelve months (each fund vehicle is generally treated as a separate client for this purposes), (ii) does not hold itself out generally to the public as an investment adviser and (iii) does not act as an investment adviser to any registered investment company or business development company.

<sup>11</sup> Section 3(c)(1) of the Investment Company Act generally exempts an issuer that has 100 or fewer holders of its securities (other than short-term paper) and that does not engage or propose to engage in a public offering of securities. Section 3(c)(7) of the Investment Company Act generally exempts an issuer all the security holders of which are “qualified purchasers” and that does not engage or propose to engage in a public offering of securities. An important interpretive issue to be clarified by the SEC is the application of the definition of “private funds” to foreign investment funds. Based on conversations with the SEC staff and Commissioners, we believe there is reason to expect that the SEC will only treat as “private funds” those foreign investment funds that have U.S. advisers or that offer or sell their securities to U.S. residents, so that foreign investment funds that neither have U.S. advisers nor offer or sell their securities to U.S. persons (even though U.S. persons may acquire such securities in secondary market transactions not arranged by the adviser) will not be treated as private funds.

<sup>12</sup> Based on our conversations with SEC staff and Commissioners, we expect that this exemption will be narrowly drafted and will focus on advisers to funds that primarily provide privately negotiated financings to start-up enterprises.

The Act also contains a provision that provides a potential exemption from registration (and more limited reporting obligations) for investment advisers to “mid-sized private funds.” The term “mid-sized private funds” is not defined, and it is unclear when the SEC will issue rules providing for a definition and what, if any, exemption or more limited reporting obligations will be provided for such investment advisers. In determining which investment advisers will benefit from the potential exemption, the SEC is required by the Act to take into account the size, governance and investment strategy of the advised funds to determine whether they pose systemic risk.

The Act creates a new limited exemption from registration for “foreign private advisers.” This foreign private adviser exemption will be available to any adviser that (i) has no place of business in the U.S., (ii) has fewer than 15 clients and investors in the United States in private funds advised by the investment adviser, (iii) has aggregate assets under management attributable to clients in the U.S. and investors in the U.S. in private funds advised by the investment adviser of less than \$25 million (such amount may be increased by the SEC) and (iv) neither holds itself out generally to the public in the U.S. as an investment adviser nor acts as an investment adviser to any registered investment company or business development company. Because the exemption is so narrowly crafted, it will significantly expand the extra-territorial application of the Investment Advisers Act for foreign investment advisers which manage capital on behalf of U.S. investors, which may, in turn, result in restricted access by U.S. investors to the services of non-U.S. advisers.

## B. Recordkeeping Requirements

Advisers of private funds that are required to register with the SEC will be subject to new reporting and recordkeeping requirements. (Advisers to private funds will also become subject to the existing provisions of the Investment Advisers Act.) The Act authorizes the SEC to require registered investment advisers to maintain records (for such periods as the SEC prescribes) and file such reports with the SEC as deemed necessary or appropriate in the public interest or for purposes of “systemic risk” assessments made by the Council. All such records will also be subject to periodic and special examination by the SEC.

The records required to be maintained (and made available for SEC inspection and subject to SEC filing requirements to be prescribed) by each private fund advised by an investment adviser will include information on the amount of assets under management, use of leverage, including off balance sheet leverage, counterparty credit risk exposure, trading and investment positions, valuations policies and practices, types of assets held, side arrangements or side letters whereby certain investors in a fund obtain more favorable rights or entitlements than other investors and trading practices of the fund. Such private funds will also be required to maintain (and make available to the SEC) “such other information” as the SEC, in consultation with the Council, determines is “necessary or appropriate in the public interest and for the protection of investors or for the assessment of systemic risk.” The Act provides that the “other information” requirements may include the establishment of different reporting requirements for different classes of fund advisers, based on the type or size of private fund being advised.

The specific content and form of the reports to be filed with the SEC are not detailed in the Act. As a result, the exact impact and burden of private fund advisers' SEC reporting obligations will not be known until such obligations are fleshed out through SEC rulemaking.

To the extent that any "proprietary information" of a private fund is contained in reports required to be filed with the SEC, the Act provides for protections from public disclosure under the Freedom of Information Act. The term "proprietary information" is defined to include sensitive, non-public information regarding the investment or trading strategies of the investment adviser; analytical or research methodologies; trading data; computer hardware or software containing intellectual property; and any additional information that the SEC determines to be proprietary.

The Act provides that the new registration requirements under the Act for advisers of private funds do not eliminate any registration obligations of such advisers, if any, under the Commodity Exchange Act. Additionally, the SEC and the CFTC are required, in consultation with the Council no later than one year after enactment, to jointly establish rules governing the form and content of reports to be filed with the SEC and with the CFTC by investment advisers registered both under the Investment Advisers Act and the Commodity Exchange Act.

\* \* \*

The Act was approved by the House, by a vote of 237 to 192, and is expected to be voted on by the Senate during the week of July 12 and signed into law shortly thereafter. Following enactment, the next part of the process, to play out over the next several years, will be the preparation of the significant volume of rules and regulations required by the Act, as well as the establishment of the new regulatory authorities created by the Act. For all the significant changes that the Act will bring, the Act leaves a number of issues unaddressed. For example, the Act contains no substantive provisions regarding Fannie Mae and Freddie Mac, although it does order a study on the options for ending their conservatorship. That study is one of dozens of studies that are required to be conducted under the Act. The completion of these studies may result in future legislative proposals by Congress.

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