Simpson Thacher

Reflections on Dodd-Frank

A Look Back and a Look Forward

July 21, 2011

Simpson Thacher & Bartlett LLP

SIMPSON THACHER

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Dear Clients and Friends:

The Dodd-Frank Wall Street Reform and Consumer Protection Act was enacted one year ago today. This landmark legislation marked the beginning of transformational change in the regulation of the financial services industry. What has Dodd-Frank changed so far, and what changes are ahead? The financial services industry has already absorbed, and has begun to anticipate, many of the statute's impacts. Hundreds of rulemakings, however, remain a work in progress, key leadership positions remain unfilled, and all priorities of regulators with new powers have not been disclosed. As a result, the effects of the legislation will not be fully understood for years.

As one of the leading firms advising participants in the financial services sector, we have closely followed Dodd-Frank and its implementing rules and continue to advise our clients regarding developing implications, particularly with regard to:

- Capital standards and qualifying instruments,
- Private equity and hedge fund formations,
- Strategic investments and mergers and acquisitions,
- Derivative transactions,
- Emerging litigation and regulatory enforcement issues, and
- Risk management and regulatory compliance.

Last year we provided our clients with a comprehensive summary of key provisions of Dodd-Frank. To mark the first anniversary, the lawyers from our financial institution practice groups reflect on recent developments in key areas of significance to our clients in a compendium titled, "Reflections on Dodd-Frank: A Look Back and a Look Forward."

We hope you find these materials useful in your business and in planning for the future. We expect to cover a number of these topics in detail in seminars this fall. In the meanwhile, visit our Dodd-Frank Resource Center at www.simpsonthacher.com or feel free to call any of the partners in our financial institutions practice areas, any article author or your firm contact for advice on Dodd-Frank or any other matter.

Sincerely,

SIMPSON THACHER & BARTLETT LLP

REFLECTIONS ON DODD-FRANK: A LOOK BACK AND A LOOK FORWARD

The impact of Dodd-Frank—like the U.S. financial industry it regulates—is greater than the sum of its parts. Dodd-Frank seeks to oversee and regulate financial markets as a whole, by increasing regulation of individual companies with the potential to compromise market stability, as well as implementing regulation of certain areas of the financial services sector previously not subject to federal supervision and regulation. Dodd-Frank also addresses consumer protection, through the creation of a new agency with broad consumer protection powers and new rules governing residential mortgage markets.

In comments regarding the impact of this historic legislation, Timothy Geithner, Secretary of the Department of Treasury, noted that "By almost any measure, the U.S. financial system is in much stronger shape" than it was prior to enactment of Dodd-Frank.[1] However, a huge amount of change still lies ahead. In the short run, uncertainty regarding the impact of Dodd-Frank on operations, capital and liquidity levels, costs and revenue, and increased litigation and enforcement risk, will continue to impact strategic decisions and valuations of financial institutions of all types and sizes. The long-term impact of the legislation is uncertain, although it could quite possibly usher in a new era of accelerated consolidation in the financial services industry.

In the articles that follow, we discuss in greater detail what has happened over the past year in key areas addressed by Dodd-Frank, including those noted below. In some of those areas at least the outline of final regulations are clear, but in a number of others the parameters of required rulemaking are still uncertain.

SYSTEMIC OVERSIGHT REGULATION OF BANK AND NONBANK FINANCIAL INSTITUTIONS

Systemic risk provisions of Dodd-Frank recognize that global financial markets are composed of interrelationships among many different types of companies, including commercial and retail banks, private equity and hedge funds, investment banks, derivative market participants, and insurance companies.

These entities interact through shared corporate ownership, capital investments and transactions that ultimately make up global markets. Dodd-Frank's comprehensive approach to regulating these markets is embodied in the newly-created Financial Stability Oversight Council, which brings together 15 regulators charged with overseeing disparate parts of the nation's financial system. All major financial market participants—including bank and nonbank financial companies—face the prospect of increased systemic risk oversight and enhanced prudential standards and regulation.

Nonbank financial companies deemed systemically important will be subject to Federal Reserve supervision and regulation and, together with bank holding companies with assets of $50 billion or more, such systemically important financial institutions ("SIFIs") will additionally be

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1 Timothy Geithner, A Dodd-Frank Retreat Deserves a Veto, WALL STREET JOURNAL, July 20, 2011.

subject to heightened prudential standards, depending upon the risks they present. Critically important rules to identify and classify SIFIs and set out the enhanced prudential standards to which they will be subject have for the most part not yet been proposed.

CAPITAL

The most important of these heightened prudential standards will likely be requirements for additional capital. Dodd-Frank seeks to address three perceived capital shortcomings evident during the crisis:

- capital ratios were too low, especially at the holding company level;
- banking organizations relied too much on forms of capital other than common equity, which were not able to absorb losses on a going-concern basis during the financial crisis; and
- the current risk-based capital requirements did not fully capture many of the risks incurred by banking organizations.

The U.S. banking regulators have been working to address these issues through U.S. regulations and through the Basel Committee on Banking Supervision. While the capital standards under Dodd-Frank have yet to be finalized, changes will include:

- new standards applicable to SIFIs and thrift holding companies that are comparable to prompt corrective action standards applicable to banks;
- exclusion of certain debt and equity instruments (such as trust preferred securities) as regulatory capital for bank holding companies; and
- annual capital plans, dividend and share buyback limitations, and stress testing for certain bank holding companies.

While the largest U.S. financial institutions have already been subjected to capital stress-testing and forced to hold much stronger cushions against the commitments they make, regulators are considering a possible capital surcharge for SIFIs, to reflect any incremental systemic risk these institutions pose to the system.

Although not fully effective until 2019, regulators and financial institutions also are focused on implementing Basel III, core components of which include: increased use of common stock and retained earnings as regulatory capital; increased capital ratios; improved risk calibration through capture of off-balance sheet and counterparty credit exposures; and imposition of short and long term liquidity ratios.

ORDERLY LIQUIDATION AUTHORITY

In addition to new capital requirements, SIFIs will potentially be subject to a new orderly liquidation authority (rather than traditional bankruptcy proceedings) in the event of their insolvency. This change in liquidation authority has potential implications for creditors and other counterparties, and firms subject to the orderly liquidation authority are required to plan their funerals in advance, by preparing complicated “living wills.”

REGULATION OF NONBANK FINANCIAL COMPANIES: PRIVATE EQUITY, HEDGE FUNDS, DERIVATIVES AND INSURANCE

Regardless of whether they are deemed SIFIs, companies and market participants historically subject to little or no government supervision or regulation—including private equity and hedge funds, and participants in derivatives markets—will be subject to significant new regulation under Dodd-Frank. Private equity and hedge funds face new registration and reporting requirements, as well as Volcker Rule restrictions on the sources of their funds. Derivatives that traditionally traded over-the-counter (not on exchanges) and were not subject to clearing rules will now be subject to enhanced supervision and regulation by the Commodity Futures Trading Commission and the Securities and Exchange Commission. Some of these firms may also face new prohibitions on incentive-based compensation arrangements that are deemed by regulators to be excessive in nature or potentially expose such firms to material financial loss.

For insurance companies, Dodd-Frank creates the Federal Insurance Office within the Treasury Department with powers to monitor industry practices, although general supervisory or regulatory authority over the business of insurance remains with state insurance regulators, and is relatively untouched by Dodd-Frank.

REGULATOR CHANGES: CONSUMER FINANCIAL PROTECTION BUREAU AND OFFICE OF THRIFT SUPERVISION

The regulatory players have changed, with the creation of one new agency and elimination of another.

- The new Consumer Financial Protection Bureau has broad powers to conduct "principles-based" regulation and enforcement with regard to federal consumer financial protection. Significant questions remain as to how this new agency will use its powers and the roles state attorneys general and regulators will play in enforcing federal laws.
- The Office of Thrift Supervision has been abolished and its functions transferred to other agencies. While the thrift charter remains, the likely imposition of bank holding company-type standards to thrift holding companies and other changes raise questions about the long term future of the thrift charter.

BANK AND THRIFT HOLDING COMPANIES

In addition to potential new capital requirements described above, bank and thrift holding companies are subject to a myriad of changes to their core businesses under Dodd-Frank that could affect profits. Key among these are:

- <u>Deposit insurance assessments</u>. The FDIC has substantially altered how deposit insurance assessments will be calculated. These changes will affect all insured depository institutions, but especially large and highly complex institutions, which are expected to bear a greater share of the assessment burden as the FDIC replenishes the Deposit Insurance Fund from historic lows.

- Proprietary trading and securities activities. Several provisions cause bank holding companies to discontinue or divest profitable nonbank activities. The Volcker Rule, for example, requires bank holding companies to discontinue proprietary trading and investments in private equity and hedge funds; and the securities push-out provisions require banks to conduct certain kinds of derivative trading activities in separately capitalized affiliates.
- Debit interchange. According to Federal Reserve estimates, new regulations implementing the debit interchange rate-setting provisions of Dodd-Frank could reduce bank revenues from debit interchange by more than 40%.
- Mortgage markets. New federal mortgage origination standards, such as minimum down payments and ability-to-pay requirements, have the potential to significantly constrict the size of future non-governmental residential mortgage markets.

MERGERS AND ACQUISITIONS

What effect will these broad-based regulatory changes have on bank mergers and acquisitions? Conventional wisdom has been that Dodd-Frank would push smaller banks towards consolidation, as decreased profitability due to more stringent capital requirements, limitations on business activities, government rate-setting and the costs of increased regulatory burdens drive the need for greater efficiencies. A variety of factors, however, have limited acquisition activity to date, including:

- Lack of certainty as to the costs of regulatory reform, most notably capital requirements.
- Environmental and regulatory emphasis for many institutions on strengthening internal operations, capital levels and asset quality before considering growth through acquisitions.
- Continued general economic uncertainty, which continues to make assets difficult to value with certainty and in many cases contributes, among other factors, to a divergence in price expectations between buyers and sellers.

Ultimately, we expect the downward pressures on profitability resulting from Dodd-Frank will contribute to meaningful consolidation activity in the financial services once the economic and regulatory climate has stabilized.

LITIGATION AND ENFORCEMENT

The aftermath of the financial crisis has seen an enormous surge in both private litigation and government enforcement actions, many of which focus on mortgage origination and servicing practices. These levels are not likely to recede in the near future. Portions of Dodd-Frank may lead to more government enforcement actions, including new whistleblower provisions, under which the SEC and the CFTC would potentially offer substantial financial bounties to individuals who provide information concerning any misconduct that falls within their jurisdictions.

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OVERSIGHT AND REGULATION OF SYSTEMICALLY IMPORTANT FINANCIAL INSTITUTIONS

BY MARIPAT ALPUCHE

One of the cornerstones of Dodd-Frank was its attempt to craft a cooperative multi-agency approach to identifying and mitigating "systemic risk"—the risk that, as a result of the size or interconnectedness of major financial institutions, financial distress at a single institution can cause a ripple effect or contagion throughout the broader financial system. As a direct response to the crippling domino effect of financial failures in the fall of 2008, Dodd-Frank created the Financial Stability Oversight Council (the "FSOC" or the "Council") to serve the following three broad purposes:

- To identify risks to U.S. financial stability from the distress, failure or activities of large interconnected bank holding companies or nonbank financial companies;
- To promote market discipline by eliminating expectations on the part of shareholders, creditors and counterparties of financial companies that the government will shield them from losses (*i.e.*, eliminating "too big to fail" institutions); and
- To respond to emerging threats to the stability of the U.S. financial system.

The primary duties of the FSOC fall into three broad categories: first, to facilitate the gathering and sharing of industry, marketplace and regulatory information in order to assist regulatory agencies in identifying threats to financial stability; second, to make recommendations to the Federal Reserve Board and other agencies regarding enhanced prudential standards and other regulatory improvements designed to reduce systemic risk; and finally, in its most publicized role, to identify and designate those nonbank financial companies and financial market utilities that pose risks to U.S. financial stability in order to subject them to substantive regulation by the Federal Reserve Board and other agencies as applicable.

Organization of the FSOC and Office of Financial Research

In response to the widespread perception that parochial concerns and insufficient cooperation among individual functional regulators may have contributed to the regulatory lapses leading to the financial crisis, Congress created the FSOC as a cooperative body on which all major U.S. financial regulatory agencies have a voice. Although chaired by the Treasury Secretary, the FSOC, with its 10 voting and five nonvoting members,[1] is structured to provide joint authority and joint accountability among all of the major federal and state financial regulators.

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[1] The voting membership of the FSOC is comprised of the Secretary of the Treasury Department, the top-ranking official of each of the Federal Deposit Insurance Corporation, the Federal Reserve Board, the Office of the Comptroller of the Currency, the new Bureau of Consumer Financial Protection, the Securities and Exchange Commission, the Commodity Futures Trading Commission, the Federal Housing Finance Agency and the National Credit Union Administration, as well as an independent member appointed by the President having insurance expertise. The non-voting members consist of

While the multi-agency approach chosen by Congress was designed to foster cooperation and an open exchange of ideas among the nation's regulatory experts, the size and breadth of the membership of the FSOC, and its reliance on members with primary responsibilities outside the Council, also pose various challenges. At this point, at the anniversary of the passage of Dodd-Frank, the FSOC has held only six meetings, and its activities to date (discussed further below) have been generally limited to organizational matters, the approval of certain mandated studies and notices of proposed rulemaking addressing only preliminary conceptual matters beyond the statute itself. Furthermore, three of the FSOC's voting positions are currently held by acting rather than permanent members due to chairperson vacancies in the departments entitled to fill those positions; the nonvoting FSOC position to be filled by the director of the newly-created Office of Financial Research ("OFR") remains vacant, and the director of Consumer Financial Protection Bureau, the Comptroller of the Currency, the chairman of the Federal Deposit Insurance Corporation and the independent insurance expert on the FSOC have been nominated but not yet confirmed.

FSOC action generally requires majority approval, although the key matter of designation of systemically important nonbank financial companies, as well as the imposition of heightened prudential standards on such companies, requires approval of two-thirds of its members and the Chairperson. It appears from FSOC minutes to date that all formal action so far has been approved unanimously. However, based on the limited and noncontroversial nature of the matters considered so far, it remains an open question whether the Council will be able to obtain sufficient consensus on the more difficult substantive regulatory matters it will consider in the future. Given the significant responsibilities of FSOC members to their primary agencies, it also remains to be seen whether the FSOC will have sufficient dedicated resources necessary to focus on the complex duties tasked to it.

Dodd-Frank also established the OFR to be headed by a Presidential appointee for a six-year term and initially funded by the Treasury Department. This office is charged with supporting the FSOC 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. As with the FSOC itself, at this point the OFR remains in its infancy. No director has been nominated by the President, and the number of additional staff members appointed to date remains limited.[2]

Progress of Substantive Regulation Regarding Designation of Systemically Important Financial Institutions

The FSOC's core task of prescribing criteria by which to identify companies that pose a threat to financial stability is among the most difficult and amorphous requirements of Dodd-Frank. First of all, Congress mandated that the FSOC evaluate and address risks posed not only by the failure of individual financial firms, but also by the nature, scope, size, scale, concentration, interconnectedness or mix of activities of such firms. Clearly it appears that Congress's mandate to the FSOC was not limited to constraining "too big to fail" institutions, as the criteria to be examined in assessing these risks was not limited merely to size or scale. In addition,

the directors of each of the newly-created Office of Financial Research and Federal Insurance Office; and a state insurance commissioner, bank regulator and securities commissioner.

2 The Treasury Department expects to have 60 full-time staff in place by the end of September 2011.

Congress gave no guidance as to the number or specific types of nonfinancial firms it expected would ultimately be designated as systemically important. Congress did specify a lengthy list of mandatory considerations for the FSOC to take into account in determining whether to subject a nonbank financial company to Federal Reserve Board regulation,[3] but it did not give any guidance as to how those considerations should be measured or weighed. The sheer number of mandatory considerations, the novel and non-numerical nature of some of them, as well as the absence of guidance as to how to measure or weigh the considerations, all complicate the FSOC's task if its goal is to formulate objective, transparent and uniform standards for subjecting nonfinancial firms to new regulation.

Given the diversity of the problems and the numerous sources of financial stress that emerged during the financial meltdown, the broad Congressional mandate assigned to the FSOC could force it to consider imposing regulation on a wide variety of firms and markets that may bear limited or no resemblance to each other. For example, during various stages of the crisis, problems in the residential real estate, commercial real estate, credit default swap, money market mutual fund, commercial paper, securitization and equity, hybrid and debt capital markets, among others, all threatened to have serious repercussions on the national economy. The participants in such markets and their capital and governance structures, as well as their customers and counterparties, differ greatly.

In response to the breadth and diversity of the firms that could come within the scope of FSOC designation, as well as the lack of specificity regarding the particular criteria to be applied, the FSOC has focused its initial efforts on soliciting public comment on broad questions regarding the general approach to be followed. In an Advance Notice of Proposed Rulemaking published October 6, 2010, the FSOC asked a series of such questions, including, among others:

- what metrics can be used to measure the factors mandated by Congress to be considered, particularly those factors that are more novel or qualitative;
- to what extent should quantitative versus qualitative factors be considered in determining whether to subject a firm to regulation;
- whether certain considerations should be weighed more heavily than others;
- if quantitative measures are used, what particular measures should be applied for each relevant consideration; and

3 These mandatory considerations include: the company's leverage, the extent and nature of off-balance sheet exposures; the extent and nature of the company's relationships with other financial firms; the importance of the company as a source of credit for households, businesses or the government, or as a source of credit to low-income, minority or underserved communities and the impact of the failure of the company on availability of credit to such communities; the extent to which the company's assets are managed rather than owned; the nature, scope, size, scale, concentration, interconnectedness and mix of the activities of the company; in the case of a foreign company, the extent to which it is subject to prudential standards on a consolidated basis in its home country; the amount and nature of the company's U.S. financial assets; and the amount and nature of the liabilities of the companies used to fund U.S. operations, including the degree of reliance on short-term funding.

- whether receipt of government assistance in the recent financial crisis should impact the FSOC's view on whether a particular recipient should be subjected to regulation.

Although the FSOC received 50 comment letters, and indicated that certain of those letters proposed specific frameworks or provided feedback regarding particular metrics under consideration, it is clear from the substance of the proposed rule itself, which was published for comment in a Notice of Proposed Rulemaking in January 2011 and which does little more than codify the broad and nonspecific statutory framework, that much work remains to be done to formulate a specific framework for evaluating the risks posed by nonfinancial firms. Although comments were due in February 2011, it is difficult to imagine that an implementable final rule will emerge from that particular proposal or those comments. Furthermore, based on summaries regularly published by the Federal Reserve Board Staff regarding meetings it holds with members of the public, a significant portion of the energy being devoted by lobbyists, industry groups and other segments of the public appears to be directed not at formulating the proper regulatory framework but rather at excluding particular industry segments from any regulation at all.[4]

Progress Regarding Systemically Important Financial Market Utilities

In addition to its responsibility for designating nonbank financial firms for regulation, the FSOC was also tasked with designating systemically important financial market utilities.[5] 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.

In this area, on July 18, 2011, the FSOC issued a Final Rule regarding the criteria and process that will be used in assessing a financial market utility's systemic importance. As set forth in the Final Rule, the FSOC expects to use a two-stage process for evaluating financial market utilities prior to a vote of proposed designation.

The first stage would be a largely data-driven process to identify a preliminary set of financial market utilities whose failure or disruption could potentially threaten the stability of the U.S. financial system. As part of the first stage, the FSOC will apply quantitative metrics where available to evaluate the following four considerations mandated by Congress, as well as other factors the Council deems appropriate, in determining whether a financial market utility is systemically important:

- aggregate monetary value of transactions processed by the financial market utility;
- aggregate exposure of the financial market utility to counterparties;
- relationship, interdependencies or other interactions of a financial market utility with other financial market utilities or payment, clearing or settlement activities; and

4 *See* Eric Dash and Julie Creswell, *Too Big to Fail, or Too Trifling for Oversight?*, N.Y. TIMES, June 11, 2011.
5 Dodd-Frank defines a financial market utility generally as a person that operates a multilateral system for the purpose of transferring, clearing or settling payments, securities or other financial transactions among financial institutions with or among financial institutions.

- the effect that the failure of or disruption to the financial market utility would have on critical markets, financial institutions or the broader financial system.

In the second stage, each of the utilities identified in the first stage of review will be subjected to a more in-depth review, with a greater emphasis on company-specific and qualitative factors and with an opportunity to provide information to the Council supporting or refuting its preliminary findings.

Ultimately, two critical determinations for the Council's designation of a financial market utility as systemically important are the following: (i) whether the failure of or a disruption to the functioning of the financial market utility now or in the future could create, or increase, the risk of significant liquidity or credit problems spreading among financial institutions or markets; and (ii) whether the spread of such liquidity or credit problems among financial institutions or markets could threaten the stability of the financial system of the United States.

While it is not clear whether this two-stage approach is being considered for application beyond financial market utilities to other nonbank financial companies, this final rule might shed light on an approach that could be adopted more generally by the Council, whereby a group of companies may be preliminarily considered or ruled out for regulation based on general data-driven or quantitative standards, with final designations based on a more tailored or qualitative analysis involving more direct interaction with the subject company.

Other Activities of the FSOC

In addition to its efforts outlined above, the FSOC was tasked with conducting studies regarding particular matters implicating systemic risk. Accordingly, since the enactment of Dodd-Frank, the FSOC has published studies on the Volcker Rule, asset based concentration limits on large financial companies and the macroeconomic effects of risk retention requirements in securitization transactions.

Additional Authority of the Federal Reserve Over Bank Holding Companies and Nonbank Financial Companies

In addition to subjecting certain nonbank financial companies to regulation by the Federal Reserve Board, Dodd-Frank also empowered the FSOC to recommend to the Federal Reserve Board, and the Federal Reserve Board to adopt on its own initiative, heightened prudential standards that would apply to nonbank financial companies subject to Federal Reserve Board regulation as well as bank holding companies with consolidated assets in excess of $50 billion 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. Dodd-Frank specified the general types of enhanced prudential requirements that must or may be implemented, including:

- risk-based capital requirements;
- leverage limits;
- liquidity requirements;

- overall risk management requirements;
- "living will" requirements;
- required reports and limits on credit exposure;
- concentration limits; and
- subject to a mandatory study to be conducted, contingent capital requirements.

The Federal Reserve Board has implemented certain proposals and guidance that may facilitate these future enhanced requirements, including a proposal to require large bank holding companies to develop and maintain a capital plan, guidance regarding stress testing for banking organizations with more than $10 billion of assets, and guidance regarding the Federal Reserve Board's Comprehensive Capital Analysis and Review process pursuant to which the Federal Reserve Board analyzes capital levels and stock dividend and redemption proposals by the 19 largest bank holding companies. However, proposed regulations specifically responsive to the particular enhanced prudential standards identified by Congress remain largely unaddressed. Given that such standards are intended to apply to both nonbank and banking companies of sufficient significance, it is possible that such regulations will not be implemented until the frameworks for designating systemically significant firms have been finalized.

NEW BANK CAPITAL REQUIREMENTS

BY GARY RICE AND MARK CHORAZAK

Dodd-Frank includes a number of provisions related to the capital adequacy of banking organizations and nonbank financial institutions designated by the Financial Stability Oversight Council (the "FSOC") as systemically important. In the year since the enactment of Dodd-Frank, federal banking regulators have proposed regulations to implement parts of what Dodd-Frank requires; they have also issued other guidance on capital issues that, while not directly satisfying Dodd-Frank mandates, presages how the regulators will implement those mandates.

Overall, the efforts to improve the U.S. capital regulations reflect a number of conclusions the U.S. banking regulators drew from the financial crisis. First, when the crisis hit, capital ratios were too low, especially at the holding company level.[1] Second, banking organizations relied too heavily on forms of capital other than common equity. Trust preferred securities and other instruments were not viewed by market participants as significantly adding to the ability of banking organizations to absorb losses, and, in some cases, their terms actually inhibited the resolution of troubled institutions. Third, the current risk-based capital requirements did not fully capture many of the risks incurred by banking organizations.

The U.S. banking regulators have been working to address these issues not only in the United States, through the issuance of guidance and proposed rules, but also at the Basel Committee on Banking Supervision (the "Basel Committee"), in an effort to ensure that U.S. banking organizations are not placed at a competitive disadvantage relative to non-U.S. banking organizations, and that potential sources of financial instability from outside the United States, as well as from within the United States, are addressed.

The Collins Amendment

Section 171 of Dodd-Frank, which is commonly referred to as the Collins Amendment, requires that federal banking regulators establish new minimum leverage and risk-based capital requirements for insured depository institutions, bank and thrift holding companies and systemically important nonbank financial institutions supervised by the Federal Reserve that are not (i) less stringent than those 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 Dodd-Frank became law.

The Collins Amendment has several ramifications. First, nonbank financial companies that are designated as systemically important financial institutions ("nonbank SIFIs") and savings and loan holding companies (after a five-year transition) will become subject to bank capital

1 According to FDIC Chairman Sheila C. Bair, by the end of 2007, the aggregate tangible equity to assets ratio of the top 10 bank holding companies stood at just 2.97% and the ratio of the top five investment banks was 2.84%. In comparison, the 10 largest FDIC-insured depository institutions had a ratio of 6.46%. Statement of FDIC Chairman Sheila C. Bair before the Committee on Financial Services of the U.S. House of Representatives (June 16, 2011).

regulations for the first time. Savings and loan holding companies currently include (and nonbanks designated as SIFIs may include) large insurance companies whose assets, liabilities and business for the most part are very different from those of banks; it will be difficult to apply the bank capital regulations to insurance companies.

Second, under Basel II and the U.S. regulations adopted pursuant to Basel II, the largest and the most internationally active U.S. banking organizations are permitted to use the "advanced approaches rules" and calculate their risk-based capital requirements largely based on their own internal risk management models, which generally results in those institutions having lower risk-based capital requirements than would be the case if they followed the generally applicable capital regulations. The Collins Amendment requirement that the minimum risk-based capital requirements for all depository institution holding companies and SIFIs be not less than the risk-based capital requirements under the prompt corrective action regulations, regardless of "total consolidated asset size or foreign financial exposure," has the effect of placing a floor under the minimum risk-based capital requirement that can result from the "advanced approaches rules."

As FDIC Chairman, Sheila C. Bair endorsed the Collins Amendment based on a view that the capital requirements resulting from the "advanced approaches" rules are too low. Others, including Acting Comptroller of the Currency John Walsh, argued that imposing a floor under the advanced approaches rules will place large U.S. banking organizations at a competitive disadvantage relative to large banks from other countries. However, it is not clear that the Collins Amendment will have a significant practical effect on the largest financial organizations. Under Basel III, those institutions will be subject to a higher leverage standard than has been the case in the past. The leverage standard, unlike the advanced approaches rules, does not reflect risk-weighting. The largest banking organizations also will be subject to an additional capital surcharge related to the systemic risk that they are determined to pose, which charge is not reflected in the prompt corrective action capital requirements that provide the basis for the Collins Amendment. The increased capital requirements set by the Collins Amendment may not be greater than what Basel III will otherwise require. Moreover, the Collins Amendment, as it relates to the advanced approaches rules, will not have an immediate effect on U.S. banking organizations for the simple reason that none of them is currently using the advanced approaches rules. The U.S. banking regulators adopted final regulations on the advanced approaches rules in 2007, but those regulations require banking organizations to first calculate capital under both those rules and the generally applicable rules for a period of time, and, after a successful parallel run, to then transition to the advanced approach over a three-year period. To date, no U.S. banking organization has even entered the transition period under the advanced approaches rules.

A third ramification of the Collins Amendment is that certain debt and equity instruments (such as trust preferred securities) that do not count as Tier 1 capital for depository institutions will no longer count for depository institution holding companies after the U.S. banking regulators issue regulations regarding the phasing out of such instruments as Tier 1 capital. The phase-out schedule for such instruments is discussed in the Simpson Thacher memorandum "U.S. Congress Nears Completion of Landmark Financial Services Reform Legislation," dated July 6, 2010. The U.S. banking regulators have indicated that the phasing out of trust preferred and other hybrid capital instruments will be addressed in more detail in a subsequent regulation. As discussed below, the phase-out of such instruments is also a feature of Basel III.

Pursuant to the Collins Amendment, on June 14, 2011, the Federal Reserve, FDIC and OCC issued a final rule revising the advanced approaches risk-based capital rules of these agencies by adding a requirement that the risk-based capital requirement under the advanced approaches rule shall not be less than the Tier 1 and total risk-based capital requirements of the generally applicable risk-based capital rules. In the case of depository institution holding companies, the applicable floor is the Tier 1 and total risk-based capital requirements generally applicable to state member banks, except that (i) such depository institution holding companies are allowed to include in Tier 1 capital trust preferred securities issued prior to May 19, 2010, and (ii) low-risk nonbanking exposures of depository institution holding companies for which there is no designated risk weight under the state member bank risk-based capital regulations may be assigned the risk weights that apply under the bank holding company risk-based capital regulations, provided that the risks associated with such assets are substantially similar to the risks of assets that otherwise are assigned a risk weight of less than 100% under the risk-based capital rules generally applicable to state member banks.

The Collins Amendment also requires that the minimum capital requirements it calls for not be "quantitatively lower" than the "generally applicable" capital requirements in effect for insured depository institutions as of the date of Dodd-Frank. Congress did not want the federal banking regulators to resolve the discrepancy between the advanced approaches ratios and the generally applicable ratios by simply lowering the latter. In issuing the final rule, the U.S. banking regulators stated that they do not regard this requirement as freezing in place the generally applicable risk-based capital rules as of 2010, but only as requiring a quantitative analysis of any new capital framework to ensure that it does not result in requirements that overall are "quantitatively lower" than the 2010 generally applicable requirements.

Other Proposals Related to Capital Issued by the Federal Bank Regulatory Agencies Since the Enactment of Dodd-Frank

<u>The Requirements of Section 165</u>

Section 165 of Dodd-Frank requires the Federal Reserve to establish prudential standards, including capital standards, for nonbank SIFIs and bank holding companies with total consolidated assets of $50 billion or more (i) that are more stringent than those applicable to companies that do not present similar risks to the financial stability of the United States and (ii) that increase in stringency based on such risks. In adopting such standards, the Federal Reserve may differentiate among companies on an individual basis or by category, taking into consideration: their capital structure; riskiness; whether the company owns an insured depository institution; nonfinancial activities and affiliations of the company; and any predominant line of business of such company, including assets under management or other activities for which particular standards may not be appropriate. These additional considerations suggest that the capital standards for nonbank SIFIs will not necessarily be the same as the capital standards that apply to large bank holding companies. In adopting its final rule regarding the Collins Amendment (discussed above), the U.S. banking regulators noted, but did not respond to, concerns expressed by insurance companies that are depository institution holding companies that, in light of differences in the assets, liabilities and business lines, it did not make sense to apply bank holding company capital standards to them. However, the Federal Reserve may make a greater attempt to reflect such differences in establishing capital standards for nonbank SIFIs, at least for those that do not control insured depository institutions.

Section 165 also requires the Federal Reserve, in coordination with the appropriate primary financial regulatory agencies and the Federal Insurance Office, to conduct annual stress tests of SIFIs. These stress tests will determine whether SIFIs have the capital, on a total consolidated basis, they would need to absorb losses as a result of adverse economic conditions.

Section 165 does not include a date by which such prudential standards or stress tests must be implemented and the Federal Reserve has not yet proposed any rules pursuant to Section 165. In part, this probably reflects the fact that no nonbank SIFIs have been designated and the FSOC has not even provided guidance (beyond repeating the wide ranging criteria included in the statute) as to how they will be selected. However, in the wake of the financial crisis, the Federal Reserve has already begun to revamp its approach to capital regulation and has acknowledged that the guidance and proposed rules it has issued as part of that overhaul (discussed below), while not specifically directed to SIFIs, reflect principles that will ultimately be reflected in the Federal Reserve's capital regulations for SIFIs.

In part, the delay in adopting capital standards for SIFIs probably also reflects a preference that such standards be preceded by heightened capital standards under Basel III (discussed below), so that U.S. SIFIs are not placed at a competitive disadvantage. The Federal Reserve is a leading participant in the Basel process, and while its role in the process is not transparent, much of Basel III addresses concerns that have been voiced by the Federal Reserve and the FDIC.

<u>Capital Planning</u>

As viewed by Federal Reserve Board Governor Daniel K. Tarullo, the Federal Reserve's point-person on regulatory matters outside of the consumer area, the central problem for large bank holding companies at the height of the crisis in the fall of 2008 was that the market was not confident that the large bank holding companies held sufficient capital to withstand losses that they had incurred and might incur in the future as the crisis continued. The Federal Reserve perceived this as not merely a problem of adding additional capital, which the TARP program had already done, but a matter of finding a way to assure the markets that the regulators had determined that the capital levels of the largest banking organizations were sufficient to meet both current conditions and more adverse conditions, should they develop.

This was the rationale for the Supervisory Capital Assessment Program (the "SCAP"), which was adopted in February 2009. The SCAP assessment was conducted on an interagency basis for banking organizations with $100 billion or more in assets, a total of 19 banking organizations. The participating banks were required to forecast their capital needs under two scenarios: a baseline scenario which reflected the consensus of economic forecasters as to the likely macroeconomic conditions over the ensuing two years, and a "more adverse" scenario designed by the regulators to reflect an unlikely but possible (roughly a 15% chance) scenario in which the recession turned out to be deeper and longer than under the baseline scenario. The firms were required to submit detailed projections regarding specific asset classes, revenues and reserves. Supervisory teams, organized by specific asset classes, evaluated the initial submissions and in some cases requested additional data. The supervisors also evaluated the submissions against independent benchmarks they developed based on firm-specific portfolio characteristics. The evaluations drew on the expertise of more than 150 senior supervisors, on-site examiners, analysts and economists from the agencies.

In keeping with the Federal Reserve's view that the exercise was about reassuring the markets, while the assessment was under way the regulators issued a detailed description of the two scenarios and the methodology of the assessment. The description emphasized the macroprudential character of the stress tests. The tests required each of the 19 bank holding companies to apply a common set of macroeconomic scenarios and a common forward-looking conceptual framework, and to provide detailed information and projections relating to all of its major asset groups and revenue sources, which enabled the regulators to apply a consistent and systematic approach across the group to evaluate the projected loss and resource estimates submitted by the firms.[2]

When the SCAP was completed in May 2009, the Federal Reserve published a detailed description of the results. The results provided information regarding each of the 19 firms and indicated expected losses for eight categories of assets, and if and how much additional capital was needed in order to have a sufficient buffer in the event of the more adverse scenario. The Federal Reserve's decision to publish detailed information regarding the results was based on a belief that only through such disclosure would the Federal Reserve be able to restore confidence in the bank holding companies that were included in the SCAP.[3] The regulators then required that the $185 billion in common equity that the SCAP indicated needed to be added in aggregate by the banks in order to provide a sufficient capital buffer be raised by November 2009.

The SCAP covered the 2009-2010 period. When the SCAP was completed, the Federal Reserve stated that the SCAP buffer did not represent a new capital standard and that the largest bank holding companies would not be expected to maintain the buffer on an ongoing basis. However, at the end of 2010, many large bank holding companies had recovered from the financial crisis and wanted to resume paying dividends. In response, on November 17, 2010, the Federal Reserve issued guidelines for a Comprehensive Capital Analysis and Review ("CCAR"), which was modeled on the SCAP. The 19 largest bank holding companies were required to submit comprehensive capital plans and additional supervisory information in January 2011. As in the SCAP, the capital plans were to cover a nine-quarter period and consider capital needs in both an expected and a more adverse set of macroeconomic conditions.

Prior to the financial crisis, most bank holding companies were considered "well capitalized" if their current capital ratios met or exceeded the "well capitalized" level and were permitted to pay dividends and repurchase stock without regulatory approval. Although in the context of

2 Board of Governors of the Federal Reserve System, "The Supervisory Capital Assessment Program: Design and Implementation" (Apr. 24, 2009).

3 Board of Governors of the Federal Reserve System, "The Supervisory Capital Assessment Program: Overview of Results," at 1 (May 7, 2009).

an acquisition a bank holding company might be asked about its capital plans going forward, there was no systematic process for requiring capital planning and for evaluating capital needs and resources of large banking organizations. The following explanation by the Federal Reserve of the CCAR provides, in a nutshell, an apt description of how its approach to capital regulation changed as a result of the financial crisis.

> The CCAR builds on lessons learned during the financial crisis about the importance of taking a forward-looking and comprehensive approach to assessing capital adequacy, including an assessment of the level and composition of a banking organization's capital resources under stressed economic and financial market conditions. As such, the CCAR significantly expands upon more traditional approaches to assessing capital adequacy. The CCAR's forward-looking evaluation encompasses both quantitative analysis and qualitative reviews of large bank holding companies' processes for assessing, and strategies for managing, their capital resources, rather than focusing on static comparisons of current capital amounts relative to regulatory minimum requirements, . . . In addition, while traditional approaches have tended to evaluate individual capital actions in isolation at a fixed point in time, the CCAR takes a longer-run, comprehensive view of a firm's strategy and management of its capital resources over a two-year period. Finally, the CCAR expands upon traditional practice by undertaking this assessment of the largest U.S. bank holding companies at the same time, thus allowing the process to be informed by a horizontal perspective of the financial condition of, and outlook for, these firms.[4]

The CCAR institutionalizes the process that began with the SCAP exercise. The Federal Reserve now intends to require large bank holding companies to submit annual capital plans to the Federal Reserve that describe their strategies for managing their capital over a 24-month, forward planning horizon. Although the CCAR was not specifically designed to address the requirements of Dodd-Frank, Section 165(i) of Dodd-Frank requires the Federal Reserve to submit large bank holding companies and nonbank SIFIs to stress tests to determine whether they have sufficient capital to absorb losses as a result of adverse economic conditions. Pursuant to that section, SIFIs will also be required to update their "living wills" based on the stress test results and the Federal Reserve must publish a summary of the stress test results.

On June 10, 2011, the Federal Reserve issued a proposal to "institutionalize" and expand the CCAR from U.S. top-tier bank holding companies with $100 billion or more in assets to those with $50 billion or more in assets. The proposal would require such bank holding companies to annually submit capital plans covering a nine-quarter forward-looking planning period and to provide prior notice to the Federal Reserve under certain circumstances before making a capital distribution. The capital plans are required to include: a discussion of how the bank holding company will, under stressful conditions, maintain capital commensurate with its risks and maintain ready access to funding; sources and uses of capital over the planning period; financial projections under expected conditions and a range of stressed scenarios; a description of all

4 Board of Governors of the Federal Reserve System, "Comprehensive Capital Analysis and Review: Objectives and Overview," at 2-3 (Mar. 18, 2011).

planned capital actions; a description of the principles and guidance used for capital planning, capital issuance, usage and distributions, including internal capital goals; and the internal governance procedures relating to capital policy. Bank holding companies are also required to calculate their pro forma ratio of Tier 1 common equity to total risk weighted assets under expected and stressful conditions and discuss in their capital plans how they would maintain a ratio of 5% under those conditions through the planning horizon. "For purposes of this requirement, Tier 1 common equity is Tier 1 capital less non-common elements in Tier 1 capital, including perpetual preferred stock and related surplus, minority interest in subsidiaries, trust preferred securities and mandatory convertible preferred securities."[5]

Under the proposal, bank holding companies would be required to submit their capital plans by January 5 of each year and would be informed by the Federal Reserve on or before March 15 as to whether the Federal Reserve has any objection to the capital plan. Prior notice by a bank holding company to the responsible Federal Reserve Bank of a distribution would be required if: (i) the distribution would result in the bank holding company not satisfying the 5% Tier 1 common ratio; (ii) the Federal Reserve has previously notified the bank holding company that it has determined that such a distribution likely would result in a material adverse change to the bank holding company's capital or liquidity structure; or (iii) the dollar amount exceeds what is in the capital plan. A bank holding company is supposed to get a response to such a prior notice within 15 days, which may be extended to 30 days if the notice is referred by the Reserve Bank to the Federal Reserve Board.

Stress Testing

As discussed above, Section 165(i) of Dodd-Frank requires the Federal Reserve, working with other relevant regulators, to adopt stress tests for bank and nonbank SIFIs. The capital plan requirement for bank SIFIs discussed above is broader than what is required by Section 165(i) in that it requires much more than stress testing, and narrower in that it does not address nonbank SIFIs. On June 9, 2011, the Federal Reserve, the FDIC and the OCC issued proposed guidance on stress testing for banking organizations with more than $10 billion in assets. This guidance includes banking organizations that are below the $50 billion SIFI threshold, and is not specifically related to the stress testing mandate in Dodd-Frank, which the regulators stated would be the subject of a future rulemaking. The purpose of the guidance "is to outline broad principles for a satisfactory stress testing framework and describe the manner in which stress testing should be employed as an integral component of risk management that is applicable at various levels of aggregation within a banking organization, as well as for contributing to capital and liquidity planning."[6]

SIFI Surcharge

As discussed above, the Federal Reserve is required to adopt capital standards for SIFIs that are more stringent than those that apply to firms that are not considered systemically important. This requirement has led to discussion of whether SIFIs should be subject to a capital surcharge.

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[5] Federal Reserve System, "Capital Plans," 76 Fed. Reg. 35351, at 35354 (June 17, 2011) (proposed rule).

[6] Office of the Comptroller of the Currency, Federal Reserve System, FDIC, "Proposed Guidance on Stress Testing for Banking Organizations with more than $10 Billion in Total Consolidated Assets," 76 Fed. Reg. 35072, at 35073-35074 (June 15, 2011) (proposed joint guidance).

Federal Reserve Board Governor Tarullo, in a June 3, 2011 speech, described the current state of thinking at the Federal Reserve regarding the SIFI surcharge.

In Tarullo's view, the rationale for a SIFI surcharge relates to the rationale for designating SIFIs in the first place, which is that the failure of a SIFI imposes costs not only on the SIFI and its stakeholders, but on the financial system (i) by making it more likely that the SIFI's counterparties will fail (the domino effect) and (ii) "because losses in a tail event are much more likely to be correlated for firms deeply engaged in trading, structured products, and other capital market instruments, all such firms are vulnerable to accelerating losses as troubled firms sell their assets into a declining market."[7] Because a SIFI has no incentive to carry enough capital to reduce the probability of such systemic losses, the function of a SIFI surcharge is to fill that void. Tarullo outlined what he regarded as five desirable characteristics of such a SIFI capital charge: (i) the charge should be based on the impact of a firm's failure on the financial system as a whole; (ii) it should be transparent; (iii) it should increase in stringency with the systemic footprint of the firm; (iv) it should be met with common equity; and (v) the U.S. standard should be congruent, to the extent possible, with international standards.

With regard to the first desirable characteristic of a SIFI surcharge, Tarullo acknowledged that there is no established method of calibrating a surcharge based on the systemic cost of a failure. He discussed several approaches, but indicated that the "expected impact" approach was receiving the most attention at the Federal Reserve. That approach is an attempt to relate the systemic impact of a SIFI failure to the amount of capital needed to avoid such a failure.

> For example, if the loss to the financial system from the failure of a SIFI would be five times that resulting from failure of a non-systemic firm, then the SIFI would have to hold additional capital sufficient to make the expected probability of failure one-fifth that of the non-SIFI. The enhanced capital requirement implied by this methodology can range between about 20% to more than 100% over the Basel III requirements, depending on choices made among plausible assumptions.[8]

The suggestion that the SIFI surcharge might double the Basel III capital requirements created a stir, but it does not appear that the surcharge will reach that level.

With regard to the third feature, that the charge should increase in stringency with the systemic footprint of the firm, Tarullo has repeatedly stated that there is no academic support for the view that there are efficiencies associated with financial institutions attaining the size and complexity of some of today's SIFIs. In the absence of any demonstrable benefit, and in light of the adverse effect such size and complexity can have on financial stability, Tarullo suggests that the SIFI charge should significantly increase with the size and complexity of the SIFI, and SIFIs can choose to incur that charge if they believe that there are economic benefits associated with those characteristics. This view also appears to be reflected in the Basel III SIFI surcharge that is under discussion in Basel (discussed below), which not only would increase with the size of the

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7 Remarks by Governor Daniel K. Tarullo at the Peter G. Peterson Institute for International Economics, at 3 (June 3, 2011)

8 Id. at 9-10.

SIFI, but which would impose an additional surcharge on firms that become larger than the currently largest firms.

With regard to the fourth characteristic, that the SIFI surcharge should be met with common equity, Tarullo's position also presaged that of the Basel III SIFI surcharge in rejecting the use of contingent capital instruments to satisfy the surcharge. In his June 3rd speech, Tarullo stated that "for all the attention paid to [contingent convertible capital instruments] in the last few years, it is even now not clear as a practical matter that an instrument can be developed which would be cheaper than common equity but still structured so as to convert in a timely, reliable fashion."[9]

The fifth characteristic, that the SIFI surcharge imposed in the United States should be congruent with international standards, is, of course, of keen interest to U.S. banking organizations and to Congress. Tarullo indicated in his June 3rd speech that some progress had been made on including a SIFI surcharge in Basel III and on June 25, 2011, the Group of Governors and Heads of Supervision, the oversight body of the Basel Committee, issued a press release stating that the committee had reached agreement on a consultative document regarding an additional loss absorbency cushion for global systemically important banks. The consultative document is not expected to be released until the end of July, but the committee stated that agreement had been reached on the assessment methodology, which is based on size, interconnectedness, complexity, lack of substitutability, and international activity. It also stated that the requirement would range from 1% to 2.5%, but an additional 1% surcharge would be applied if banks that are subject to the highest surcharge chose to materially increase their systemic significance. The SIFI surcharge will take effect at the same time as the Basel III capital conservation and countercyclical buffers, which will begin in 2016 and will be fully effective by January 1, 2019. The requirement will have to be satisfied with common equity, although the committee stated that it would continue to consider the possible role of contingent convertible instruments.

Countercyclical Capital Requirements

Section 616 of Dodd-Frank requires (i) that the appropriate federal banking regulators make the capital requirements of insured depository institutions, bank holding companies and savings and loan holding companies "countercyclical" so that required capital increases in times of economic expansion and decreases in times of contraction, and (ii) that holding companies be required to serve as sources of strength to their insured depository institution subsidiaries. Rules to implement this section are due by July 21, 2011. No rules have been proposed to date, but, as discussed below, Basel III includes countercyclical elements and the U.S. banking regulators have stated that they intend to propose rules to implement Basel III by the end of 2011 and finalize such rules by the end of 2012.

The Use of Credit Ratings in Capital Requirements

Section 931 of Dodd-Frank includes a Congressional finding that the inaccuracy of credit ratings on structured financial products contributed significantly to the mismanagement of risks by financial institutions and investors and Dodd-Frank includes a number of measures that are

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[9] Id. at 7.

intended to improve the regulation of the credit rating agencies. Section 939 of Dodd-Frank removed statutory references to credit ratings from the Federal Deposit Insurance Act and a number of other statutes. Section 939A requires the federal agencies to remove from their regulations any reference to or requirement to rely on credit ratings and to substitute in such regulation such standard of credit-worthiness as each respective agency shall determine is appropriate for such regulations. This task is to be completed by July 21, 2011.

In response to this requirement, on August 25, 2010, the Federal Reserve, the OCC, the FDIC and the OTS published a Joint Advance Notice of Proposed Rulemaking which describes the areas in the agencies' general risk-based capital rules, market risk rules and advanced approaches rules where the agencies rely on credit ratings and requests comments on potential alternatives to the use of such ratings.[10] Such reliance is extensive, particularly in the rules related to the sale of assets with recourse and in the standardized approach for credit risk, which was proposed by the agencies in 2008 for banking organizations that are not eligible to use the advanced approaches rules. The notice stated that the agencies are considering a variety of substitutes for credit ratings, which range from the Basel I approach of treating broad categories of exposures as entailing the same credit risk (e.g., under Basel I all corporate exposures received a 100% risk weight) to developing risk weights for exposure categories based on objective criteria established by regulators. The process of finding replacements for the use of credit ratings appears to be at a very early stage.

Contingent Capital

Dodd-Frank provides that the Federal Reserve "may" issue regulations that require SIFIs to maintain a minimum amount of contingent capital to be converted into equity in times of stress. However, such a regulation will follow the submission by the FSOC of a report to Congress regarding contingent capital and that report is not due until July 21, 2014. In any event, based on Governor Tarullo's comments, there seems to be little enthusiasm for contingent capital at the Federal Reserve.

Basel III Developments

"Basel III" is a collection of proposals issued by the Basel Committee that, in light of the lessons learned from the financial crisis that began in 2007, are intended to improve upon the Basel II Capital Accord. The proposals were reflected in consultative documents that were issued in December 2009 and finalized on December 16, 2010.

Improving the Quality of Capital

A key element of Basel III is a requirement that the predominant form of Tier 1 capital be common shares and retained earnings. All instruments included in Tier 1 must have full discretionary non-cumulative dividends and neither a maturity date nor an incentive to redeem. The December 2009 proposal stated that minority interest would not be eligible for inclusion in the common equity component of Tier 1 capital. In the final rules, however, the

[10] Comptroller of the Currency, Federal Reserve System, FDIC, Office of Thrift Supervision, "Advance Notice of Proposed Rulemaking Regarding Alternatives in the Use of Credit Ratings in the Risk-Based Capital Guidelines of the Federal Banking Agencies," 75 Fed. Reg. 52283 (Aug. 25, 2010).

Basel Committee stated that it would include minority interest in a bank subsidiary to the extent that it related to the minimum capital requirement of the bank (excess capital would be deducted in proportion to the minority interest share).

In January 2011, the Basel Committee issued further guidance on the qualification criteria for inclusion in Tier 1. The Basel Committee noted that during the financial crisis a number of distressed banks were rescued through common equity injections by governments, which meant that Tier 2 instruments and some Tier 1 instruments did not absorb losses. Going forward, debt instruments will have to be able to absorb losses through conversion to common shares or a write down at a pre-specified trigger point. "The trigger event is the earlier of: (1) a decision that a write-off, without which the firm would become non-viable, is necessary, as determined by the relevant authority; and (2) the decision to make a public sector injection of capital, or equivalent support, without which the firm would have become non-viable, as determined by the relevant authority."[11]

Innovative hybrid capital instruments with an incentive to redeem through features like step-up clauses will be phased out under Basel III as will Tier 3 capital instruments.

Goodwill and other intangibles, net of any associated deferred tax liability that would be extinguished if the goodwill becomes extinguished or impaired, will be deducted from common equity (not just Tier 1). Deferred tax assets that rely on the future profitability of the bank will be deducted from common equity. A shortfall in provisions relative to expected losses is deducted from common equity. The Basel Committee originally proposed complete deduction of mortgage servicing rights and deferred tax assets, but ultimately decided to allow them to count as capital up to a combined maximum of 15%.

A second key element of Basel III is an increase in required capital ratios. The minimum common equity risk-based ratio would be increased from 2.0% to 3.5% as of 2013, increasing to 4.5% by 2015. The "capital conversion buffer" (discussed below), would add 2.5% to the common equity ratio (0.625% for each of the three years between 2016 and 2019). Minimum Tier 1 capital would increase to 4.5% in 2013 and to 6.0% in 2015.

A third element of Basel III is an attempt to improve risk calibration. The Basel Committee stated that the failure to capture major on- and off-balance sheet risks, as well as derivative related exposures, was a key factor that amplified the crisis. In July 2009, the Basel Committee implemented changes, including a stressed value-at-risk ("VaR") capital requirement, which resulted in higher capital requirements for the trading book and complex securitization exposures, and strengthened capital requirements for counterparty credit exposures arising from derivatives, repo and securities financing activities. There is a great deal of detail in this part of Basel III. Some key features are: capital requirements for counterparty credit risk will be calculated based on inputs that reflect significant financial stress; capital charges will be imposed for mark-to-market losses associated with a deterioration in the creditworthiness of a counterparty; and the use of central counterparties will be encouraged by assigning a zero risk weight to those that meet prescribed standards. The Basel Committee is also considering higher risk weights for financial counterparties (because financial exposures are more highly correlated

11 Press Release, Bank for International Settlements, "Basel Committee issues final elements of the reforms to raise the quality of regulatory capital," at 3 (Jan. 13, 2011).

than nonfinancial exposures). The Basel Committee is also conducting a fundamental review of the use of credit ratings in Basel III.

A fourth element of Basel III is the supplementation of the risk-based capital requirement with a minimum leverage ratio. The new leverage ratio will be based on Tier 1 capital. (Prior to September 2010, the Basel Committee was strongly inclined to base it on common equity.) The ratio will be based on balance sheet assets, as determined for accounting purposes, net of provisions and valuation adjustments. Netting generally is not permitted. Unlike the leverage ratio that currently applies to U.S. banks and bank holding companies, which does not include off-balance sheet items, the Basel III leverage ratio will reflect potential future exposure on derivatives and commitments, direct credit substitutes, and acceptances and letters of credit. The Basel Committee agreed to test a 3% Basel III leverage ratio with the intention of implementing the leverage requirement as of January 1, 2018. (The Federal Reserve's current measure for bank holding companies is 3% for the strongest bank holding companies and 4% for most other bank holding companies; however, it does not include off-balance sheet liabilities in its denominator.)

Basel III includes a number of countercyclical measures, including the use of long-term data horizons to estimate probabilities of default, the introduction of forward-looking provisioning, and a capital conservation buffer of 2.5% (common equity). Banking organizations would be permitted to draw down on the capital conservation buffer in an adverse environment, but would be restricted in paying distributions if they have depleted their capital buffer. The purpose of this buffer is to address the tendency for banks to continue to pay dividends in a financial crisis to avoid being perceived as weak. Basel III also contemplates countercyclical capital buffers, with a range of 0% to 2.5% of Tier 1 capital. This buffer would be in place during times of excess credit growth.

Finally, Basel III includes both short-term and longer-term liquidity ratios that must be maintained. The minimum 30-day liquidity coverage ratio will require a specified amount of high quality liquid assets that can be used to offset the net cash outflows that would occur under an acute short-term stress scenario specified by the regulators. The proposal limits "high quality liquid assets" to cash and high-quality governmental obligations. Banking organizations have objected to this definition, in which zero credit is given to other types of quality assets, as too severe and the Basel Committee is considering the inclusion of high quality corporate debt, subject to haircuts.

The longer-term liquidity ratio will require a minimum amount of funding that is expected to be stable over a one-year time horizon based on liquidity risk factors assigned to assets and off-balance sheet liquidity exposures. "Stable funding" for this purpose includes equity, long-term liabilities and the portion of other funding that would be expected to stay with the institution in the event of an idiosyncratic stress event. The short-term liquidity requirement will be introduced in 2015 and the net stable funding ratio in 2018.

Both U.S. banking organizations and members of Congress have expressed considerable concern that U.S. capital requirements will place U.S. banking organizations at a competitive disadvantage relative to non-U.S. banking organizations. The House Committee on Financial Services invited the federal regulators to testify on this topic in a hearing on June 16, 2011. In his testimony, Governor Tarullo highlighted a problem with the Basel process that goes beyond the establishment of uniform, or at least very similar, capital rules that apply internationally.

> Despite extensive sharing of information on supervisory practices, the Basel Committee has, over the years, found it difficult to achieve . . . rigorous and consistent application of those rules by supervisors and firms across countries . . . An international process for monitoring implementation on a bank-by-bank basis has become increasingly necessary as capital standards have relied to a greater extent on internal market-risk or credit-risk models, the parameters and operation of which are not transparent. .... Indeed, with regard to capital for trading activities . . . U.S. trading banks appear to hold multiples of the capital non-U.S. trading banks hold per unit of VaR.[12]

Conclusion

Apart from the final regulations issued to implement a portion of the Collins Amendment, the federal banking regulators have not even proposed regulations to implement Dodd-Frank's mandates relating to capital. For example, no regulations have been proposed to address SIFI capital standards or countercyclical capital requirements. However, the Federal Reserve has made progress in these areas in the sense that, partly because of its efforts, the Basel Committee has issued final Basel III rules that address countercyclical capital buffers and has reached agreement on a capital surcharge for global systemically important financial institutions. The Federal Reserve has stated that it intends to propose regulations to implement Basel III in 2011 and that it expects such rules to become effective in 2012.

In addition, without specifically relying on Dodd-Frank, the Federal Reserve has begun to implement an approach to capital regulation that is fundamentally different from the approach it took prior to the financial crisis. Instead of merely requiring that bank holding companies satisfy specified capital ratios and allowing them full discretion on distributions and share repurchases as long as they do so, the Federal Reserve is now requiring the largest bank holding companies to submit capital plans that cover a nine-quarter period, that provide detailed financial projections under a variety of stress scenarios, and that describe in detail the bank holding company's capital planning process. Bank holding companies will need Federal Reserve approval to pay distributions or engage in share repurchases that deviate from the approved capital plan. In this way, without actually issuing capital regulations to implement Dodd-Frank, the Federal Reserve has laid the groundwork, both domestically and internationally, for those regulations.

12 Statement of Federal Reserve Governor Daniel K. Tarullo before the Committee on Financial Services of the U.S. House of Representatives, at 8-9 (June 16, 2011).

SIMPSON THACHER

CONSUMER FINANCIAL PROTECTION BUREAU: PRINCIPLES-BASED REGULATION AND ENFORCEMENT

BY STACIE E. MCGINN AND MARK CHORAZAK[1]

Few would dispute that having a regulatory agency ensure consumer protection in financial products and services is important and necessary. The new Bureau of Consumer Financial Protection (the "CFPB" or "Bureau") is charged with ensuring that all consumers have access to markets for consumer financial products and services, and that markets for consumer financial products and services are fair, transparent and competitive.[2] Financial institutions today claim to share the same objectives. Responsible banks already seek to ensure that consumers are provided with timely and understandable information to make responsible financial decisions and are not subject to unfair, deceptive, or abusive acts and practices or discrimination. So why the controversy surrounding an agency that ensures banks do what they claim to do?

Some concerns reflect general dissatisfaction with change to the status quo, but others focus on the broad statutory mandate of this agency and its potential to fundamentally change the industry. Three specific areas include:

- the broad scope of powers granted to the CFPB and its future director;
- its relationship vis-à-vis prudential regulators; and
- the role of states in enforcing federal consumer protection laws.

Legislators were sensitive to these issues at the time Dodd-Frank was drafted, and the final statute includes compromise language designed to ensure both effective consumer protection and affordable and convenient banking services and credit. Notwithstanding this compromise language, some legislators have insisted additional changes are needed to curb the powers of the CFPB and its director.[3] This article explores the roots of the controversy surrounding the new agency and the practical implications of its creation for the industry and consumers.

Broad scope of powers. Dodd-Frank grants the CFPB unprecedented power to write rules, conduct examinations and bring enforcement actions that affect all providers of consumer financial products. A federal consumer protection regime for financial services existed long before Dodd-Frank, but the powers granted to this new agency are unique:

1 The authors acknowledge the substantial contribution to this article by Randy Benjenk (summer associate).

2 The CFPB's objectives also include ensuring that "Federal consumer financial law is enforced consistently, without regard to the status of a person as a depository institution, in order to promote fair competition; and markets for consumer financial products and services operate transparently and efficiently to facilitate access and innovation." Dodd-Frank § 1021(b)(4)-(5).

3 Forty-four Republican senators recently suggested they would consent to no Presidential appointee as Director, until such amendments were made. *See* Letter to President Obama (May 2, 2011), *available at* http://www.aba.com/aba/documents/blogs/doddfrank/SenateToObamaCFPBApril2011.pdf.

- Dodd-Frank effectively adopts a "principles-based" approach[4] to consumer financial protection regulation, granting the agency broad powers to choose those areas, products or practices that it will regulate, examine and enforce.

In rulemaking, for example, the CFPB is charged with writing rules, and issuing orders or guidance, "as may be necessary or appropriate to enable the Bureau to administer and carry out the purposes and objectives of the Federal consumer financial laws, and to prevent evasions thereof."[5] By contrast, under prior federal consumer protection statutes (*e.g.*, the Truth in Lending Act, Truth in Savings Act, Electronic Fund Transfer Act), Congress prescribed with greater specificity its expectations with regard to consumer protection, and agencies were charged with ensuring the industry complied with these more prescriptive congressional expectations.

This broad power grant is tempered somewhat by requirements that the Bureau consider in its rulemaking,

> both the potential benefits and costs to consumers and [financial service providers], including the potential reduction of access by consumers to consumer financial products or services resulting from [the] rule; and the impact of proposed rules on [financial service providers].[6]

In addition, the CFPB is required by Dodd-Frank to conduct periodic self-assessments of the quality of its rulemakings and to publish a report of the assessment within five years of the effective date of the rule.[7] While these additional criteria, the self-assessments and other required Congressional reporting[8] may prove important in ensuring the CFPB is balanced in its

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4 One argument in favor of a principles-based approach to supervision and regulation, as opposed to a static, rules-based approach, is that it allows agencies to more easily stay abreast of changes in industry products and practices. *See* Richard M. Kovacevich, James Dimon, Thomas A. James, and Thomas A. Renyi, *The Blueprint for U.S. Financial Competitiveness*, THE FINANCIAL SERVICES ROUNDTABLE 45 (2007), http://www.fsround.org/cec/pdfs/FINALCompetitivenessReport.pdf.

5 Dodd-Frank § 1022(b)(1). In addition to this general grant of power, Dodd-Frank transfers to the CFPB rule-writing, supervision and enforcement powers with regard to nearly all existing federal consumer protection statutes, such as the Equal Credit Opportunity Act, the Fair Debt Collection Practices Act, the Truth in Lending Act and Truth in Savings Act, among others (the "Enumerated Consumer Laws"). *See id.* § 1061. The CFPB has identified regulations issued under these statutes for which it assumed responsibility as of the transfer date, July 21, 2011. *See* Identification of Enforceable Rules and Orders, 76 Fed. Reg. 31222 (May 31, 2011).

6 Dodd-Frank § 1022(b)(2)(A).

7 Dodd-Frank provides, "the Bureau shall conduct an assessment of each significant rule or order adopted by the Bureau under Federal consumer financial law. The assessment shall address, among other relevant factors, the effectiveness of the rule or order in meeting the purposes and objectives of this title and the specific goals stated by the Bureau." *Id.* § 1022(d)(1). Dodd-Frank also requires the Bureau to identify and address outdated, unnecessary, or unduly burdensome regulations in order to reduce unwarranted regulatory burdens. *Id.* § 1021(b)(3).

8 Dodd-Frank requires the CFPB to provide an annual report on complaints tracked and monitored, *id.* § 1012(b)(3)(C); an annual report to Congress on efforts to fulfill its fair lending mandate, *id.* § 1012(c)(2)(D); a semi-annual report to the House as to a number of issues (significant problems faced by consumers in shopping for or obtaining consumer financial products or services; budget; significant

rulemaking, like the grant of power itself, these additional factors are subjective determinations made by the CFPB.[9]

The most significant "principles-based" power may prove to be the agency's ability to declare acts or practices to be unfair, deceptive or abusive. The statute charges the agency with determining when a company is,

> committing or engaging in an unfair, deceptive, or abusive act or practice under Federal law in connection with any transaction with a consumer for a consumer financial product or service, or the offering of a consumer financial product or service.[10]

The statute provides some standards by which these determinations are to be made. In the case of "unfairness," for example, the CFPB must have a reasonable basis to conclude that:

- the act or practice causes or is likely to cause substantial injury to consumers which is not reasonably avoidable by consumers; and
- such substantial injury is not outweighed by countervailing benefits to consumers or to competition.

In determining whether an act or practice is unfair, the CFPB also may consider established public policies, although such public policy considerations may not serve as a primary basis for such determinations.[11]

While financial service providers have long been subject to both state and federal laws prohibiting "unfair and deceptive" practices,[12] Dodd-Frank adds a new category of "abusive" practices, which includes those acts or practices that:

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rules and orders adopted, and other significant initiatives by the Bureau; an analysis of complaints; public supervisory and enforcement actions to which the Bureau was a party; an assessment of significant actions by state attorneys general or state regulators relating to federal consumer financial law; efforts as to its fair lending mission; and an analysis of hiring and contracting diversity), id. § 1016(c).

9 With regard to the power to establish usury limits for credit, Dodd-Frank is clear. The CFPB has no such power. Id. § 1027(o).

10 Id. § 1031(a).

11 If the agency had existed, and these statutory principles had been applied earlier, could we have prevented some of the mistakes of the past mortgage crisis? The answer to that is far from clear. Some "alternative mortgage loans," for example, might have been determined to have been "likely to cause substantial injury to consumers," although that harm arguably was "reasonably avoidable" by consumers, who had options to choose less risky forms of credit. Moreover, at a time when the prices of homes in some markets made homeownership unaffordable for consumers, such alternative products offered "countervailing benefits" and were consistent with public policies at the time favoring homeownership, both of which presumably would have been weighed in favor of allowing such alternative loans.

12 Prior to Dodd-Frank, for example, the banking agencies had powers to deem practices unfair or deceptive through rulemaking or enforcement actions under the Federal Trade Commission Act. 15

- materially interfere with the ability of a consumer to understand a term or condition of a consumer financial product or service; or
- take unreasonable advantage of—
  - a lack of understanding on the part of the consumer of the material risks, costs, or conditions of the product or service;
  - the inability of the consumer to protect his or her interests in selecting or using a consumer financial product or service; or
  - the reasonable reliance by the consumer on the financial service provider to act in the interests of the consumer.[13]

This new standard has two effects. First, it requires that all consumer products and services must contain terms, and be offered and sold in a way, that can be easily understood by consumers.[14] Second, it places a greater burden on financial service providers to ensure that in designing and offering financial products or services and executing transactions, they are not taking "unreasonable advantage" of consumers. This may require financial institutions to ensure that consumers are aware of the risks, offer alternatives that allow the consumer to protect his or her interests, and be clear regarding institutions' intentions and obligations to act in the interests of consumers.

CFPB determinations regarding unfair, deceptive and abusive acts and practices are likely to be made in the context of enforcement actions brought against industry participants. The CFPB has broad powers to initiate such actions, including powers to:

- issue subpoenas and civil investigatory demands,
- hold hearings and adjudication proceedings, including cease and desist orders, and
- initiate civil actions.

U.S.C. § 57a(f). In addition, most states have consumer protection laws prohibiting unfair and deceptive advertising, acts and practices, and these state laws have frequently been used as the basis for actions brought against federal banking and nonbanking companies by state attorneys general and class action law firms.

13 Dodd-Frank § 1031(d).

14 Elizabeth Warren, Special Assistant to the Treasury Department charged with standing up the CFPB in the absence of a confirmed Director, has been a strong proponent of transparency in financial products. In 2007, she famously advocated for the creation of a Financial Product Safety Commission—an idea that inspired the CFPB—by comparing ineffective disclosures in consumer financial products to exploding toasters. *See* Elizabeth Warren, *Unsafe at Any Rate*, 8 DEMOCRACY: A JOURNAL OF IDEAS (2007), *available at* http://www.democracyjournal.org/pdf/5/Warren.pdf. In her speeches and congressional testimony in her capacity as Special Assistant, Warren has continued to emphasize the role of transparency in the consumer financial markets. *See, e.g.*, *Oversight of the Consumer Financial Protection Bureau: Hearing Before the Subcomm. on Financial Institutions and Consumer Credit of the H. Comm. On Financial Services*, 112th Cong. 48 (Mar. 16, 2011) (statement of Elizabeth Warren).

Damages paid by financial firms to settle consumer protection claims—particularly those involving claims of unfair or deceptive acts and practices—have increased substantially of late. The CFPB has been given an arsenal of additional remedies it may apply in future enforcement actions, which will have the effect of increasing overall damage awards, including:

- rescission or reformation of contracts;
- refund of moneys or return of real property;
- restitution;
- disgorgement or compensation for unjust enrichment;
- payment of damages or other monetary relief;
- public notification regarding the violation, including the costs of notification; and
- limits on the activities or functions of the person.

While the CFPB may not impose exemplary or punitive damages, it has powers, similar to powers of federal prudential regulators, to impose civil money penalties, which can be as high as $1,000,000 per day for knowing violations of the law.[15]

Role of the CFPB in relation to prudential regulators. Prior to Dodd-Frank, federal consumer protection rule-writing was largely the responsibility of the Board of Governors of the Federal Reserve System (the "Federal Reserve"), and supervision and enforcement of consumer protection was largely the responsibility of the appropriate prudential regulators.[16] Dodd-Frank significantly changed this approach: For the first time, the power to write, examine, and enforce federal consumer protection laws are concentrated in one agency.[17]

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15 Dodd-Frank § 1055(c). Dodd-Frank establishes three categories of civil money penalties, capping fines at $5,000 per day for any violation of a law, rule or final order of the Board, $25,000 for any reckless violation of a Federal consumer finance law, and $1,000,000 for any knowing violation of a Federal consumer finance law. Id.

16 Prudential regulators generally are those federal and state regulators responsible for licensing and continuing supervision of a financial entity to ensure, among other things, its continued safety and soundness. After Dodd-Frank, this includes the Office of the Comptroller of the Currency (the "OCC") for national banks and federal thrifts; the Federal Deposit Insurance Corporation (the "FDIC") and state banking departments for state-chartered banks that are not members of the Federal Reserve System and state thrifts; the Federal Reserve for bank and thrift holding companies and their nonbank subsidiaries and state-chartered member banks; and state banking departments for all state-chartered nonbanking companies.

17 One advantage of concentrating powers in one agency is that for the first time the CFPB's federal rules will apply to both bank and nonbank entities, although it remains unclear the extent to which the CFPB will focus attention on nonbanking companies, as opposed to banking companies. Dodd-Frank enumerates a specific category of firms subject to CFPB jurisdiction (generally, mortgage banking and mortgage servicing companies, private education lenders, payday lenders, and any person who is a "larger participant of a market for other consumer financial products or services"). The CFPB recently

The organizational structure of the CFPB ensures it will exercise this jurisdiction with autonomy. CFPB is run by a Director, who is appointed by the President, with advice and consent of the Senate, for a term of 5 years.[18] 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 Financial Stability Oversight Council (the "Council"). Although it is organized as a bureau within the Federal Reserve, and its budget is based upon the Federal Reserve's budget,[19] Dodd-Frank makes clear the CFPB is not controlled or otherwise influenced by the Federal Reserve or its Board.[20] Moreover, the Bureau has exclusive authority in circumstances where another federal agency has rule-writing, supervision or enforcement authority[21] over a bank or nonbank company with regard to a federal consumer financial law.[22]

Such absolute and exclusive authority on the part of the CFPB and its director have given rise to concerns that the CFPB might pursue its primary mission of consumer protection without consideration of the effects upon the safety and soundness of individual institutions, markets or the financial system as a whole.

To address these concerns, Dodd-Frank ensures prudential regulators retain some (albeit limited) influence over the power of the CFPB. With regard to rulemaking, the Bureau must consult with the appropriate prudential regulators or other Federal agencies, prior to proposing a rule and during the comment process, regarding consistency with prudential, market, or systemic objectives administered by such agencies; and if, during the consultation process, a prudential regulator provides the Bureau with a written objection to the proposed rule, the Bureau must include in the adopting release a description of the objection and the basis for the Bureau's decision.

In rare instances, regulations of the CFPB may also be overturned. On the petition of a member agency of the Council, the Council, with a two-thirds vote, may set aside a final regulation prescribed by the Bureau, or any provision thereof, if the Council decides that the regulation or provision would put the safety and soundness of the United States banking system or the

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proposed a regulation that would deem certain participants in the markets of debt collection, financial reports, consumer credit, money transmitting and check cashing, prepaid cards and debt relief as large providers subject to its supervisory jurisdiction. *See* Notice and Request for Comment, Defining Larger Participants in Certain Consumer Financial Products and Services Markets, 76 Fed. Reg. 38059 (June 29, 2011). Categories of nonbanking companies exempt from Bureau powers of rule-writing, supervision and enforcement include merchants who directly provide credit to purchase the good or service, real estate brokers or agents, modular or manufactured home retailers, lawyers, state-regulated insurance companies and auto dealers.

18 On July 18, 2011, President Obama nominated Richard Cordray to be the Director of the CFPB. Prior to his recent work at the CFPB as the Assistant Director of Enforcement, Cordray last served as the Attorney General of Ohio.

19 The Bureau is funded at up to 12% of the Board's overall budget. *See* Dodd-Frank § 1017(a)(2).

20 Dodd-Frank expressly provides that the CFPB is to be autonomous from the Board, which may not intervene in any matter or proceeding before the Director. *See id.* § 1012(c)(2)-(5).

21 The statute also provides that within six months of the transfer date, the Bureau and the Federal Trade Commission must reach agreement as to which agency has primary enforcement authority with regard to classes of nonbanking companies. *See id.* § 1024(c)(3).

22 Notably, the Bureau shares this authority with state authorities in similar circumstances, as described in greater detail below.

stability of the financial system of the United States at risk. Any such decision by the Council to overturn or stay a Bureau rule will be subject to judicial review.

Dodd-Frank also addresses potential conflicts with regard to the CFPB's supervisory powers. These are likely to arise (if at all) in the context of supervision of large banks.[23] To avoid conflicts and reduce regulatory burden, Dodd-Frank provides that the CFPB must coordinate examinations with prudential regulators.

Moreover, Dodd-Frank has procedures by which banks can challenge conflicting supervisory determinations. Specifically,

- an insured depository institution may request the agencies to coordinate and present a joint statement of coordinated supervisory action.

- The agencies must provide a joint statement, not later than 30 days after the date of receipt of the request; and if the agencies do not resolve the conflict or issue a joint statement, an insured institution may institute an appeal to a governing panel.

Role of States in Enforcing Federal Consumer Protection Laws. Perhaps the most striking change is the access and deference provided under Dodd-Frank to state enforcement agencies and regulators and the future role of these entities in consumer financial protection. In several key areas, Dodd-Frank suggests that the Bureau is to *share* its rule-writing, supervision and enforcement authority with state agencies.

In rule-writing, the Bureau must issue a notice of proposed rulemaking whenever a majority of the States has enacted a resolution in support of the establishment or modification of a consumer protection regulation by the Bureau. In addition, Dodd-Frank provides that state laws are not preempted, unless inconsistent with a Bureau rule; and a state law, order, or interpretation is not inconsistent with a Bureau rule if it gives greater protections to consumers.[24]

In supervision, state authorities now have greater rights to confidential business information regarding financial institutions, including:

- Information collected by the Bureau regarding customer complaints about an institution; and[25]

- Copies of examination and other reports of the Bureau.[26]

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[23] For depository organizations with assets over $10 billion, the CFPB has exclusive supervisory and enforcement powers, relative to other federal regulators, as to federal consumer protection laws. Banks with assets of $10 billon or less may be subject to some examination (or requested reporting) by the Bureau, but generally are subject to exclusive enforcement by their primary regulators.

[24] *See id.* § 1041(a). Existing preemption provisions found in existing consumer protection statutes, like the Truth in Lending Act, remain effective. *Id.* § 1041(b). While not the subject of this article, the extent to which Dodd-Frank affects current regulatory and judicial interpretations of preemption as applied to national banks is a matter of considerable debate.

[25] The statute provides, "the Bureau shall share consumer complaint information with . . . State agencies" for supervision and enforcement, among other purposes. *Id.* § 1013(b)(3)(D).

The CFPB also must defer to state regulators and enforcement agencies with regard to its supervision of nonbanking companies.

- In deciding whether or not to exercise supervisory jurisdiction over nonbank entities, for example, the Bureau must consider "the extent to which such institutions are subject to oversight by State authorities for consumer protection."[27]

- The Bureau also must coordinate examinations of nonbank entities with state examiners, "to minimize regulatory burden."

Finally, with regard to enforcement powers, the attorney general of any state may bring a civil action in the name of the state in state or federal district court to enforce the consumer protection provisions of Dodd-Frank or regulations of the CFPB.[28]

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In sum, Dodd-Frank vests in one federal agency—the CFPB—broad powers applicable to bank and nonbank financial service providers to write rules, conduct examinations and bring enforcement actions. The standards by which this new agency will operate are principles-based, which creates greater uncertainty as to whether particular products, services and practices are legal or not. And the potential penalties for failing to abide by these principles are quite severe.

The CFPB's mission and approach will be substantively different from prudential regulators, which will have limited (to no) influence over the new agency. States, on the other hand, will play a larger role in defining consumer financial services protection in the future.

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26 The statute provides, "Upon providing reasonable assurances of confidentiality . . . a State regulator, or any other Federal agency having jurisdiction over a covered person or service provider shall have access to any report of examination made by the Bureau with respect to such person, and to all revisions made to any such report." Id. § 1022(c)(6)(C)(i).

27 Id. § 1024(b)(2)(D).

28 Id. § 1042(a)(1). Existing preemption provisions found in existing consumer protection statutes, like the Truth in Lending Act, remain effective. Id. § 1042(a)(3). State banking regulators have similar powers to bring civil actions to enforce federal consumer protection laws with regard to persons other than national banks and federal thrifts.

THE NEW REGULATORY LANDSCAPE FOR THRIFTS AND THRIFT HOLDING COMPANIES

BY GARY RICE, STACIE E. MCGINN AND MARK CHORAZAK

Dodd-Frank ushered in important changes for thrifts and thrift holding companies by abolishing the Office of Thrift Supervision (the "OTS") and the reallocating its supervisory and regulatory responsibilities to other federal banking agencies. In the near term, thrifts and thrift holding companies face a number of challenges in meeting the heightened supervisory expectations of their new regulators. But in the long term, notwithstanding Dodd-Frank's preservation of the federal thrift charter and the Home Owners' Loan Act, it remains to be seen whether they will retain their unique characteristics vis-à-vis their bank and bank holding company counterparts.

Background

Two crises serve as bookends to the relatively short history of the OTS. Founded in 1989 in response to one crisis, the collapse of the savings and loan industry, the OTS was highly criticized for its role leading up to another crisis, the subprime mortgage meltdown and 2008 financial crisis. As the financial crisis deepened and as Congress set its sights on reform agendas, the OTS was quickly cited as part of the problem. Amidst calls for an overhaul of how Washington regulates Wall Street, the OTS found itself in the unenviable position of being the primary federal banking regulator for some of the largest financial institutions that failed during the recent crisis.

Post-crisis reports by the Treasury Department,[1] a U.S. Senate investigative subcommittee[2] and others were highly critical of the OTS's narrow regulatory focus, weak examination standards and sometimes deferential approach towards the entities that it regulated. Not surprisingly, the OTS was slated for elimination by Dodd-Frank.

The Abolishment of the OTS and Transfer of Functions

Section 312 of Dodd-Frank required the transfer of various powers and duties applicable to thrifts and thrift holding companies from the OTS to three other federal banking agencies: the Federal Reserve, the Office of the Comptroller of the Currency (the "OCC") and the Federal Deposit Insurance Corporation (the "FDIC"). The first anniversary of Dodd-Frank was the "transfer date" and, without delay, the regulatory landscape for approximately 670 federal thrifts, 61 state-chartered thrifts and their holding companies changed on July 21, 2011.

The following summary reflects the division and transfer of the various functions, powers, rights and duties previously held by the OTS to the Federal Reserve, the OCC and the FDIC, respectively:

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1 *See* Treasury Department, "Financial Regulatory Reform, A New Foundation: Rebuilding Supervision and Regulation," released June 17, 2009, at 35.

2 *See generally* "Wall Street and the Financial Crisis: Anatomy of a Financial Collapse," U.S. Senate Permanent Subcommittee on Investigations, Committee on Homeland Security and Government Affairs (Majority and Minority Staff Report), Apr. 13, 2011.

Regulator	Transferred Authority
Federal Reserve	• supervisory, examination and regulatory authority over savings and loan holding companies and nonbank subsidiaries of such entities • rulemaking authority over savings and loan holding companies • rulemaking authority for federal and state-chartered thrifts relating to affiliate transactions, insider loans and tying arrangements
OCC	• supervisory, examination and regulatory authority over federal thrifts • rulemaking authority over federal thrifts and state-chartered thrifts (other than those limited areas transferred to the Federal Reserve)
FDIC	• supervisory, examination and regulatory authority over state-chartered thrifts • no rulemaking authority

The Challenges Ahead

Since the enactment of Dodd-Frank, the OTS, the Federal Reserve, the OCC and the FDIC have been focused on matters relating to the orderly transition of functions and powers. Many of these matters have centered on tasks associated with the disposition of an agency's operations and affairs: the transfer of personnel and the continuation of pay and benefits; the transfer of property, contracts, records and leases; the sharing of confidential supervisory information; and the continuation of administrative and legal proceedings and the substitution of parties.[3] More substantively, the agencies have been focused on matters relating to, among other things, the transition of reporting requirements; the review of examiners and examination schedules; and the identification of OTS regulations that will be transferred.[4]

With regard to reporting requirements, the agencies have proposed a number of changes, including uniform reporting requirements and a common set of reports for monitoring and

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3 *See, e.g.*, Joint Implementation Plan of Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision (the "Joint Implementation Plan"), Jan. 2011 (Revised Apr. 2011).
Dodd-Frank provides for a 90-day period for the OTS to fully wind up its affairs, with a skeletal staff expected to be in place until the OTS is officially abolished on October 19, 2011.

4 *See id.*; Joint Notice Regarding List of Office of Thrift Supervision Regulations to Be Enforced by the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation Pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 Fed. Reg. 39246 (July 6, 2011).
On July 20, 2011, the OCC issued a final rule to implement various provisions applicable to the transfer of certain functions from the OTS to the OCC. The final rule also revises OCC rules in areas that are central to internal agency functions and operations immediately upon the transfer of supervisory jurisdiction for federal thrifts. These include amendments to the OCC's assessment fee rule to include federal thrifts.

evaluating financial condition and trends. Below is a listing of some of the key changes to reporting requirements applicable to thrifts and thrift holding companies:

- Thrift Reporting – As of March 31, 2012, all schedules of the Thrift Financial Report will be eliminated and thrifts will be required to file quarterly Call Reports, which are reports that commercial banks are required to file. In addition, the agencies have expressed agreement to phase-out production of the separate Uniform Thrift Performance Report.

- Holding Company Reporting – As of March 31, 2012, thrift holding companies will be required to file the same reports with the Federal Reserve that bank holding companies file. These reports are much more extensive than the reports thrift holding companies were required to file with the OTS.

- Branch Deposit Reporting – As of June 30, 2011, the OTS's Branch Office Survey will be eliminated and thrifts will be required to file deposit data through the Summary of Deposits with the FDIC.

- Cost of Funds Reporting – As of January 31, 2012, data regarding monthly medium cost of funds will no longer be collected from thrifts; instead, the last cost of funds indices will be required to be published as of December 31, 2011.

For thrift holding companies, the transition to Federal Reserve reporting is likely to be of relatively little concern. Instead, thrift holding companies face a more challenging transition on other fronts of the post-Dodd-Frank landscape, as highlighted below:

- New Regulatory Capital Requirements – The biggest change relates to capital. In contrast to bank holding companies, thrift holding companies have not been subject to regulatory capital requirements. Instead, the OTS applied a qualitative and quantitative supervisory capital assessment that was based on guidance, not statute or regulation. Effective July 21, 2011, Section 616 of Dodd-Frank authorizes the Federal Reserve to issue regulations and orders relating to capital requirements for thrift holding companies and requires such companies to serve as a source of strength for their depository institution subsidiaries. Furthermore, under the Collins Amendment of Dodd-Frank, subject to a transition period that ends in July 2015, thrift holding companies will be subject to minimum leverage and risk-based capital requirements that are not less than the generally applicable leverage and risk-based capital requirements for depository institutions.

  In preparation for the OTS's transfer of functions, as well as for Basel III, the Federal Reserve has been working with other federal banking agencies in reviewing consolidated capital requirements for all depository institutions and their holding companies. As part of this review, the Federal Reserve has expressed a desire for thrift holding companies generally to be subject to the same consolidated leverage and risk-based capital requirements. While the Federal Reserve has expressed a willingness to take into account any "unique characteristics, risks, or specific activities" of thrift holding companies, it is generally expected that the consolidated capital requirements applicable to thrift holding companies will be substantially similar to those applicable to bank holding companies.[5]

- Consolidated Supervision and Tougher Examinations – Since the enactment of Dodd-Frank, the Federal Reserve has provided notice of its intent to apply its consolidated supervision program to thrift holding companies. During the transition period leading up to the transfer of authorities, the Federal Reserve acknowledged that its consolidated supervision program "may entail more intensive supervisory activities than under current OTS practice" and that thrift holding companies could face "more rigorous review of internal control functions and consolidated liquidity, as well as the conduct of discovery reviews of specific activities."[6] The Federal Reserve also expects it will employ a heightened review of thrift holding companies' nonbank subsidiaries.[7]

  In general, thrift holding companies should expect their supervisory oversight to be aligned with the Federal Reserve's consolidated supervision program, as set forth in the Federal Reserve's Supervision and Regulation Letter SR 08-9.[8] For thrift holding companies with consolidated assets of $1 billion or less, the Federal Reserve has said that it expects to apply the supervisory program that it has in place for small shell bank holding companies, as set forth in its Supervision and Regulation Letter SR 02-1. The relevant Federal Reserve Bank will determine whether such a small savings and loan holding company is "complex" or "noncomplex" and tailor its supervision as appropriate.

  As for examinations of thrift subsidiaries, these too are expected to be tougher. The OCC has sought to minimize fears among thrifts by conducting outreach meetings across 17 cities earlier this year, and Acting Comptroller of the Currency John Walsh has written to thrifts stressing the OCC's experience in community bank supervision (according to the Joint Implementation Plan, the OCC expects the vast majority of

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5 *See* Notice of Intent to Apply Certain Supervisory Guidance to Savings and Loan Holding Companies, Board of Governors of the Federal Reserve System, 76 Fed. Reg. 22662, 22665 (Apr. 22, 2011).

6 Id. at 22663.

7 Consistent with the Federal Reserve's intent to align oversight of thrift holding companies to the supervisory program for bank holding companies, thrift holding companies should expect to eventually come under the Federal Reserve's holding company rating system.
The Federal Reserve and the OTS have employed two distinct, but similar, ratings systems for depository institution holding companies. The Federal Reserve will likely transition thrift holding companies from the OTS's "CORE" rating system (capital, organizational structure, risk management and earnings) to its "RFI/C(D)" rating system (risk management, financial condition, impact of nondepository entities on subsidiary depository institutions, composite rating of the bank holding company's managerial and financial condition and an assessment of potential future risk to subsidiary depository institutions). As part of the transition process, earlier this year the Federal Reserve invited public comment on whether any changes should be made to the RFI/C(D) rating system to accommodate the particular characteristics and activities of thrift holding companies.

8 The Federal Reserve currently organizes its supervision across delineated portfolio categories (e.g., community banking organizations, regional banking organizations and large banking organizations) based on an institution's size and complexity.

federal thrifts to fall within its Community Bank Supervision program).[9] Nevertheless, industry leaders have expressed concerns that OCC examinations will be much more rigorous than OTS examinations, particularly with regard to risk management and credit concentration limits. Even beyond examinations, thrifts should expect the OCC to make substantive changes to existing OTS regulations—changes that will likely require substantial changes in current practices.[10]

- Heightened Capital and Management Criteria for Thrift Holding Companies Engaged in Financial Activities – Thrift holding companies have generally been permitted to conduct certain activities, such as insurance and securities underwriting, to the extent such activities are permissible for bank holding companies.[11] However, their ability to engage in such activities had not been tied to meeting the "well capitalized" and "well managed" criteria under the Bank Holding Company Act. That has changed under Dodd-Frank. Effective July 21, 2011, in order to engage in financial activities, they must comply with all of the criteria applicable to a financial holding company "as if the savings and loan holding company was a bank holding company."[12] Moreover, thrift holding companies will need to conduct their financial activities on the same terms, conditions, and requirements that apply to the conduct of such activities under the Bank Holding Company Act and the Federal Reserve's related regulations and interpretations.

- Treatment of Grandfathered Unitary Thrift Holding Companies – Thrift holding companies that have only one thrift subsidiary (i.e., "unitary thrift holding companies") and that operate impermissible nonbanking businesses under grandfather authority may continue to rely on such authority.[13] However, Dodd-Frank authorizes the Federal Reserve to require a unitary thrift holding company to establish an intermediate holding company for all or a portion of its financial activities. The intermediate holding company would be treated as a thrift holding company and subject to Federal Reserve regulation and supervision. A grandfathered unitary thrift holding company that directly or indirectly controls such an intermediate holding company will be required to serve as a source of strength to its subsidiary intermediate holding company. The Federal Reserve has yet to issue a final rule regarding how it will exercise its new

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9 See Letter of John Walsh, Acting Comptroller of the Currency, to Chief Executive Officers of Federal Savings Associations, dated Sept. 24, 2010; see also Letter of Jennifer C. Kelly, Senior Deputy Comptroller of the Currency, to Chief Executive Officers of Federal Savings Associations, dated Nov. 22, 2010.

10 See 76 Fed. Reg. 39246 (July 6, 2011).

11 See 12 U.S.C. § 1467a(c)(2)(F); 12 C.F.R. § 584.2-2.

12 Dodd-Frank § 606(b); 12 U.S.C. § 1467a(c)(2). Note that Dodd-Frank also changed the criteria for becoming a financial holding company. Until recently, only a bank holding company's depository institution subsidiaries had to be "well capitalized" (under the prompt corrective action guidelines) and "well managed" for the bank holding company to qualify as a financial holding company. Effective July 21, 2011, the Federal Reserve will further require that the bank holding company itself be "well capitalized" and "well managed." See Dodd-Frank § 606(b); 12 U.S.C. § 1843(l)(1).

13 A grandfathered unitary thrift holding company is one that became a savings and loan holding company on or before May 4, 1999, or that became one pursuant to an application pending on or before that date. See 12 U.S.C. § 1467a(c)(9)(C).

authority with regard to intermediate holding companies, but has established a working group to consider, among other things, the effective supervision of unitary thrift holding companies.

The Start of a Long Goodbye

Taken together, the foregoing areas of change demonstrate that the world for thrift holding companies and their subsidiaries will be a different one going forward. Although Dodd-Frank preserves the thrift charter, many within the industry have expressed concern that it will be a remnant of a pre-Dodd-Frank era, existing in name only. Such a view certainly has weight when considering the number of steps the Federal Reserve and the OCC, in particular, are expected to take in aligning the regulation and supervision of thrift holding companies and federal thrifts to that of bank holding companies and national banks.

Furthermore, while the Home Owners' Loan Act will continue as the principal statute governing thrift holding companies, there is also the possibility that the existing body of OTS precedents and interpretations will be superseded over time by Federal Reserve interpretations. That concern is perhaps best demonstrated by the fact that most of the OTS's approximately 1,000 employees have transferred to the OCC. The remaining employees have transferred to the FDIC, but none have transferred to the Federal Reserve, which, of course, now has jurisdiction over thrift holding companies.

Prior to Dodd-Frank, the limitations of the thrift charter (principally, the requirement that it focus on the residential mortgage business) were balanced by two key benefits: (i) the ability—denied to commercial banks prior to Dodd-Frank—to branch *de novo* into other states; and (ii) very light regulation of the activities and financial condition of thrift holding companies. With these advantages almost entirely removed, the rationale for holding a thrift charter no longer seems to exist.

In short, the first anniversary of Dodd-Frank may not only signify the "transfer date" of various OTS functions, but the start of a long goodbye to what it means to be a thrift holding company. The traditional advantages associated with thrift holding company status may just be gone forever.

VOLCKER RULE DEVELOPMENTS

BY GARY RICE AND MICHAEL W. WOLITZER

Dodd-Frank added a new Section 13 to the Bank Holding Company Act of 1956, as amended (the "BHC Act"), which provides 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." This rule is popularly referred to as the "Volcker Rule." The Volcker Rule takes effect on July 21, 2012, but banking entities[1] do not need to achieve compliance until July 21, 2014, and certain investments may be retained for a longer period under the conformance rules discussed below.

The Simpson Thacher memorandum dated July 14, 2010, "The Volcker Rule Provisions in the Dodd-Frank Wall Street Reform and Consumer Protection Act" provides a detailed discussion of the statutory language. The purpose of this section is to discuss developments since the enactment of the Volcker Rule.

As required by Dodd-Frank, in January 2011 the Financial Stability Oversight Council issued a study (the "FSOC Study") of and recommendations regarding implementation of the Volcker Rule.[2] Also as required by Dodd-Frank, the Federal Reserve issued proposed and final regulations regarding the extended conformance periods that are available for some investments in private funds and hedge funds that were made or committed to prior to May 1, 2010. Those developments are discussed below. The regulators are not required to issue final regulations to implement the Volcker Rule (other than the conformance rules) until October 2011, and, as of this writing, they have not proposed any regulations.

The FSOC Study of the Volcker Rule

<u>The FSOC Study Recommendations Relating to the Ban on Proprietary Trading</u>

The Volcker Rule Ban on Proprietary Trading

The term "proprietary trading" is defined for purposes of Section 13 to mean "engaging as a principal for the trading account of the banking entity . . . in any transaction to purchase or sell . . . any security, any derivative, any contract of sale of a commodity for future delivery, . . . or any other security or financial instrument" that the regulators may determine. The term "trading account" is defined to mean "any account used for acquiring or taking positions in

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1 For purposes of the Volcker Rule, a "banking entity" is defined to include (i) an insured depository institution (which generally does not include a limited purpose trust company), (ii) any company that controls an insured depository institution (i.e., bank holding companies, savings and loan holding companies, and any company that directly or indirectly controls a nonbank bank, such as an industrial loan company or a credit card bank); (iii) any company that is treated as a bank holding company under the International Banking Act (i.e., a foreign bank that has a U.S. branch, agency or commercial lending subsidiary, and any company that directly or indirectly controls such a bank); and (iv) any "affiliate" or subsidiary" of any of these entities.

2 Financial Stability Oversight Council, "Study and Recommendations on Prohibitions on Proprietary Trading and Certain Relationships with Hedge Funds & Private Equity Funds" (January 2011).

[such] securities and instruments . . . principally for the purpose of selling in the near term (or otherwise with the intent to resell in order to profit from short-term price movements) and any other accounts" that the regulators may, under their Section 13(b)(2) regulations, determine (emphases added). Although Section 13 does not include definitions of "near term" or "short-term," it seems clear that proprietary trading should not include merchant banking investments by banking entities where the intention is to hold the investment for a year or more.

In addition, the following activities are exempt from the Volcker Rule's basic prohibition on proprietary trading by banking entities: purchases and sales of securities issued by the U.S. government and certain government-sponsored enterprises; purchases and sales of securities in connection with underwriting and market-making activities to the extent such activities are designed not to exceed the reasonably expected near term demands of clients, customers or counterparties; risk-mitigating hedging activities in connection with and related to individual or aggregated positions, contracts, or other holdings of the banking entity that are designed to reduce the specific risks to a banking entity in connection with and related to such positions, contracts, or other holdings; purchases and sales on behalf of customers; investments by insurance companies that are banking entities for the general account of the insurance company; and proprietary trading by foreign banking organizations in reliance on Section 4(c)(9) or Section 4(c)(13) of the BHC Act so long as they do not engage in such activities in the United States.

The FSOC Study Recommendations

The FSOC Study observed that certain types of permitted activities, and most notably market making, hedging, underwriting and other types of transactions on behalf of customers, "often evidence outwardly similar characteristics to proprietary trading," and these similarities may be especially pronounced in less liquid markets. For example, in highly liquid markets the characteristics of market making activities may be easily identifiable, but in other markets, such as the over-the-counter derivatives markets, "market making typically entails a customer-initiated transaction involving a bespoke financial transaction that the trading desk will then hold and hedge." Similarly, while a transaction specific hedge may be identifiable as a permitted hedging activity, elements of proprietary trading may be more difficult to detect in the case of portfolio hedging or in the case of a decision not to hedge an instrument acquired in the course of market making activities.

The approach that the FSOC Study takes to such issues is generally to recommend that the federal regulatory agencies, in writing the Volcker Rule regulations, consider a variety of factors. For example, in the case of hedging, the FSOC Study suggests that the agencies "consider factors such as the nature of the risks being hedged; the extent to which banks measure, monitor and control risks at a portfolio level; the extent to which portfolio hedging is part of an entity's formal hedging strategy; whether traders are compensated based on earnings generated by portfolio hedging activity."[3] The FSOC Study also suggests certain metrics that may be of use in distinguishing among permissible and impermissible activities, at the same time acknowledging that such metrics have their limitations. In general, the FSOC Study is useful in identifying some of the difficulties in making such distinctions and in describing a

3 FSOC Study, at 21.

process that the regulatory agencies might use to oversee the Volcker Rule prohibitions on proprietary trading. However, the work of assembling a set of rules to implement the Volcker Rule is left to the regulatory agencies.

The Prohibition on Investing in or Sponsoring Hedge or Private Equity Funds

Description of the Prohibition

The term "hedge fund or private equity fund" is defined in Section 13 to mean an issuer that would be an investment company but for the exemptions contained in Section 3(c)(1) (funds with 100 or fewer beneficial owners) or Section 3(c)(7) (funds all the holders of which are "qualified purchasers") of the Investment Company Act of 1940 (the "ICA") "or such similar funds as the appropriate Federal banking agencies, the [SEC] and the [CFTC] may determine" in the implementation of the Volcker Rule regulations that such regulators are required to issue by October 21, 2011.

As a general matter, hedge funds and private equity funds (collectively, "private funds") that are exempt from the ICA based on exemptions other than those provided by Sections 3(c)(1) and 3(c)(7) of the ICA are not subject to the restrictions of Section 13 of the BHC Act. For example, funds exempt under ICA Rule 3a-1 (issuers that primarily own stock of their subsidiaries), Section 6(b) of the ICA (employees' securities companies) and Section 3(c)(5)(C) of the ICA (funds that hold mortgages) are not covered. However, in their Volcker Rule regulations, the regulators have the authority to extend the restrictions of Section 13 to relationships of banking entities with "similar funds."

The FSOC Study Recommendations Relating to Private Funds

The FSOC Study had much less to say about the prohibition on investment in private funds than it did on the proprietary trading ban. The FSOC Study states that by defining private funds in terms of Section 3(c)(1) and 3(c)(7) of the ICA, the Volcker Rule may have included some types of funds that the purposes of the rule suggest should not have been covered (suggesting that the agencies in particular consider whether venture capital funds should be exempt) and not included others (such as commodity funds) that it might be appropriate to include. In this regard, the FSOC Study suggests that the federal regulatory agencies consider, in writing their Volcker Rule regulations, whether the fund earns an allocation for both realized and unrealized gains; the nature of the fund's trading/investment strategy; the use of leverage; and whether the fund has a broad investor base.[4]

With regard to the exemption in the Volcker Rule that allows banking entities to establish private funds that are offered only to customers of the banking entity's bona fide trust, fiduciary, or investment advisory services, the FSOC Study suggests that the agencies consider whether the customer relationship preceding organization of the fund is extensive, direct and initiated by the customer. The FSOC Study also suggests that the agencies consider whether employee interests in such a fund should be counted toward the 3% limit on banking entity investments in such funds.

[4] FSOC Study, at 62-63.

As in the case of its recommendations relating to the ban on proprietary trading, the FSOC Study is more useful in pointing out some of the issues that will need to be addressed by the federal banking agencies in writing their Volcker Rule regulations, than in making detailed recommendations as to how such issues should be resolved.

The Federal Reserve Rules Relating to the Conformance Period and Extensions Thereof

On February 14, 2011, the Federal Reserve published final rules regarding the time that banking entities (and certain nonbank entities that are subject to the Volcker Rule) will have to conform their activities to the Volcker Rule.[5] The conformance rules address only the transition process, and not other substantive Volcker Rule questions that will be the subject of an interagency rulemaking process that is required to be completed by October 21, 2011. The conformance rules do not, for example, expand on or clarify the statutory definitions of certain terms, such as "banking entity," "hedge fund" and "private equity fund" (or "such similar funds" that may be subsumed by these terms), or "sponsor." They do not clarify the exemption for investments held by non-U.S. banking entities in private funds that are not offered and sold in the United States. They do not set forth the additional capital requirements and other restrictions the regulators are authorized by the Volcker Rule to impose with respect to proprietary trading and private funds activities permitted by the Rule, if the regulators determine that such measures are necessary to protect the safety and soundness of the banking entities engaged in those activities. And the conformance rules do not implement any of the affiliate transaction restrictions on relationships with private funds.

<u>The General Conformance Period for Banking Entities: A Two-Year Minimum</u>

As a way of allowing the markets and firms to adjust to the Volcker Rule, a general two-year conformance period is provided by statute under Dodd-Frank, which will run until July 21, 2014. During this time, banking entities may continue to engage in proprietary trading or private fund activities, but they will have to conform such positions or activities to the Volcker Rule by July 21, 2014, absent an extension.[6]

<u>Potential Extensions to the General Conformance Period</u>

Potential for Up to Three One-Year Extensions to the Conformance Period

Once the general conformance period has expired, the Federal Reserve may, by rule or order, extend it by up to three additional one-year periods, one year at a time, if, in the Federal Reserve's judgment, each such one-year extension is consistent with the Volcker Rule and not detrimental to the public interest. The process for seeking a one-year extension and the factors

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[5] Federal Reserve System, "Conformance Period for Entities Engaged in Prohibited Proprietary Trading or Private Equity Fund or Hedge Fund Activities," 76 Fed. Reg. 8265 (Feb. 14, 2011).

[6] For a company that was not a banking entity (or a subsidiary or affiliate of a banking entity) at the time Dodd-Frank was enacted but becomes a banking entity (or a subsidiary or affiliate of such banking entity) thereafter, then the conformance period would commence on the later of (i) the date the Volcker Rule's prohibitions would otherwise become effective to banking entities that were in existence at the time Dodd-Frank was enacted or (ii) two years after the date on which such company first becomes a banking entity (or a subsidiary or affiliate of such banking entity).

relevant to a determination by the Federal Reserve are discussed in "The Extension Process and Factors Relevant to the Federal Reserve" below. The extensions, if granted, apply to "any activities, investments and relationships that may be prohibited or restricted by the Volcker Rule."[7]

A Potential Five-Year Extension for "Illiquid Funds"

The Volcker Rule also provides for a single extension, which may be as long as five years, with respect to an investment in an "illiquid fund" for which the acquisition or retention of an interest in the fund, or the provision of additional capital to the fund, is "necessary to fulfill a contractual obligation of the banking entity that was in effect on May 1, 2010." The conformance rules define what constitutes an illiquid fund under the Volcker Rule and clarify that the illiquid fund extension is in addition to, and not in lieu of, the three separate one-year extensions, something that is not entirely clear from the statutory language. Thus, a banking entity could have up to eight years after the commencement of the conformance period (i.e., until July 21, 2022) to conform qualifying illiquid fund investments.

The Volcker Rule prohibits both investments in and sponsorship of private funds. The Volcker Rule by its literal terms only provides the Federal Reserve with the authority to extend the period that a banking entity may make or retain an investment in an illiquid fund and does not address whether such an extension also applies to sponsorship of private funds. However, in issuing the conformance rules the Federal Reserve stated that if a banking entity has both invested in and sponsored a fund and receives an extension to hold the investment, it also may continue as a sponsor "to the extent such service is related to the banking entity's retention of its permitted ownership interest."[8]

The process for seeking the five-year extension and the factors relevant to a determination by the Federal Reserve to grant such extensions are discussed in "The Extension Process and Factors Relevant to the Federal Reserve" below.

(i) The "Illiquid Fund" Definition

The five-year extension applies to investments in illiquid funds. Under the Volcker Rule, an "illiquid fund" means a private fund that, as of May 1, 2010, (i) was principally invested in illiquid assets or was invested in, and contractually committed to principally invest in, illiquid assets; and (ii) makes all investments pursuant to, and consistent with, an investment strategy to principally invest in illiquid assets. The conformance rules include a two-prong approach to defining an illiquid fund: the fund must invest in illiquid assets and the investment in the fund must itself be illiquid.

(ii) The Nature, Assets and Investment Strategy of the Fund

The first set of criteria focuses on the nature, assets and investment strategy of a private fund. For a fund to qualify as an illiquid fund it must, among other things, be invested in or be contractually committed to be invested in and have an investment strategy centered on "illiquid

[7] 76 Fed. Reg. at 8267.
[8] 76 Fed. Reg. at 8272.

assets." The Federal Reserve's conformance rules define illiquid assets essentially by reference to what they are not. In so doing, the rules contain a definition of "liquid assets," with a list that includes the following:

- Cash and cash equivalents;
- Assets that are traded on a recognized, established exchange, trading facility or other market on which there exist independent, *bona fide* offers to buy and sell;
- Assets for which there are *bona fide*, competitive bid and offer quotations in recognized inter-dealer quotation systems or similar systems;
- Assets with prices that are quoted routinely in widely disseminated publications that are readily available to the general public or through an electronic service that provides indicative data from real-time financial networks;
- Assets with initial terms of one year or less and that can be monetized or converted at maturity into liquid assets; and
- Other assets that the Federal Reserve may determine are liquid assets.

The conformance rules provide some guidance on what is meant by these various categories of liquid assets. The Federal Reserve makes clear that the intent is to include as illiquid assets investments in portfolio companies, investments in real estate (other than those made through publicly traded REITs), venture capital investments and investments in other private funds that are not publicly traded and invest in illiquid assets. The fact that some form of secondary trading exists with respect to such assets is insufficient, standing alone, for them to be treated as liquid assets. On the other hand, an asset is not considered illiquid merely because the size of an investor's position in the asset or adverse market conditions make it a difficult asset to sell.

The conformance rules also clarify that an asset (such as restricted stock) is not liquid merely because it is part of a class that is liquid, if the particular asset held by the fund is illiquid due to legal restrictions on its sale. And the fact that the restrictions may be in place for a limited period of time does not cause the asset to be considered liquid, but the future expiration of the restrictions will be considered when the Federal Reserve reviews an extension request.

The Volcker Rule also requires that the private fund either (i) have been "principally invested" in illiquid assets as of May 1, 2010, or (ii) have been invested to some degree in illiquid assets and "contractually committed to principally invest" in illiquid fund as of such date. To be considered "principally invested" in illiquid assets, the conformance rules provide that at least 75% of the private fund's consolidated total assets (as reflected in the fund's financial statements prepared in accordance with applicable accounting standards) must be either illiquid assets or risk-mitigating hedges entered into in connection with and related to individual or aggregated positions in, or holdings of, illiquid assets. In explaining this aspect of the fund-related criteria, the Federal Reserve stated that "Congress appears to have intended the extended transition period to be available to those types of funds that principally focus and direct their capital towards investments in illiquid assets." As examples, the Federal Reserve cites certain types of funds, such as real estate or start-up companies (*e.g.*, technology, life sciences, alternative energy or "clean tech") that focus "almost exclusively on one type of illiquid assets."[9]

To be considered "contractually committed to principally invest" in illiquid assets as of May 1, 2010, a private fund's organizational documents (limited partnership agreements, etc.), other documents (side letter agreements, etc.), or written representations contained in the offering documents must obligate the fund to be principally invested in illiquid assets during the period beginning on the date when capital contributions are first received by the fund for the purpose of making investments (other than limited temporary periods such as when the fund is liquidating investments) and ending on the fund's expected termination date. The Federal Reserve's explanation of this aspect of the fund-related criteria expressly provides that any such contractual commitment must have been in effect as of May 1, 2010. The contractual commitment in question is not that of the investor to the fund, but of the fund's commitment to make investments principally in illiquid assets.

Finally, the rules explain what is meant by a private fund having an "investment strategy to principally invest" in illiquid assets. Such a strategy is evidenced by either the fund (i) marketing or holding itself out to investors as "intending to principally invest" in illiquid assets, or (ii) having "a documented investment policy" of principally investing in illiquid assets. In its release, the Federal Reserve advises banking entities to consider whether a fund's organizational and contractual documents, marketing materials or investment policy provide for the fund to principally invest in illiquid assets by examining "whether the assets to be acquired by the fund (as specified in such materials) are of the type and nature that would make the assets 'illiquid assets' or 'liquid assets' for purposes of the rule."[10]

(iii) The Terms of the Banking Entity's Investment

The second set of criteria used in determining whether an illiquid fund extension period is applicable focuses on the terms of the banking entity's investment in a private fund. Specifically, the acquisition or retention of an interest in a fund, as well as the injection of additional capital into the fund, by a banking entity must be necessary to fulfill a "contractual obligation" that the banking entity had on May 1, 2010.

It is important to note that the authority to retain an investment in an illiquid fund automatically terminates on any date—which may occur in the middle of a five-year extension—on which the banking entity is no longer contractually obligated to retain the investment.

Under the conformance rules, a banking entity will be considered to have a contractual obligation to retain or make an equity, partnership or other ownership interest in an illiquid fund if it would be prohibited under the terms of its equity, partnership or other ownership interest in the fund or under other contractual arrangements with the fund from redeeming all of its interest in the fund and selling or otherwise transferring its ownership interests to an unaffiliated person. Furthermore, a banking entity will be considered to have a contractual obligation to make additional investments in an illiquid fund if it is required to do so under the

9 76 Fed. Reg. at 8270.
10 76 Fed. Reg. at 8271.

terms of its equity, partnership or other ownership interest in the fund or under any other contractual arrangements with the fund.

An important qualification to a finding that a banking entity had a contractual obligation to make or retain an investment is (i) that the banking entity (including its subsidiaries and affiliates, as applicable) be unable to effect a unilateral termination of the obligation pursuant to the terms of its agreement with the fund; and (ii) if it may terminate the obligation with the consent of another party or parties, it must have used its reasonable best efforts to obtain such consent and such consent has been denied. With regard to (ii), we note that, under the terms of many illiquid fund documents, an investor does not have a right to redeem or transfer its interest, but that the general partner of the fund will often accommodate such requests. If, under the terms of a fund document, a banking entity may terminate its obligations to the fund if its investment would be impermissible under banking laws or regulations (including the Volcker Rule), then the banking entity is obligated to exercise such right. The Federal Reserve declined to provide a grace period in such cases, reasoning that a banking entity has until July 21, 2014 to exercise such a right. This suggests that banking entities will need to withdraw from most hedge funds, whether or not the underlying assets are liquid, because most hedge funds offer the right of periodic withdrawals.

The Extension Process and Factors Relevant to the Federal Reserve

Whether seeking a one-year extension or the five-year illiquid fund extension, a banking entity must submit a written request to the Federal Reserve at least 180 days prior to the expiration of the applicable time period; provide the reasons why it believes the extension should be granted; and offer a detailed explanation of its plan for divesting or conforming the activity or investment.

The conformance rules provide a litany of factors that a banking entity must address, to the extent they are relevant to the facts underlying the particular activity or investment. The factors to be addressed by a banking entity seeking an extension, and by the Federal Reserve in acting on such a request, include the following:

- Whether the activity or investment (a) involves or results in material conflicts of interest between the banking entity and its clients, customers or counterparties; (b) would result, directly or indirectly, in a material exposure by the banking entity to high-risk assets or high-risk trading strategies; (c) would pose a threat to the safety and soundness of the banking entity; or (d) would pose a threat to the financial stability of the United States;
- Market conditions;
- Nature of the activity or investment;
- Contractual terms governing the banking entity's interest in the fund;
- Degree of control held by the banking entity over investment decisions of the fund;
- Types of assets held by the fund;

- Expected date for the fund's winding up of its activities and liquidation, or when its investments may be redeemed or sold;

- Total exposure of the banking entity to the activity or investment and the risks that disposing of, or maintaining, the investment or activity may pose for the banking entity or for U.S. financial stability;

- Cost to the banking entity of disposing the activity or investment within the applicable period;

- Whether conformance would result in a material conflict of interest between the banking entity and unaffiliated parties to which it owes a duty (something which is expected to be relevant when the banking entity is the general partner or sponsor of a fund, but not when it is merely the investment advisor); and

- Other factors that the Federal Reserve believes to be appropriate.

If a banking entity is primarily supervised by another federal banking agency or by the SEC or CFTC, the Federal Reserve will consult with such agency prior to any approval of an extension request.

Under the conformance rules, the Federal Reserve has the authority to impose conditions on any extension approval if such conditions are necessary or appropriate to protect the safety and soundness of the banking entity or U.S. financial stability, in response to material conflicts of interest or other unsound banking practices or otherwise further the purposes of the Volcker Rule and related transition rules.

The Conformance Period for Nonbank Financial Companies Supervised by the Federal Reserve

Under Dodd-Frank, the Federal Reserve is given supervisory authority over certain nonbank financial companies that are determined by the Financial Stability Oversight Council to be systemically important. Although such companies are not banking entities for purposes of the Volcker Rule, they will nevertheless be subject to quantitative limitations, capital charges or other restrictions in order to address certain risks that their proprietary trading activities or fund relationships pose. The proposed transition rules provide a two-year conformance period for such companies, with the two-year period commencing on the date a company becomes supervised by the Federal Reserve. These nonbank financial companies will also have an opportunity to apply for up to three one-year extensions.

Conclusion

Thus far, the steps to implement the Volcker Rule primarily consist of the FSOC Study and the promulgation of final conformance rules by the Federal Reserve. The FSOC Study provides a useful analysis of some of the difficulties inherent in defining and monitoring proprietary trading, and highlights the need for the regulators to refine the statutory definition of private fund to better capture entities that engage in the types of activities Congress intended to address. The Federal Reserve's final conformance rules are helpful in resolving a number of questions relating to potential Federal Reserve extensions of the conformance period within which banking entities must comply with the Volcker Rule.

However, pending the issuance of regulations to implement the Volcker Rule, which must be completed by October 21, 2011, a great many questions remain unanswered. These include: how prohibited proprietary trading activities will be distinguished from permissible underwriting, market-making and hedging activities; how the statutory definition of private fund and “similar fund” will be interpreted to avoid covering entities that lack the characteristics that Congress intended to address; how managed accounts, co-investment vehicles and parallel fund structures will be treated under the final regulations; and which U.S. contacts will be viewed as consistent with the exemptions of proprietary trading and private fund activities by non-U.S. banking entities.

DEPOSIT INSURANCE AND OTHER RELATED REFORMS

BY GARY RICE, STACIE E. MCGINN AND MARK CHORAZAK

Last year, Congress embedded a number of reforms within Dodd-Frank aimed at promoting public confidence and stability in the nation's banking system, including a permanent increase in the level of federal deposit insurance coverage to $250,000 and an extension of the guarantee of funds held in noninterest-bearing transaction accounts above the existing deposit insurance limit through 2012. But Dodd-Frank went further than just extending insurance coverage. It granted the Federal Deposit Insurance Corporation (the "FDIC") more authority to manage the Deposit Insurance Fund and, over the past year, there have been important rulemaking developments that have substantially altered how deposit insurance assessments will be calculated. These changes will affect all insured depository institutions, but especially large and highly complex institutions, which are expected to bear a greater share of the assessment burden as the FDIC replenishes the Deposit Insurance Fund from historic lows. Besides deposit insurance, however, there have been other notable developments, including the repeal of a nearly 80-year prohibition on banks paying interest on demand deposits.

Adoption of Restoration Plan and New Minimum Reserve Ratio of 2%

On October 19, 2010, the FDIC adopted a new Restoration Plan in light of the various mandates of Dodd-Frank, including the requirement that the FDIC take "such steps as may be necessary" to increase the level of the Deposit Insurance Fund from 1.15% to 1.35% of estimated insured deposits by September 30, 2020.[1]

The Restoration Plan is part of a larger, long-term plan to improve the management of the Deposit Insurance Fund, with the goal of maintaining a positive fund balance, even during periods of large fund losses, and maintaining steady, predictable assessment rates throughout economic and credit cycles. The Restoration Plan memorializes the requirement under Dodd-Frank that the FDIC, in setting assessments, offset the effect of requiring the Deposit Insurance Fund to reach the new minimum reserve ratio on insured depository institutions with total consolidated assets of less than $10 billion. It also incorporates a decision by the FDIC to forego a uniform 3 basis point increase in initial assessment rates that had been scheduled to take effect in 2011, in light of the "continuing stresses on the earnings of insured depository institutions" and the new timeline to restore the Deposit Insurance Fund.[2]

Although the FDIC must increase the minimum reserve ratio to 1.35% of insured deposits by September 30, 2020, the FDIC has greater discretion to manage the Deposit Insurance Fund as a result of Dodd-Frank. Dodd-Frank eliminated the requirement that the FDIC pay dividends when the reserve ratio meets certain levels and gave the FDIC sole discretion in determining whether to suspend or limit the declaration or payment of dividends altogether. It also removed the upper limit on the reserve ratio, which was set at 1.5%. Significantly, however, Dodd-Frank did not change the FDIC's authority under the Federal Deposit Insurance Act to

1 Dodd-Frank § 334(a).

2 Notice of Adoption of Federal Deposit Insurance Corporation Restoration Plan, Federal Deposit Insurance Corporation, 75 Fed. Reg. 66293 (Oct. 27, 2010).

revisit and revise the minimum reserve ratio each year, taking into account the risk of loss to the Deposit Insurance Fund, economic conditions generally affecting the banking industry and other factors.

On December 14, 2010, the FDIC approved an increase in the minimum reserve ratio to 2% of insured deposits. The FDIC views the new ratio, which took effect on January 1, 2011, as not only a long-term goal but what is “needed to withstand a future crisis of the magnitude of past crises.”[3] It is expected to provide the banking industry with greater certainty and reduce the risk of pro-cyclical spikes in assessment rates during times of economic distress.

The New Approach to Assessments

On February 7, 2011, the FDIC issued a final rule implementing various provisions in Dodd-Frank relating to the assessment base for banks, changes to assessment rate adjustments, dividends and large bank assessment pricing methodology. Except for future assessment rate schedules, the changes took effect on April 1, 2011 and will apply for assessments due September 30, 2011.

Among other things, the FDIC introduced a “scorecard” method for calculating assessment rates for large and highly complex insured depository institutions. As a consequence, the FDIC will no longer consider credit ratings and defined risk categories in setting assessments for such institutions. Instead, scorecards will differentiate large and highly complex institutions based on CAMELS ratings and certain forward-looking financial measures that assess the disproportionate risk that such institutions pose on the Deposit Insurance Fund. Importantly, the FDIC will have the discretion to make limited adjustments to an institution’s assessment score after considering idiosyncratic and other qualitative factors. The FDIC is finalizing guidelines on how such adjustments will be made.

In general, the revised assessment base and new assessment methodology mean that large banks will have more of the burden of funding the Deposit Insurance Fund. Based on data as of the third quarter of 2010, the FDIC estimates that the share of total assessments paid by large banks will increase from 70% to 79%.[4]

<u>New Assessment Base</u>

As a cost of insuring a depository institution’s deposits, the FDIC imposes a quarterly assessment on the institution. An institution’s assessment is calculated by multiplying its “assessment rate” by its “assessment base.” Historically, the FDIC has defined an institution’s assessment base by reference to its total domestic deposit base.

3 Final Rule Regarding the Designated Reserve Ratio (“DRR Notice”), Federal Deposit Insurance Corporation, 75 Fed. Reg. 79286, 79287 (Dec. 20, 2010). Based on historical losses to the Deposit Insurance Fund, the FDIC estimates that a minimum reserve ratio of 2% is the “lowest level that would have prevented a negative fund balance at any time since 1950.” *See id.* at 79290.

4 *See* Final Rule Regarding Assessments and Large Bank Pricing (“Final Rule”), Federal Deposit Insurance Corporation, 76 Fed. Reg. 10672, 10701 (Feb. 25, 2011).

For a variety of reasons, Congress sought a better measure of the risk that a depository institution poses to the Deposit Insurance Fund than "just plain deposits."[5] The recent financial crisis, which resulted in a wave of bank failures that depleted the Deposit Insurance Fund for the second time in the FDIC's history,[6] demonstrated that the FDIC was being exposed to losses beyond domestic deposit liabilities. An institution's assessment base was not, for example, capturing secured liabilities, nor was it including other liabilities, such as uninsured deposits, foreign deposits and short-term unsecured liabilities, which were often either paid before the institution failed, reducing the assets available to the FDIC to cover losses, or were replaced by insured deposits or secured liabilities. An institution's assessment base was also not incorporating an institution's assets, such as residential and commercial mortgage loans that it made, or securities, such as asset-backed securities or derivatives, that it held. Furthermore, Congress recognized that community banks with less than $10 billion in assets, given their greater reliance on deposits for funding, were paying disproportionately higher assessments than larger banks, resulting in community banks "pay[ing] deposit insurance premiums above and beyond the risk they pose[d] to the banking system."[7]

Dodd-Frank required the FDIC to revise the definition of "assessment base" as an amount equal to an institution's "average consolidated total assets" during an assessment period minus its "average tangible equity" during the assessment period.[8] In the FDIC's final rule, average consolidated total assets is based on the daily average balance (or weekly average balance, if the institution has less than $1 billion in consolidated assets), using the accounting methodology established in quarterly Call Reports. Goodwill and intangibles are included in total consolidated assets. Depository institutions are required to calculate average tangible equity on the basis of their Tier 1 capital, using monthly averaging for the quarter (or the end-of-quarter balance, if the institution has less than $1 billion in consolidated assets). The FDIC's final rule provides special adjustments applicable to banker's banks and custodial banks, which generally may deduct their low risk, liquid assets from their assessment base, subject to some limitations.

Assessment Pricing

Background

Traditionally, the FDIC has placed depository institutions into one of four risk categories using a two-step process based, first, on capital ratios (the capital category assignment) and, second, on supervisory-related information, including CAMELS ratings (the supervisory group assignment). Depending on the risk category assigned, an institution would be subject to an assessment rate expressed in basis points, or cents, per $100 of the institution's assessment base.

Generally, depository institutions within Supervisory Group A have CAMELS ratings of 1 or 2 and are the strongest of institutions. Those within Supervisory Group B generally have a CAMELS rating of 3 and demonstrate weaknesses that, if left uncorrected, could result in significant deterioration and increased risk of loss to the Deposit Insurance Fund. The

5 156 Cong. Rec. S3297 (May 6, 2010) (statement of Sen. Hutchinson, co-sponsor of Amendment No. 3749, which incorporated the new assessment base into Dodd-Frank).

6 *See* DRR Notice at 79290.

7 Final Rule at 10701.

8 Dodd-Frank § 331(b).

remaining institutions, with CAMELS ratings of 4 or 5, fall within Supervisory Group C and pose a substantial probability of loss to the Deposit Insurance Fund.

<table>
<tr><th colspan="4">Table 1: Historic Annual Assessment Rates by Capital Category and Supervisory Group
(in basis points, or cents per $100 of assessment base)</th></tr>
<tr><th rowspan="2">Capital Category</th><th colspan="3">Supervisory Group</th></tr>
<tr><th>A</th><th>B</th><th>C</th></tr>
<tr><td>Well Capitalized</td><td>I
12 – 16</td><td rowspan="2">II
22</td><td rowspan="2">III
32</td></tr>
<tr><td>Adequately Capitalized</td><td>II
22</td></tr>
<tr><td>Undercapitalized</td><td colspan="2">III
32</td><td>IV
45</td></tr>
</table>

Source: FDIC. Rates as of March 31, 2011.

Table 1 illustrates a basic principle of FDIC deposit insurance: institutions posing the least risk of loss to the Deposit Insurance Fund will be charged the lowest of insurance premiums by the FDIC, while institutions posing the greatest risk will pay the highest premiums (or, if circumstances warrant, will be dropped from FDIC insurance coverage altogether). For example, a "well capitalized" bank with a strong CAMELS rating would typically fall within Risk Category I, meaning that it would pay between $0.12 and $0.16 for insurance per $100 in deposits. An "undercapitalized" bank with a CAMELS rating of 4 or 5, falling within Risk Category 4, would pay substantially more for such coverage.

As demonstrated in Table 2, assessments can also be adjusted downward or upward based on the capital structure of an institution. In 2009, the FDIC adopted adjustments into its risk-based pricing system for three types of liabilities: unsecured debt, secured liabilities and brokered deposits.[9]

Table 2: Historic Annual Assessment Rates by Risk Category
(in basis points, or cents per $100 of assessment base)

	Risk Category I	Risk Category II	Risk Category III	Risk Category IV
Initial Base Adjustment Rate	12 – 16	22	32	45
Unsecured Adjustment Rate (added)	(5) – 0	(5) – 0	(5) – 0	(5) – 0
Secured Liability Adjustment Rate (added)	0 – 8	0 – 11	0 – 16	0 – 22.5
Brokered Deposit Adjustment Rate (added)	n / a	0 – 10	0 – 10	0 – 10
Total Base Assessment Rate	7 – 24.0	17 – 43.0	27 – 58.0	40 – 77.5

Source: FDIC. Rates as of March 31, 2011.

The unsecured debt adjustment is the only adjustment that provides for a reduction in an institution's assessment. It is available for institutions that issue long-term unsecured debt, which generally reduces the FDIC's loss in the event of a bank failure. Until recently, another adjustment was available for secured liabilities, which expose the Deposit Insurance Fund to

9 See 74 Fed. Reg. 9525 (Mar. 4, 2009).

greater risk of loss in cases where institutions rely heavily on secured funding. The third adjustment relates to brokered deposits, particularly where an institution's ratio of brokered deposits to domestic deposits exceeds 10%. Brokered deposits have traditionally been viewed by the FDIC as increasing an institution's risk profile because, among other things, they are associated with rapid asset growth. Also, as an institution's capital condition weakens, the ability to attract, renew or roll over these deposits may be limited, creating liquidity problems.[10]

New Pricing System

The new pricing system continues to be a risk-based system. However, it now incorporates Dodd-Frank's revision to the assessment base and reflects Congress's intent that larger institutions, as well as those that are structurally and operationally more complex or that pose unique challenges and risks in the case of failure, bear a greater share of the assessment burden.[11]

Table 3: New Annual Assessment Rates by Risk Category*
(in basis points, or cents per $100 of assessment base)

	Risk Category I	Risk Category II	Risk Category III	Risk Category IV	Large and Highly Complex Institutions
Initial Base Adjustment Rate	5 – 9	14	23	35	5 – 35
Unsecured Adjustment Rate (added)**	(4.5) – 0	(5) – 0	(5) – 0	(5) – 0	(5) – 0
Brokered Deposit Adjustment Rate (added)	n/a	0 – 10	0 – 10	0 – 10	0 – 10
Total Base Assessment Rate	2.5 – 9	9 – 24	18 – 33	30 – 45	2.5 – 45

Source: FDIC. Rates effective as of April 1, 2011.

* Total base assessment rate does not include an adjustment for depository institution debt.

** The unsecured debt adjustment cannot exceed the lesser of 5 bps or 50% of an insured depository institution's initial base assessment rate.

As shown in Table 3, assessments rates under the new pricing system, which took effect on April 1, 2011, will range from $0.05 to $0.35, per $100 of an institution's assessment base, and, after accounting for adjustments, total base assessment rates will range from $0.025 to $0.45, per $100 of an institution's assessment base. The rates under the new system are lower than under the old system, but because the assessment base under Dodd-Frank has been enlarged (from deposits to total assets less tangible common equity), the changes are expected to be revenue

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10 *See* id. at 9541. As required under Dodd-Frank, the FDIC conducted a study on core deposits and brokered deposits. In the study, the FDIC identified the "serious concerns" that exist when institutions increase their reliance on brokered deposits and ultimately concluded that Congress should not amend or repeal the brokered deposit statute. *See* Federal Deposit Insurance Corporation, "Study on Core Deposits and Brokered Deposits, Submitted to Congress Pursuant to the Dodd-Frank Wall Street Reform and Consumer Protections Act" (July 8, 2011), at 7, 32-48.

11 *See* Final Rule at 10701.

neutral to the FDIC. The FDIC's final rule also makes clear that there will be no dividends paid out of the Deposit Insurance Fund for the foreseeable future. Instead, assessments will be progressively lowered as the minimum reserve ratio hits or exceeds certain thresholds—1.5%, 2% and 2.5%—at the end of any year.

The FDIC has made various changes to the assessment rate adjustments applied to certain types of liabilities. The FDIC kept the bank-favorable adjustment for long-term unsecured debt, although it made relatively minor tweaks to account for the new assessment base, among other things.[12] The adjustment for secured liabilities has been eliminated. The FDIC retained the adjustment for brokered deposits, but will now provide an exemption for institutions that are well capitalized and have a CAMELS rating of 1 or 2. A new adjustment has also been introduced to account for institutions issuing long-term, unsecured debt to other insured depository institutions. Although the issuance of unsecured debt reduces the potential loss to the Deposit Insurance Fund in the event of an institution's failure, the FDIC concluded that when such debt is held by other banks, the reduction in overall risk to the Deposit Insurance Fund is not as great.[13]

The most significant feature of the assessment pricing system, however, is the treatment of large and high complex insured depository institutions. A "large" institution is generally one with assets of $10 billion or more.[14] A "highly complex" institution is generally (i) a large institution (other than a credit card bank) that has had at least $50 billion in total assets for at least four consecutive quarters and that is controlled by a U.S. parent or intermediate holding company that has had at least $500 billion in total assets for four consecutive quarters, or (ii) a very large processing bank or trust company.

Under the new pricing system, the FDIC has eliminated risk categories and the use of long-term debt issuer ratings for large and highly complex institutions. Instead, the assessment rate for these institutions will be calculated using a "scorecard" that combines CAMELS ratings and certain forward-looking financial measures. One scorecard will apply to large institutions, as set forth in Table 4; the other will apply to highly complex institutions. The two scorecards, however, are substantially similar.

[12] For example, the FDIC revised the adjustment for unsecured debt to exclude Tier 1 capital, since the new assessment base now expressly excludes such capital. Otherwise there would be a double deduction.

[13] *See* Final Rule at 10681.

[14] The calculation is made as of December 31, 2006. If an institution does not have at least $10 billion in assets after such date, then the FDIC will look to whether the institution reports assets of at least $10 billion or more in its Call Report for four consecutive quarters. In this regard, the FDIC seeks to avoid a so-called "cliff effect" in which a small institution could become subject to significantly higher assessments almost immediately upon having assets of at least $10 billion. As the FDIC has said, "[m]ovement from one size category to another will not occur without warning," and so a small institution whose assets are at, or hovering slightly above, $10 billion will have the necessary time to prepare for increased assessments. *See* Final Rule at 10702.

Table 4: Scorecard for "Large" Insured Depository Institutions*		
Scorecard Measures and Components	Measure Weights	Component Weights
Performance Score		
Weighted Average CAMELS Rating	100%	30%
Ability to Withstand Asset-Related Stress		50%
Tier 1 Leverage Ratio	10%	
Concentration Measure	35%	
Core Earnings/Average Quarter-End Total Assets	20%	
Credit Quality Measure	35%	
Ability to Withstand Funding-Related Stress		20%
Core Deposits/Total Liabilities	60%	
Balance Sheet Liquidity Ratio	40%	
Loss Severity Score		
Loss Severity Measure		100%

Source: FDIC. Effective as of April 1, 2011.

* The scorecard for "highly complex" insured depository institutions includes a 4% weighting for average short-term funding and applies slightly lower weights to the core deposits-to-total liabilities and balance sheet liquidity ratio measures. It also adds a market risk measure alongside the credit quality measure to account for trading revenue volatility, among other things.

Each scorecard produces two scores—a performance score and a loss severity score. The performance score measures an institution's ability to withstand stress, while the loss severity score measures the relative magnitude of potential losses to the Deposit Insurance Fund in the event of an institution's failure. Multiplying the performance score by the loss severity score produces a total score, ranging between 30 and 90. The total score is converted into an initial base assessment rate, which, after the application of certain adjustments discussed above, results in a total assessment rate. A large or highly complex institution with a total score of 30 will pay the lowest rate, while an institution with a total score of 90 will pay the highest rate. As discussed below, the FDIC has the discretion to adjust the total score of a large or highly complex institution.

Assessment Rate Adjustment for Large and Highly Complex Institutions

The FDIC will have the ability to adjust the scores that are used in calculating the assessment rates of large and highly complex institutions by a maximum of 15 points, up or down, based upon significant risk factors that are not adequately captured in the scorecards. On April 12, 2011, the FDIC released proposed guidelines regarding the process the FDIC will follow to determine whether to make an adjustment and the size of such adjustment.[15]

Two sets of information will be used by the FDIC in determining whether to make a large bank adjustment: (i) scorecard measure "outliers" and (ii) information not directly captured in the scorecard:

[15] *See* Proposed Assessment Rate Guidelines for Large and High Complex Institutions, Federal Deposit Insurance Corporation, 76 Fed. Reg. 21256 (Apr. 15, 2011).

- Scorecard Measure Outliers—Scorecard measure outliers refer to when a scorecard ratio or measure exceeds the maximum cutoff for a ratio or measure or is less than the minimum cutoff value for a ratio or measure along with the degree to which the ratio or measure differs from the cutoff value.

- Complementary Risk Measures and Qualitative Risk Considerations—In looking to information beyond that which is captured by the scorecard, the FDIC will consider complementary quantitative risk measures and qualitative risk considerations. Complementary risk measures are measures that are not included in the scorecard, but that can inform the appropriateness of a given scorecard for a particular institution. These measures are readily available for all institutions and include quantitative metrics and market indicators that provide further insights into an institution's ability to withstand financial adversity and the severity of losses in the event of failure. Qualitative risk information includes, but is not limited to, underwriting practices, risk management practices, strategic risk, the use and management of government support programs and information obtained through the supervisory process, such as stress test results. In general, the FDIC will give more weight to qualitative information in determining whether to apply an adjustment when an institution has high performance risk or if the institution has high asset, earnings or funding concentrations. For example, if a bank has material concentrations in some asset classes, the FDIC will view the quality of underwriting as highly important in the adjustment process.

The FDIC plans to evaluate scorecard results each quarter to identify institutions with a score that is "clearly too high or too low," as compared to risks or risk-mitigating factors that are inadequately accounted for by the scorecard.[16] Examples of such factors include considerations for purchased credit impaired loans, accounting rule changes such as FAS 166/167, credit underwriting and credit administration practices, collateral and other risk mitigants, including the materiality of guarantees and franchise value. In addition, to the extent possible, the FDIC will consider how a particular institution compares to similar institutions within its peer group. The comparison will allow the FDIC to account for variations in risk measures that may exist among institutions with differing business models.[17]

Assuming the FDIC determines that an adjustment is warranted, the FDIC will determine the adjustment amount necessary to bring an institution's total score into better alignment with those of other institutions that pose similar levels of risk. Significantly, an institution should expect an adjustment only when a combination of risk measures and its relative risk profile warrant a "meaningful adjustment" (generally, an adjustment of five points or more) to its final score. In this regard, the adjustment process is meant to "address material idiosyncratic issues in a small number of institutions rather than as a fine-tuning mechanism for a large number of institutions."[18]

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16 Id. at 21258.

17 The proposed peer groups are processing banks and trust companies; residential mortgage lenders, non-diversified regional institutions, large diversified institutions and diversified regional institutions. See id. at 21258-59.

18 Id. at 21259.

In terms of process, prior to making an adjustment, the FDIC will consult with an institution's primary federal regulator and appropriate state banking supervisor to obtain further information and comment. The FDIC will also provide affected institutions with advance notice of any decision to make an upward adjustment to a total score, although advance notice will not be given for a downward adjustment. The notice will include, among other things, the reasons for the proposed adjustment and provide institutions with up to 60 days to respond.

Repeal of Prohibition on Paying Interest on "Business Checking" Accounts

Besides the various reforms related to deposit insurance, Dodd-Frank also required the repeal of a Roosevelt-era prohibition on insured depository institutions paying interest on "business checking" accounts, or "demand deposits," which are payable on demand or represent funds for which the depository institution does not reserve the right to require at least seven days' written notice of an intended withdrawal. The prohibition was part of the Glass-Steagall Act and, over time, had been weakened with the use of legal workarounds, such as NOW accounts and "sweep accounts" in which funds are swept overnight from a demand deposit account to a money market account or "repo sweep" account and then swept back to the demand deposit account the next morning.

On July 21, 2011, provisions in the Federal Deposit Insurance Act, the Federal Reserve Act and the Home Owners' Loan Act prohibiting the payment of interest on such deposits were automatically repealed.[19] Accordingly, depository institutions may now pay interest on demand deposits, though they will not be required to do so.

For some banks, the repeal of the prohibition may not be welcomed. Many small community banks, for example, have developed business models in which much of their funding comes from business depositors. These depositors, of course, had no incentive to change their banking relationships on the basis of interest payments. That will change, particularly as interest rates rise and as other banks with fewer business depositors see an opportunity to tap into a new source of funding. As institutions in a given market start paying interest and gaining deposit market share, there will be increased pressure on other institutions to do the same.

For now, it remains to be seen how banks will adapt their business models to the repeal, whether a pricing war could eventually ensue in certain markets or whether the repeal will inspire changes in the pricing of other products to make up for the shortfall in income as a result of paying interest to business depositors.

[19] *See* Dodd-Frank § 627; *see also* Final Rule Regarding Prohibition Against Payment of Interest on Demand Deposits, Board of Governors of the Federal Reserve System, 76 Fed. Reg. 42015 (July 18, 2011); Final Rule Regarding Interest on Deposits and Deposit Insurance Coverage (Regulation Q), Federal Deposit Insurance Corporation, 76 Fed. Reg. 41392 (July 14, 2011).

DEBIT INTERCHANGE REGULATION: ANOTHER BATTLE OR THE END OF THE WAR?

BY STACIE E. MCGINN AND MARK CHORAZAK[1]

As one governor of the Board of Governors of the Federal Reserve System (the "Board" or "Federal Reserve") recently observed, "the financial crisis spawned or strengthened many reform agendas—among them consumer protection, securities and commodities market regulation, and traditional bank regulation."[2] The crisis also created opportunities unrelated to these reform agendas. At least one group—merchants—realized a legislative goal that had been unimaginable a year earlier: giving the Federal Reserve the authority to set debit interchange rates.

Still reeling from the financial crisis and preoccupied with defending innumerable other measures in Dodd-Frank,[3] retail bankers—big and small—watched as an unprecedented government rate-setting amendment was approved in the U.S. Senate by a bipartisan vote of 64 to 33.[4] Under the so-called Durbin Amendment, named for U.S. Senator Richard Durbin, an estimated $7.2 billion—or roughly 45%—of interchange revenue paid to banks for facilitating debit card transactions will be eliminated.

This article explores the events that led to passage of the Durbin Amendment and describes the likely impact of this historic legislation on the banking industry, payments companies, merchants and consumers. Finally, we discuss whether the Durbin Amendment represents the final battle on debit interchange in the United States, or merely a skirmish in a long-running war.

The Durbin Amendment was preceded by a long-running feud over interchange, with retailers on one side, and payment networks and the banking industry on the other.

The seeds of the dispute were sown by payment processing arrangements and the success of debit cards with American consumers.

Understanding the battle over interchange begins with understanding interchange itself. When a consumer uses a debit card to make a purchase, the merchant does not receive the full purchase amount, because a portion of the sale is deducted to compensate other parties to the transaction. In particular, the merchant's bank (the "acquirer"), the bank that issued the card (the "issuer"), and the card network that processes the transaction (the "network") all receive a

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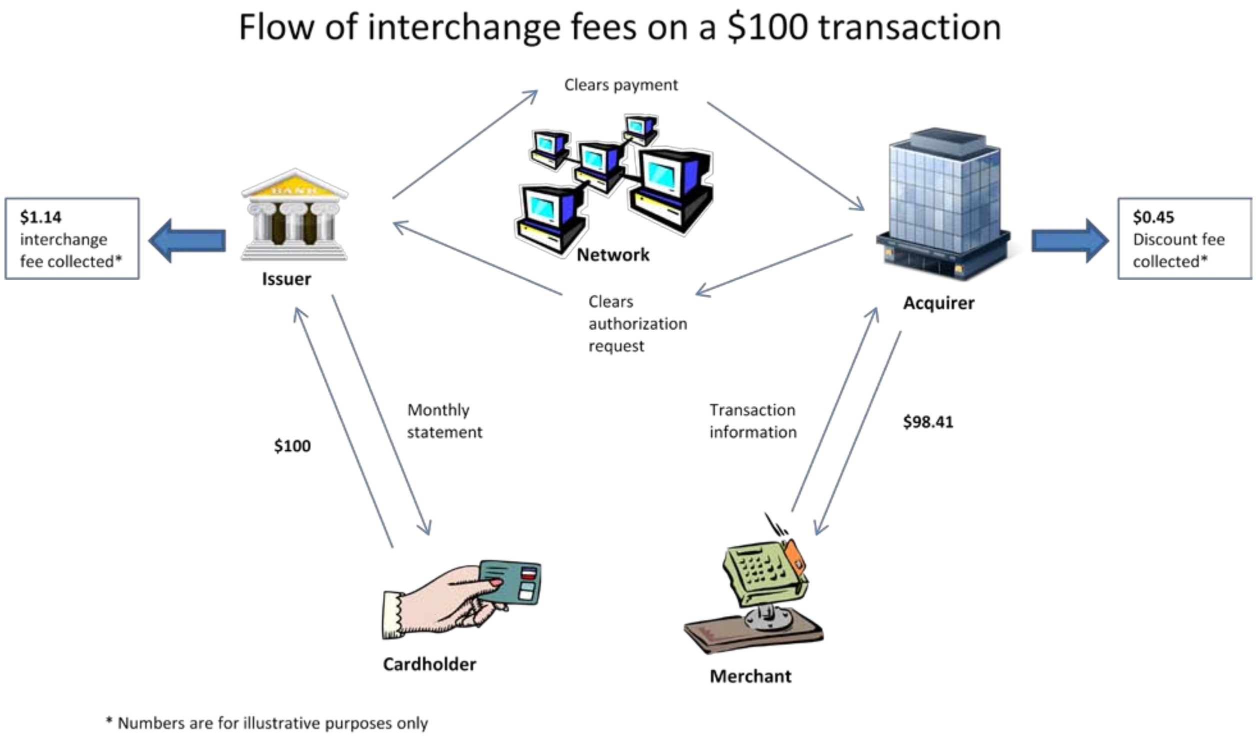
1 The authors acknowledge the substantial contribution to this article by Randy Benjenk (summer associate).

2 Daniel K. Tarullo, Governor, Federal Reserve System, Speech at the Peter G. Peterson Institute for International Economics (June 3, 2011).

3 Public Law 111-203 (July 21, 2010).

4 Dodd-Frank was enacted on July 21, 2010. Section 1075 of Dodd-Frank amends the Electronic Fund Transfer Act ("EFTA") (12 U.S.C. § 1693 et seq.) by adding a new provision regarding interchange transaction fees and rules for payment card transactions.

portion of the transaction, with the largest portion paid to the card-issuing bank as an interchange fee.[5] This multi-party relationship is shown in the simplified chart, below.[6]



The level and growth of debit interchange rates had become increasingly controversial. Retailers felt their costs for accepting cards were too high and increasing. The total costs to merchants who accept debit cards did rise over time, in part because of the extraordinary success of the product.[7] Consumers rapidly substituted debit cards for cash and checks. Debit share of U.S. Personal Consumption Expenditure (PCE), for example, grew 75% in five years—it represented 9.7% of PCE in 2003 (for a total of $585 billion), and represented 17% of PCE in 2008 (for a total of $1.3 trillion).[8] Payment networks report there were approximately 37.7 billion

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5 The Federal Reserve defines an "interchange transaction fee" as "any fee established, charged, or received by a payment card network and paid by a merchant or an acquirer for the purpose of compensating an issuer for its involvement in an electronic debit transaction." Final Rule Regarding Debit Card Interchange Fees and Routing, Federal Reserve System, 76 Fed. Reg. 43394, 43467 (July 20, 2011) (to be codified at 12 C.F.R. § 235.2(j)).

6 This describes what is known as a "four-party," or "open-end" processing relationship. Processing arrangements also can involve a "three-party," or "closed-end" processing system, in which the network itself acts as both issuer and acquirer. For a more detailed description of the debit card industry, see *id.* at 43395-43396 (Dec. 28, 2010).

7 Merchants claimed processing costs also rose as a consequence of increased interchange rates, and that rate increases were used by payment networks to compete for issuers. *See* "Understanding the Federal Reserve's Proposed Rule on Interchange Fees: Implications and Consequences of the Durbin Amendment," Hearing Before the Subcomm. on Financial Institutions and Consumer Credit of the H. Comm. on Financial Services, 112th Cong. 4-5 (Feb. 17, 2011) (statement of Doug Kantor, Counsel, Merchants Payments Coalition).

8 "U.S. Consumer Payment Systems," Nilson Report #939 at 10, December 2009.

debit and prepaid card transactions in 2009, valued at over $1.45 trillion.[9] At the same time, interchange revenue became increasingly important to card issuers of all sizes. Smaller issuers, such as community banks and credit unions, rely on interchange fees as a significant source of revenue for their card operations, and card operations were highly profitable activities for large banks, as well.

Faced with escalating processing costs, merchants sought relief in the courthouse and in Congress.

As interchange revenues climbed in the mid-1990s, payment networks began to face antitrust litigation over their practices. Beginning in 1996, various class action and Department of Justice lawsuits were filed against Visa U.S.A. Inc., MasterCard International and issuers, in some cases, claiming violations of federal antitrust laws. In the intervening decade, most of these claims were settled, and both Visa and MasterCard became publicly-owned institutions.[10]

With judicial challenges proceeding slowly through the courts, merchants took their cause to Capitol Hill. Largely under the auspices of the Merchants Payments Coalition,[11] and with the support of Senator Durbin, merchants made several unsuccessful attempts at legislation regulating interchange rates. In 2009, they were able to attach an interchange provision to a major piece of credit card legislation, the 2009 Credit Card Accountability, Responsibility, and Disclosure Act (the "CARD Act"). The provision directed the Government Accountability Office ("GAO") to conduct a study of interchange.[12] The resulting GAO study found no competitive concerns or the need for government rate-setting.[13]

But 2010 ushered in the perfect storm for long time opponents of interchange regulation. Few in Congress understood the issues surrounding interchange, and industry leaders and members of Congress already were grappling with the complexities of other provisions of the 2,300 page bill that ultimately became Dodd-Frank. Senator Durbin's influence in the Senate was at an all-time high, and influence (and trust) of the banking industry at an all-time low. In the midst of this chaos, retail bankers, big and small, watched as Senator Durbin's unprecedented government rate-setting amendment was approved in the Senate and ultimately became law.[14]

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9 Proposed Rule, Debit Card Interchange Fees and Routing, 75 Fed. Reg. 81722, 81725 (Dec. 28, 2010).

10 At least one lawsuit, which consolidated approximately 55 complaints, has been pending for the last six years. See Second Consolidated Amended Class Action Complaint, In Re Payment Card Interchange Fee and Merchant-Discount Antitrust Litigation, No. 1:05-md-1720-JG-JO (E.D.N.Y. Jan. 29, 2009).

11 The Merchants Payments Coalition is a merchant trade association representing over 2.7 million merchants in the challenge to interchange fees.

12 GAO was directed to review (1) how the fees merchants pay have changed over time and the factors affecting the competitiveness of the credit card market, (2) how credit card competition has affected consumers, (3) the benefits and costs to merchants of accepting cards and their ability to negotiate those costs, and (4) the potential impact of various options intended to lower merchant costs.

13 U.S. Government Accountability Office, Credit Cards: Rising Interchange Fees Have Increased Costs for Merchants, but Options for Reducing Fees Pose Challenges (2009).

14 Opponents of the Durbin Amendment waged an unsuccessful attempt to change the law. Senator Jon Tester of Montana introduced a bill to delay implementation of the Durbin Amendment by a year. Senator Tester's proposal called for a study of the effect of the Durbin Amendment and the Board's proposed rule on all costs associated with debit card programs to issuers and networks, the costs to consumers, including the impact on fraud prevention services and the cost and accessibility of debit

The Durbin Amendment was designed to change fundamentally the economic underpinnings of debit payment processing and shift decision-making power as to transaction processing in favor of merchants.

In adopting final interchange regulations, Federal Reserve Governors and staff believed their hands were tied by a narrow statutory mandate.

Dodd-Frank required the Board to establish its interchange fee standards no later than April 21, 2011, with final rules effective on July 21, 2011.[15] Prior to issuing its rule, Board staff held numerous meetings with debit card issuers, payment card networks, merchant acquirers, merchants, industry trade associations and consumer groups. Interested parties also provided written submissions.[16] The Board also distributed three surveys to industry participants (an issuer survey, a network survey and a merchant acquirer survey) to assist the Board in developing its rules.[17]

Section 1075 of Dodd-Frank and the Board's regulations fundamentally change the status quo in debit processing in three ways: introducing government regulation of interchange fees, prohibiting "exclusive" arrangements between an issuer and a network, and allowing merchants to "steer" a customer to use one type of card rather than another. Each is described below.

Regulation of Interchange Fees. Under Dodd-Frank, the amount of any interchange fee with respect to an electronic debit transaction received or charged by an issuer must be "reasonable and proportional to the cost incurred by the issuer with respect to the transaction."[18] Dodd-Frank directs the Federal Reserve to prescribe regulations to establish standards for assessing whether the amount of any interchange transaction fee is "reasonable and proportional" to this cost.[19] Dodd-Frank permits the Board to allow in its regulation for an adjustment to the fee

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services, and the effectiveness of the small issuer exemption. Any adverse finding would result in a withdrawal of the proposed rule and the issuance of a new rule. On June 8, 2011, Senator Tester's amendment received 54 votes in the Senate, but failed to obtain a filibuster-proof majority.

15 On March 29, 2011, Board Chairman Ben Bernanke wrote in a letter to Congressional banking committee leaders that the Board was unable to meet the April 2011 deadline provided in the statute for the final rule, due to the high volume of comments the Board had received and the complexity of the issues raised by the comments. The final rules were approved by the Board, with one objection, on June 29, 2011, and covered issuers have until October 1, 2011 to comply with the interchange fee restrictions, as described in greater detail below.

16 Meeting summaries and written submissions are available on the Regulatory Reform section of the Board's web site, at http://www.federalreserve.gov/newsevents/reform.htm.

17 The card issuer survey was distributed to 131 financial organizations with assets of $10 billion or more. The Board received 89 responses; it received no communication at all from 26 of the 131 organizations that received the survey.

18 15 U.S.C. § 1693o-2(a)(2).

19 Id. § 1693o-2(a)(3). The statute notes several factors that must be considered by the Board in prescribing its regulations. The Board must consider the functional similarity between debit transactions and check transactions. In addition, the Board must distinguish between (i) "the incremental cost incurred by an issuer for the role of the issuer in the authorization, clearance, or settlement of a particular" debit transaction, which costs must be considered; and (ii) other costs incurred by the issuer which are not specific to a particular transaction, which costs shall not be

amount for costs incurred by the issuer in preventing fraud, provided the issuer complies with fraud-related standards established by the Board.[20]

In setting new interchange rates, the Board's final rule caps the maximum debit interchange fee that an issuer may receive per transaction at the sum of 21 cents,[21] plus 5 basis points (0.05%, multiplied by the transaction amount) to account for fraud losses. The Board provides an additional allowance for fraud prevention equal to 1 cent per transaction, provided the issuer adopts fraud prevention procedures established under the regulation.[22] While a significant improvement over the proposed rule, which capped interchange rates at 12 cents, the final rule will decrease interchange revenue by about 45% for covered issuers.[23]

Certain entities and programs are exempt from the rate provisions of Dodd-Frank. Issuers that, together with all affiliates, have less than $10 billion in assets are exempt from the Board regulations, under the "small issuer" exemption.[24] In addition, prepaid cards used in connection with government-administered payment programs and certain general purpose prepaid cards are exempt.[25]

During consideration of the final interchange regulations, the Board staff acknowledged they could not predict the impact of the statute on small banks or the effectiveness of the small-issuer exemption. Staff noted that while the major payment networks have indicated their intentions to adopt a "two-tier" pricing structure that accounts for small issuers, there is no certainty

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considered. Id. § 1693o-2(a)(4). The latter considerations were particularly controversial during the rulemaking process.

20 Id. § 1693o-2(a)(5). The Board is required to establish such fraud standards within nine months of Dodd-Frank's enactment.

21 In arriving at the 21 cent figure, the Federal Reserve took into account from its survey of covered issuers the average per-transaction allowable processing costs for issuers at the 80th percentile of the survey. Allowable costs are those total fixed and variable transaction processing costs related to authorization, clearance and settlement, as well as network processing fees (e.g., switch fees), and the costs of processing chargebacks and other non-routine transactions, and transactions monitoring.

22 This additional fraud allowance was based on the median of reported issuer fraud losses from the Federal Reserve survey. The Board adopted this additional fraud allowance in a separate interim final rule with a request for public comment. *See* Interim final rule, Debit Card Interchange Fees and Routing, 76 Fed. Reg. 43478 (July 20, 2011).

23 Based on a comparison of the Federal Reserve survey data (which reflects debit interchange rates for all transactions of 1.14% and an average debit transaction amount of $38.03), the Federal Reserve's final rule on debit interchange will cause average debit interchange rates to decline about 45%, from approximately 1.14% to approximately 0.63%. Put another way, average per transaction rates will decline from around 44 cents to 24 cents.

24 For a list of institutions qualifying as small issuers, see Interchange Fee Standards: Small Issuer Exemption, http://www.federalreserve.gov/paymentsystems/debitfees.htm.

25 To qualify for this exemption, the payment device must be (i) linked to funds or other assets that are loaded on a prepaid basis, (ii) not used by the card holder to access the cardholder's account (other than a recordkeeping subaccount of an omnibus account), (iii) redeemable at unaffiliated merchants or service providers, (iv) used to transfer or debit funds, and (v) reloadable and not marketed or labeled as a gift card. In addition, the card must be the only means to access the underlying funds, except when all remaining funds are provided to the cardholder in a single transaction (as when the account is closed out). In other words, transactions using prepaid cards that provide regular access to funds underlying the card through check or ACH would be subject to interchange restrictions.

interchange rates for small banks will remain at current levels.[26] Moreover, Board staff acknowledged they have no authority to require networks to maintain a two-tier structure. Governor Elizabeth Duke objected to the Board's final rules largely on the basis of the uncertainty surrounding the impact on small banks.

The statute also provides that the Federal Reserve may regulate fees charged by payment networks, but only for the purpose of ensuring that the network fee is not used to circumvent the interchange fee provisions. To prevent circumvention or evasion of the limits on interchange fees, the rule prohibits an issuer from receiving net compensation from a debit card network, excluding interchange fees. In other words, the total amount of compensation provided by the network to the issuer, such as rebates, incentives or payments, may not exceed the total amount of fees paid by the issuer to the network.

Elimination of "Exclusive" Arrangements. In addition to prescribing rules regarding restrictions on interchange fees, the Board also is required by Dodd-Frank to prescribe certain rules regarding transaction routing. The Board regulations must provide that neither an issuer nor a payment network may (i) restrict the number of payment card networks on which a transaction is processed to only one network, or (ii) inhibit a merchant who accepts debit cards from directing the routing of transaction processing over any payment card network that may process such transaction.[27]

Board regulations provide that an issuer or payment card network may not restrict the number of payment card networks over which an electronic debit transaction may be carried to fewer than two unaffiliated networks. Under this approach, it is sufficient for an issuer to issue a debit card that can be processed over one signature-based network and one PIN-based network, or alternatively, two signature-based networks, provided the networks are not affiliated.[28] The final rule also adopts the statutory prohibition on routing restrictions. In practice, this means issuers will choose two or more unaffiliated payment card networks over which an electronic debit transaction may be carried, and merchants (not issuers or networks) will be able to direct the routing of the transaction from among the networks chosen by the issuer.

Merchant Steering. The statute provides that a network may not keep a merchant from offering a discount or other in-kind incentive for payment by the use of cash, checks, debit cards, or credit cards, provided the discount does not distinguish on the basis of issuer or payment card network (in the case of debit or credit cards).[29] In accordance with Dodd-Frank, the Board

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[26] *See* Staff Memorandum, Final Rule on Debit Interchange Fees and Routing and Interim Final Rule on Fraud Prevention Adjustment 18 (June 22, 2011), *available at* http://www.federalreserve.gov/aboutthefed/boardmeetings/20110629_FINAL_RULE.BOARD_MEMO.06_22_2011.SGA.FINAL2.pdf.

[27] Exemptions for small issuers and government and prepaid cards do not apply to these routing restrictions.

[28] Merchants argued in favor of requiring issuers to have at least two payment card networks for each authentication method an issuer offers: This would have meant that an issuer that used both signature and PIN-based authorization would have to enable its debit cards with two unaffiliated signature-based networks and two unaffiliated PIN-based networks. In the end, the Board determined such an interpretation was beyond its statutory mandate.

[29] The law also allows merchants to establish minimum dollar amounts in the case of credit card sales.

prohibits issuers and payment card networks from restricting the ability of a merchant to direct the routing of electronic debit transactions over any of the networks that an issuer has enabled on its card.

Application of Interchange Fee Restrictions to ATM and "closed-loop" networks. The rule defines "payment card networks" to exclude three-party, or so-called closed-loop networks, such as American Express, and ATM networks.

Effective dates. While the statute provides that final rules should be effective July 21, 2011, the final rule takes a more practical approach. The Board rule ensures that the fraud prevention adjustment would apply at the same time as interchange fee provisions become effective, and provides additional time to account for technological challenges. Specifically,

- The restrictions on interchange fees and routing restrictions will take effect on October 1, 2011 (including, on an interim basis, the fraud prevention adjustment).
- The prohibitions on network exclusivity take effect on October 1, 2011 for payment card networks and April 1, 2012 for issuers.
- A delayed effective date of April 1, 2013 applies to certain cards with particular technological challenges, such as health benefit and certain other prepaid cards.

Industry participants must weigh carefully their responses.

The Dodd-Frank interchange provisions change the economic relationships between issuers (large and small), networks and merchants, and the steps they take in response will ultimately impact consumers.

Issuers. In the short run, issuers will seek new ways to make up some of their lost revenue. Several banks have already announced plans to increase fees on other bank products and services.[30] Small banks should benefit from fee increases by larger banks, as they too may increase prices, while interchange rate regulation purports not to affect these institutions.

Some issuers will seek to take advantage of the exemptions. Those issuers operating within a "closed loop" system would appear to be less impacted by declines in interchange rates, although market pressure on interchange rates generally and new powers of merchants to route transactions and discount may put pressure on interchange rates of these companies, as well. At least one financial institution has introduced a new general purpose prepaid card, which would appear to be exempt from the Board's interchange restrictions. Prepaid products need to be carefully structured to meet regulatory requirements, and as prepaid cards become more

[30] See, e.g., Fee Plans Take Shape at Wells Fargo, Regions In Case Durbin Deadline Sticks, AMERICAN BANKER, May 24, 2011; U.S. Bancorp Ends Waiting Game with Durbin Debit Rule, AMERICAN BANKER, January 20, 2011.

prevalent as a payment device, the industry can expect increased supervision and examination by the newly-formed Consumer Financial Protection Bureau.[31]

Debit card issuers will need to review existing arrangements with payment card networks in light of the "exclusivity" provisions of the Federal Reserve's regulations. They will also need to ensure that the total amount of compensation provided by the network to the issuer, such as rebates, incentives or payments, does not exceed the total amount of fees paid by the issuer to the network.

Issuers that wish to collect the additional fraud adjustment will need to ensure their fraud prevention activities are (and remain) consistent with standards established by the Federal Reserve regulation.

Issuers will need to rethink their debit card offers in view of "allowable costs" under the rule. Issuers might consider increasing fees for debit card transactions, or taking other measures that would have the effect of causing consumers to steer away from debit card use. A more likely scenario is the elimination of benefits: Rewards on debit cards will likely be curtailed, if not eliminated altogether. The final rule also may impact issuers' willingness to spend money on innovation with regard to payment methods that fall within the rule, as issuers will be unable to recoup their fixed development costs.[32]

Networks. The networks will need to reset interchange rates. One of the most difficult issues networks will face in this regard is whether to establish a two-tier system for large and small banks (Visa and MasterCard have both indicated their intention to do so); and where to set rates. Competitive pressure, created by merchants' ability to direct network routing and offer consumer discounts, will be a factor.

New routing and steering powers of merchants are likely to drive change. Networks (and issuers) may need to make adjustments to network operating rules and payment processing protocols to account for the merchant routing provisions. While historically responsive to merchant needs, networks have additional incentives following Durbin to compete for merchant business.

Merchants. Merchants will receive a reduction in their processing costs and will face the question of how much, if any, of these cost savings they will pass on to consumers. Federal Reserve staff indicated that while they cannot predict merchant behavior, they would expect merchants in highly competitive markets operating on smaller margins were most likely to pass

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31 The Consumer Financial Protection Bureau suggested in a recent proposed rulemaking that it is considering regulating prepaid cards. Proposed Rule, Defining Larger Participants in Certain Consumer Financial Products and Services Markets, 76 Fed. Reg. 38059 (June 29, 2011).

32 During deliberations on the final rule, Federal Reserve staff expressed a view that the final rule could have a negative impact on payments innovation.

the savings on to consumers, whereas merchants with less competition were likely to retain the cost savings.[33]

Merchants must consider how to implement new routing and steering powers. Some merchants (and their acquirers) might make technological investments to allow merchants to take advantage of routing provisions. Merchants will also consider whether to offer consumer discounts for use of particular payment methods.

Consumers. The impact on consumers will depend largely on steps taken by issuers, networks and merchants, as outlined above, and consumer behavior in response to these changes. Costs of banking services generally, and debit cards in particular, may increase, to the detriment of consumers. Merchants in highly competitive markets might pass on cost savings to consumers in the form of lower prices. And issuers and merchants might both take action to steer consumers to use one payment product over another. How consumers modify their behavior in response to these changes will affect the costs and benefits associated with the products and services they ultimately receive.

Legal challenges to the Federal Reserve's rule are possible.

While the Federal Reserve carefully balanced its final decisions within the constraints of the statutory language, few are pleased with the final rule. One bank sued the Federal Reserve even before the Federal Reserve's proposed rule was released, citing a number of constitutional claims.[34] Moreover, on the day the Federal Reserve announced the final rule, the Merchants Payments Coalition publicly announced its dissatisfaction with the result and the fact that it was looking at ways to "challenge" the rule.[35] It would appear from these comments the final battle over interchange has not yet been fought.

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33 *See* Mark D. Manuszak, Senior Economist, Division of Research and Statistics, Federal Reserve, Remarks at the Open Board Meeting of the Board of Governors of the Federal Reserve System (June 29, 2011), *video available at* http://bcove.me/hud5ew6j.

34 In October 2010, TCF National Bank sued the Board in the U.S. District Court for the District of South Dakota to prevent implementation of the Durbin Amendment, claiming that the Amendment unconstitutionally deprived the bank of substantive due process and equal protection. *See* Complaint at 47-51, *TCF Nat'l Bank v. Bernanke*, No. CIV 10-4149, 2010 WL 3960576 (D.S.D. Oct. 12, 2010). The District Court denied a preliminary injunction to TCF, ruling that the bank was unlikely to prevail on the merits of its constitutional challenges. *See TCF Nat'l Bank v. Bernanke*, No. CIV 10-4149, 2011 WL 1578535 (D.S.D. Apr. 25, 2011) (order denying motion to dismiss and denying preliminary injunction). After the Eighth Circuit Court of Appeals affirmed, *TCF Nat'l Bank v. Bernanke*, No. 11-1805, 2011 WL 2555696 (8th Cir. June 29, 2011), and the Board issued its final rule, TCF requested voluntary dismissal of the lawsuit. In a press release, TCF Chairman and CEO William Cooper said "While we continue to believe that the Durbin Amendment is unconstitutional because it requires below-cost pricing and exempts 99% of all U.S. banks, we believe our lawsuit has served its purpose in demonstrating the unfairness of the Durbin Amendment and that it is time for us to move on. The Federal Reserve's final rule is an improvement from its initial proposal and recognizes many of the points we made in our case."

35 George Zornick, *The Nation: You Swipe Card, Banks Swipe Cash*, NATIONAL PUBLIC RADIO (July 1, 2011), *available at* http://www.npr.org/2011/07/01/137547730/the-nation-you-swipe-card-banks-swipe-cash (quoting Mallory Duncan, Chair of the Merchants Payments Coalition).

ORDERLY LIQUIDATION AUTHORITY AND LIVING WILLS

BY ELISHA D. GRAFF AND JASON S. FRIEDMAN

The Orderly Liquidation Authority

Criteria for Being Subject to the Orderly Liquidation Authority

Title II of Dodd-Frank provides a new regime for restructuring and liquidating financial companies whose failure would pose a systemic risk to the United States' financial stability—so-called "covered financial companies" ("CFCs"). The framework of this new regime, the Orderly Liquidation Authority ("OLA"), incorporates much of the statutory and regulatory framework that exists for resolving insured depository institutions under the Federal Deposit Insurance Act ("FDIA"). Under Title II, subject to certain threshold requirements discussed below, the Federal Deposit Insurance Corporation ("FDIC") will be appointed as receiver for a failed or failing CFC, and will use the OLA framework for liquidating the distressed CFC (as discussed below, the OLA defines "liquidation" broadly, with such term including the possible sale of the CFC's assets or business to a private purchaser or a so-called "bridge financial company").

For all companies that are not CFCs, the Bankruptcy Code will remain the insolvency regime used for reorganization or liquidation. The OLA itself 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 financial company's default. As discussed below, the lack of bright line rules as to, among other things, what size financial company will be categorized as a CFC, what business activities will be deemed "financial in nature," and in which situations the OLA will be considered the preferable regime for resolving a CFC, leads to unpredictability regarding whether a company will be resolved under the OLA or the Bankruptcy Code.

Under Title II, CFCs include bank holding companies, nonbank financial companies supervised by the Board of Governors of the Federal Reserve System (the "Federal Reserve Board"), and other companies predominantly engaged in "activities that are financial in nature," as defined in Section 4(k) of the Bank Holding Company Act.[1] In practice, however, it may be difficult to predict whether a company will meet the criteria of a "nonbank financial company."

To assist with determining whether a company qualifies as a CFC,[2] Title II also establishes the Financial Stability Oversight Council (the "FSOC") which has broad authority to collect information from bank holding companies and nonbank financial companies. In the event that the FSOC determines that a nonbank financial company's material financial distress, or the nature and scope of its activities, could pose a systemic threat to U.S. financial stability, it can

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1 *See* Dodd-Frank § 102(a)(6). Section 4(k) of the Bank Holding Company Act includes an extensive list of activities designated as "financial in nature." *See* 12 U.S.C. § 1843(k).

2 The mere fact that an entity is a financial company does not mean that it is eligible to be placed into Title II federal receivership. To be eligible, the financial company must constitute a CFC (*i.e.*, a financial company which the applicable authorities have determined poses a "systemic risk"). As discussed below, the process for determining whether a particular financial company's distress or insolvency presents a systemic risk to U.S. financial stability begins with recommendations from the FDIC and the Federal Reserve Board (for a CFC other than a covered broker or dealer).

require such company to be supervised by, and registered with, the Federal Reserve Board. All supervised companies must comply with regulatory reporting and examination requirements, including the so-called "living will" requirement, as discussed in detail below.

Certain nonbank financial companies, wary of being caught up by Title II's broad definition of a CFC, have been lobbying regulators in an effort to establish that they are not systemically important, and thus should not be subject to the regulatory oversight and restrictions proposed by Dodd-Frank.[3] In particular, many insurance companies, hedge funds and mutual funds have argued that their failure will not pose a systemic risk to U.S. financial stability, and that they are not like the "big banks."

<u>The Process for Invoking the OLA</u>

Recommendations of the FDIC and the Federal Reserve Board

Title II of Dodd-Frank vests the power to invoke the new resolution authority with the Treasury Secretary, following a recommendation by the Federal Reserve Board and the FDIC (or the Federal Reserve Board and the SEC in the case of broker-dealers). On their own initiative, or at the request of the Treasury Secretary, the FDIC and the Federal Reserve Board must make a written recommendation regarding whether a failed or failing financial company presents a systemic risk and, thus, whether the Treasury Secretary should appoint the FDIC as receiver. Such recommendation is made upon a vote of no less than two-thirds of the then-serving members of the Federal Reserve Board and the board of directors of the FDIC (or, in the case of a covered broker or dealer, the members of the SEC then serving, and in consultation with the FDIC).[4]

To invoke the resolution authority, the Treasury Secretary must make a determination based upon a written recommendation that must contain, among other things, conclusions that:

- The company is a financial company and in default or danger of default;
- The company's failure and resolution under otherwise applicable federal or state law would have serious adverse effects on financial stability in the United States;[5]
- 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;

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3 *See* Eric Dash and Julie Creswell, *Too Big to Fail, or Too Trifling for Oversight?*, N.Y. TIMES, June 11, 2011.

4 This approval protocol has often been referred to as a "three-key" process because three approvals are required. By placing two of the keys in the hands of independent agencies, it is asserted that the trigger is insulated from the pressures of day-to-day political forces.

5 No financial company can be placed into receivership pursuant to Title II without an assessment of whether the Bankruptcy Code already provides an appropriate remedy. This requirement is important, as it forces consideration of alternatives under a longstanding and well-understood insolvency regime that affords a comprehensive mechanism for reorganizing a troubled entity, and that affords creditors and other stakeholders significant input into, and control over, the reorganization process—input and control that does not exist with respect to Title II receiverships.

- Applying the OLA 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.

Upon determining that the financial company meets these criteria, the Treasury Secretary, in consultation with the President of the United States, must seek the FDIC's appointment as receiver for the financial company. The Treasury Secretary initially pursues the receivership appointment confidentially and gives the financial company's officers and directors the opportunity to consent to such appointment.

Judicial Review of FDIC Appointments by the Treasury Secretary

In the absence of such consent, the Treasury Secretary must petition the U.S. District Court for the District of Columbia for an order authorizing the FDIC's appointment as receiver. The petition must be made under seal, and the district court must make a decision within 24 hours (or if no such decision is made, the petition will be deemed granted by operation of law). The district court must issue the order appointing the FDIC as receiver unless the district court concludes that the Treasury Secretary's determination was "arbitrary and capricious," a standard which is very deferential to the Treasury Secretary and effectively presumes the validity of the Treasury Secretary's determination.

Once the initial application 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—and the deferential "arbitrary and capricious" standard continues to apply even at these appellate levels. Since the district court's decision is not subject to any stay or injunction pending appeal, virtually any appellate review is likely to be effectively moot by the time it is heard.

Selected Core Features of Title II

Creating Bridge Financial Companies

To protect against asset value deterioration that may result if a CFC's assets cannot be disposed of immediately, and aide potential buyers in assessing asset values, the FDIC is empowered to create a so-called "bridge financial company" to succeed to selected assets and liabilities of the CFC.[6] A bridge financial company is a temporary creation designed to serve as a "bridge" to a permanent transaction with a private acquirer. To ensure a reasonably prompt transaction, a bridge financial company terminates two years after it is granted its charter (although the FDIC has the discretion to extend such status for up to three additional one-year periods). A bridge financial company can be created without notice to, or input or consent from, any creditors or shareholders of the CFC, and without the need to obtain court approval. The bridge financial company need not be funded with capital or surplus (though the aggregate amount of liabilities assumed by the bridge financial company may not exceed the aggregate amount of assets that

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[6] Once created, the bridge financial company will be managed by a board of directors appointed by the FDIC and it may follow the corporate governance rules of the State of Delaware or the state in which the applicable CFC is organized.

are transferred to it). During the bridge financial company's life, the FDIC is not subject to the discretion or supervision of any other governmental agency regarding the assets, liabilities and ultimate disposition of such bridge financial company.

Safe Harbors for Qualified Financial Contracts

Title II affords special protections to so-called "qualified financial contracts"[7] and the counterparties thereto. Similar to federal bankruptcy law, and subject to certain restrictions discussed below, Title II provides that no counterparty may be stayed or prohibited from exercising any right to terminate, liquidate or accelerate any qualified financial contract with a CFC which arises at any time after the FDIC is appointed as receiver.

Yet Title II also temporarily suspends *ipso facto* clauses and prohibits a party to a qualified financial contract from exercising 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 is appointed (*i.e.*, a one-day moratorium), or until after the counterparty receives notice that the contract was transferred pursuant to the OLA. By contrast, under the safe harbors of the Bankruptcy Code, the counterparty has the immediate right to terminate such a contract upon a bankruptcy filing. In addition, Title II provides that all "walkaway" clauses—which purport to eliminate any of the counterparty's payment obligations to the CFC upon the appointment of a receiver—are unenforceable.

By temporarily suspending *ipso facto* clauses (and temporarily staying the enforcement of termination, netting and setoff rights), Title II gives the FDIC time to repudiate the qualified financial contracts or transfer them to other institutions. However, the time during which the FDIC may do so is quite limited; counterparties may enforce their termination, netting or setoff rights after the contract has been transferred to another entity, such as a bridge financial company, or once the one-day moratorium expires. Thus, Title II provides CFCs (which may be party to numerous qualified financial contracts) with a brief "breathing spell" in which it can determine what action to take with respect to its qualified financial contracts.

As discussed below, these contracts as well as all of the CFC's other contracts, are subject to an "all or none" rule—in its capacity as receiver, the FDIC may repudiate all qualified financial contracts with a counterparty or none of them.

The Orderly Liquidation Fund and Risk-Based Assessments

Dodd-Frank was implemented, in part, as a response to the recent federal "bailouts" of financial companies that were deemed to be "too big to fail." As such, Title II specifically provides that no taxpayer funds can be used to prevent a CFC from failing, and taxpayers shall not bear any losses from a resolution of a CFC under the OLA. One means of paying for the expenses associated with an OLA resolution is for the FDIC to borrow from the Orderly Liquidation Fund (the "Fund"), a new and separate U.S. Treasury fund. The Fund will not be funded until a CFC is placed in FDIC receivership. Once the FDIC is appointed as receiver for a CFC, and

[7] "Qualified financial contracts" include swaps, options, futures, forwards, repurchase agreements and any other contracts described in 12 U.S.C. § 1821(e)(8)(D).

subject to limits prescribed in Title II, funds will be generated in the form of proceeds from the FDIC's issuance of obligations to the Treasury Secretary.

The FDIC is authorized to issue debt securities to the Treasury Department up to a maximum amount equal to:

- During the 30-day period immediately following the FDIC's appointment as receiver, 10% of the book value of the CFC's total consolidated assets; and

- After the 30-day period, 90% of the fair value of the CFC's total consolidated assets.

Before borrowing from the Fund, however, the FDIC must first develop a resolution plan, approved by the Treasury Secretary, which provides for the repayment of any obligations issued by the FDIC. This resolution plan will include having costs borne by those with interests in the CFC and by the CFC's assets.

In the event that these sources cannot cover the costs of a resolution under the OLA, the FDIC can impose "assessments," to the extent necessary to repay the Treasury all amounts owed within 60 months after the issuance date of the obligations. First, assessments will be made against claimants who received payments from the FDIC during the resolution in excess of payments that similarly situated creditors received. The recoupment from these claimants will be the difference in the amount the claimants received and the amount they would have been entitled to receive from the proceeds of the liquidation of the CFC. Second, if these creditor assessments are insufficient to repay Treasury funds, then bank holding companies with total consolidated assets in excess of $50 billion, nonbank financial companies supervised by the Federal Reserve Board and any other financial company with total consolidated assets of at least $50 billion may be subject to graduated "risk-based" assessments based upon such bank's or financial company's level of assets and risk, as determined by the FDIC.

<u>The Effects on Creditors: Key Distinctions between an OLA Resolution and a Chapter 11 Reorganization or Chapter 7 Liquidation</u>

In order to fully appreciate the potential impact that orderly liquidation of CFCs under the OLA might have on the restructuring landscape, it is important to highlight some of the key distinctions (both in policy and practice) between the OLA and Chapter 11.

Purpose

Title II's underlying purpose is to put the losses of, and responsibility for, failing financial companies on creditors, shareholders, and the financial companies themselves, so as to mitigate serious harm to the U.S. financial system and avoid taxpayer and FDIC loss.[8]

To this extent, Title II provides that all financial companies put into receivership must be "liquidated" and that taxpayers may not bear any losses from the exercise of the OLA. However, as noted above, Title II defines "liquidation" broadly and an OLA resolution can

8 Dodd-Frank § 204(a); 12 U.S.C. § 5384.

involve transferring a CFC's assets to a private purchaser or, in the interim, a bridge financial company.[9]

In addition, Title II requires that the management responsible for the CFC's financial condition not be retained and shall bear losses consistent with their responsibility, including paying damages, restitution and recoupment of compensation and other gains.

By contrast, the underlying purpose of the Bankruptcy Code is to maximize value available to creditors and to equitably distribute assets through liquidation (using Chapter 7), or to restructure and restore a debtor to financial solvency (through a Chapter 11 reorganization). Chapter 11 provides flexibility in implementing such restructurings, which can take the form of section 363 sales or standalone restructurings (in which existing creditors may restructure their debt and / or convert their pre-petition debt to equity in the reorganized debtor). Bankruptcy law is not concerned with systemic risk, but rather focuses on the relationships and outcomes for the debtors and creditors involved.[10]

Control Over the Process

The FDIC's control over the resolution process is subject to extremely limited court oversight.[11] In its capacity as receiver, the FDIC may operate the CFC with all the powers of its shareholders, directors and officers, and may conduct all aspects of the CFC's business. The FDIC may liquidate and wind up the CFC's affairs in any manner it deems appropriate, including by selling assets, transferring assets to a bridge financial company or exercising any other rights or privileges that it has been granted; in each case, the FDIC does not need to obtain any approval, assignment or consent from any stakeholder. In addition, only the FDIC can commence a liquidation proceeding; creditors cannot force a CFC into an OLA resolution.

By contrast, the typical Chapter 11 debtor remains in possession and in control of its day-to-day operations throughout the course of a Chapter 11 case. In a bankruptcy, there is comprehensive court oversight and notice procedures which are meant to facilitate stakeholder involvement in the case. A Chapter 11 case may be commenced voluntarily by the debtor or involuntarily by certain qualified creditors; however, such creditors typically may not initiate a case until the debtor is in default.

Speed of Process

Title II embraces speedy resolutions as one of its primary goals. As such, Title II gives the FDIC three days to transfer the CFC's assets (including qualified financial contracts) to a private party successor or bridge financial company. Title II also attempts to ensure faster resolutions by

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9 This outcome is similar to an auction and sale process under section 363 of the Bankruptcy Code, in which all or a portion of the debtor's assets or businesses may be marketed and sold to the highest and best bidder.

10 *See* Robert R. Bliss & George G. Kaufman, *U.S. Corporate and Bank Insolvency Regimes: A Comparison and Evaluation*, 2 VA. L. & BUS. REV. 143, 153–54 (2007).

11 The district court's principal role during the receivership is to review challenges to the receiver's determinations on allowance of claims and ensure adequate protection of secured creditors that are primed.

imposing a three year limit on the FDIC's appointment as receiver (subject to two one-year extensions).

The Bankruptcy Code does not contain such rigid requirements about the speed of disposition and transaction milestones. Generally, it places more of a premium on notice, due process, and fair process—all in the name of maximizing stakeholder involvement and recovery. Moreover, the adversarial process in bankruptcy court, the participation of various parties-in-interest, the ability to appeal, and the possibility of reorganization (as opposed to a hurried liquidation or sale) usually result in a slower process. Yet, restructurings and liquidations in bankruptcy proceedings can be implemented speedily; for example, certain assets of Lehman Brothers Holdings Inc. and certain of its affiliates ("Lehman") were sold to Barclays Capital ("Barclays") within three days of Lehman's bankruptcy filing and then approved by the bankruptcy court a few days later,[12] and the General Motors and Chrysler sales were each consummated in less than 45 days.

Treatment of Qualified Financial Contracts and Other Contracts

As noted above, both Chapter 11 and Title II incorporate safe harbors for qualified financial contracts, permitting counterparties to terminate, liquidate and / or net swaps without imposition of a stay. Under Title II, other than the one-day moratorium applicable to qualified financial contracts and the ban on "walkaway" clauses, there is no stay imposed on a counterparty's exercise of its contractual rights. The lack of a stay is a by-product of Title II's goal of speedy resolution, but can be harmful to creditors because it eliminates the window of time during which creditors can organize their claims without fear of assets being disposed of in the interim. In contrast, in a Chapter 11 case a counterparty's ability to terminate, liquidate and / or net a qualified financial contract is not subject to any moratorium, walkaway clauses are enforced, and there is an automatic stay applicable to all other contracts that continues for as long as the bankruptcy court deems necessary.

Assuming and Rejecting Contracts

Title II empowers the FDIC to disaffirm, repudiate or transfer contracts, regardless of whether or not the contract is "executory,"[13] subject to an "all or none" rule—the FDIC may either repudiate all contracts (including qualified financial contracts) with a given counterparty, or none of them. The Bankruptcy Code limits contract assumption and rejection to "executory" contracts, but allows the debtor to "cherry pick" contracts, electing to assume only beneficial contracts with a counterparty and reject all other contracts with that same counterparty.[14]

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[12] However, the adversarial nature of bankruptcy and the "vast judicial wrangling" over some of Lehman's other assets led to delays in paying out some claims. DAVID H. CARPENTER, CONG. RESEARCH SERV., R40928, LEHMAN BROTHERS AND INDYMAC: COMPARING RESOLUTION REGIMES 20 (2009).

[13] An "executory" contract is a contract between a debtor and another party under which both sides still have material unperformed obligations, i.e. if either side stopped performing it would be an actual breach of contract.

[14] An executory contract may not be assumed in part and rejected in part. The debtor must either assume the entire contract or reject the entire contract, shedding obligations as well as benefits. The

Claims Priority and Treatment of Secured Claims

Title II's ranking of the priority of claims is substantially similar to the priority scheme in the Bankruptcy Code, with two key differences. First, the FDIC's administrative expenses have first priority;[15] followed by all debts the CFC owes the United States. Second, unsecured claims for senior executives and directors' wages are junior to all debts—even subordinated debt—and senior only to equity. As under the Bankruptcy Code, Title II generally requires that all similarly situated creditors receive equal treatment; however, the FDIC can take any action it determines necessary to maximize the CFC's value, continue essential operations, and maximize return or minimize loss from disruption. This discretion to vary from the priority scheme injects a greater element of uncertainty in respect of creditor recoveries than under Chapter 11.

Secured claims are intended to remain unaffected under Title II. As under the Bankruptcy Code, to the extent the value of the collateral securing the claim is less than the amount of the claim, the claim is bifurcated into a secured and unsecured portion, with the unsecured portion being subject to the general priority scheme. The FDIC has three options for disposing of collateral:

- Voluntarily surrender the collateral to the secured creditor;
- Sell the collateral and attach the security interest to the sale proceeds (with the secured creditor having the right to credit bid); or
- Redeem the collateral from the lien by paying the creditor the fair market value of the property (up to the value of the lien) in cash.

Title II provides that, at minimum, creditors should receive no less than they would in a Chapter 7 liquidation or any similar provision of state insolvency law that might otherwise apply to the failing CFC.[16] The Council is still conducting a study on how secured claims "haircuts" of varying degrees could improve market discipline and protect taxpayers.

The OLA differs significantly from the Bankruptcy Code with regard to calculating and paying post-insolvency interest on a secured claim. First, under the OLA no post-insolvency interest may be paid until the FDIC has satisfied in full the principal amount of all claims, including unsecured claims. Second, if there are sufficient funds, post-insolvency interest is paid at a rate

Bankruptcy Code does not permit a debtor-in-possession to assume the benefits of the executory contract without incurring the related burdens.

15 In addition to statutorily mandated administrative expenses, Title II provides the FDIC with wide discretion to determine other expenses that are "necessary and appropriate to facilitate [a] smooth and orderly liquidation." These expenses may be incurred by the FDIC pre-failure, and may include costs for monitoring the CFC pre-failure, and reviewing the CFC's books and records in anticipation of failure. Including pre-failure expenses as administrative expenses is contrary to the Bankruptcy Code, under which administrative expenses are limited to actual and necessary costs of administering the case incurred post-petition.

16 *See* §§ 210(a)(7)(B), (d)(2)(B). A major industry concern is that Title II does not specify *who* will perform the Chapter 7 liquidation analysis and make the comparison to every proposed OLA distribution. *See infra* "Industry Concerns—The OLA as an Alternative to Chapter 11."

based on the coupon yield of the average discount rate set on the three-month U.S. Treasury bill. In contrast, post-insolvency interest under Chapter 7 is paid at the "legal rate" (although case law has not established a uniform rate of interest) and in Chapter 11, post-petition interest on a secured claim is allowed at the contract rate and is paid, with certain fees and expenses, up to the value of the secured creditor's collateral and prior to any unsecured claims distribution.

Setoff

Generally, the right of setoff is preserved under Title II, which permits creditors to offset certain qualified mutual debts between the CFC and the creditor. However, a creditor may be deprived of its right of setoff because the FDIC may transfer a CFC's assets free and clear of setoff rights under its umbrella power to take all "necessary actions" to maximize the CFC's value. This power was conferred upon the FDIC so it could preserve the CFC's going concern value by maximizing the return from asset disposition and transferring unencumbered assets to a bridge financial company.

To compensate creditors for losing their setoff right, the creditors are afforded a preferred recovery priority, immediately prior to all other general unsecured creditors. The FDIC believes this preferred treatment provides value to the setoff claimant roughly equivalent to the value it would have received under the Bankruptcy Code, where claims subject to a right of setoff are treated like secured claims. However, the FDIC has not yet determined how it will value the lost setoff right (whether on a dollar-for-dollar, or some other, basis).

Claims Administration

The FDIC has unilateral authority to allow or disallow claims. The FDIC is required to publish notice to provide creditors with an opportunity to file claims, and all proofs of claim not timely filed will be disallowed. Furthermore, the FDIC may object to any portion of any creditor's claim which is not proven to the FDIC's satisfaction. Claims will be disallowed if the FDIC fails to make a determination within 90 days (for a secured claim) or 180 days (for an unsecured claim) and the parties do not reach any agreement as to the allowed amount of such claims. If a claim is disallowed, the claimant can file suit to challenge the FDIC's determination in the U.S. District Court for the district in which the CFC is located. If the claimant does not file a suit within the prescribed timeframe, the claim will be disallowed on a final basis.

In contrast, under the Bankruptcy Code, filed claims are prima facie valid and allowed unless the debtor objects and the claimant is entitled to be heard in court on the allowance or disallowance of its claim.

The FDIC may, in its discretion and to the extent funds are available, pay creditor claims that are allowed on an ongoing basis; however, any such payments may be subject to claw-back or "assessment" (to pay for costs of liquidation) to the extent a creditor receives more than the liquidation value of its claim.

Case Funding

As discussed above, the FDIC can obtain funding through the Fund and, if necessary, through "assessments." If the FDIC creates a bridge financial company, such company may obtain financing from private lenders, and the rules governing such financing are virtually identical to the Bankruptcy Code's rules governing DIP financing.[17] For example, if the bridge financial company is unable to obtain unsecured credit, the FDIC may authorize it to issue debt with priority over all other obligations (super-administrative expense priority), with a lien on unencumbered assets or with a junior lien on encumbered assets. Also, the FDIC may authorize the bridge financial company to issue debt on a "priming" basis (*i.e.*, with first-priority security interests in property that is already encumbered by liens), subject to the lienholders being primed receiving "adequate protection."[18]

The Effect on Systemic/Covered Financial Companies: Living Wills

The Living Will Requirement

Under Dodd-Frank, every nonbank financial company supervised by the Federal Reserve Board and every bank holding company with assets of $50 billion or more must periodically present a plan for rapid and orderly resolution in the event of material financial distress or failure.[19] This resolution plan, known as the "living will," will then be presented to the Federal Reserve Board, the FDIC, and the FSOC. The FDIC considers the information included in a CFC's living will to be a vital element in its resolution planning because, among other things, it is assumed that such information will help regulators better understand a CFC's business and how the CFC may be resolved under Title II. A CFC may request confidential treatment of the often sensitive information submitted in its living will. Also, a living will is not binding on a bankruptcy court or on any receiver appointed pursuant to Title II.

Information Included in a Living Will

Background Information

The FDIC's current proposed rule provides for living wills to include the following background information:

- The manner and extent to which any insured depository institution affiliated with the CFC is adequately protected from risks arising from the activities of any nonbank subsidiaries;

- A full description of the CFC's ownership structure, assets, liabilities and contractual obligations;

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17 "DIP financing" refers to financing obtained by a debtor-in-possession. If unsecured or junior secured credit is not available, a debtor-in-possession may borrow funds on a priming basis so long as primed lienholders receive adequate protection. *See* 11 U.S.C. § 364.

18 The district court conducts a hearing to determine the sufficiency of the proposed adequate protection. Nevertheless, this is also an area of industry concern, as Title II lays down neither a valuation process—even though it is likely to give rise to significant litigation over valuation of the collateral security—nor what constitutes "adequate protection" for a primed creditor. *See* Harvey Miller and Maurice Horowitz, *One Way That Dodd-Frank's Liquidation Authority Could Achieve Parity with the Bankruptcy Code*, 1 HARV. BUS. L. REV. ONLINE 1, 3 (2010).

19 *See* Dodd-Frank § 165(d).

- Identification of any cross-guarantees tied to different securities;
- Identification of major counterparties;
- A process for determining to whom the CFC's collateral is pledged; and
- Any other information the FDIC and the Federal Reserve Board jointly require.

Strategic Analyses

Living wills must contain a strategic analysis of how the company can be resolved under the Bankruptcy Code in a way that would not pose systemic risk to the U.S. financial system. To this end, a CFC must map its business lines to material legal entities and provide integrated analyses of its corporate structure, funding, capital and cash flows, and its supporting information systems for core business lines and critical operations. Further, it has been suggested that the CFC include all domestic and foreign jurisdictions in which it operates, in order to produce a single, "master" living will.[20] The CFC will also be required to submit credit exposure reports.[21] Understandably, identifying the CFC's significant credit exposures for the regulators is critical to ongoing risk management and advance planning processes.

Timeliness, Updating, and Review

A CFC must submit its initial resolution plan within 180 days after the effective date of the final section 165 rules or the date on which the company becomes a CFC. If the CFC makes no other changes, it must submit an updated resolution plan no later than 90 days after the end of each calendar year. In addition, the CFC must file an updated resolution plan within 45 days of any event or change which has, or could reasonably be foreseen to have, a "material" effect on the resolution plan.[22]

A CFC's "material" changes include a significant acquisition, significant sale or divestiture, discontinuing business or dissipating assets, material reorganization, loss of a material servicing subsidiary or servicing contract, loss of a significant counterparty relationship or source of funding, transfer or relocation of 5% or more of the total consolidated domestic assets to a

[20] *See* MCKINSEY & COMPANY AND DAVIS POLK & WARDWELL LLP, CREDIBLE LIVING WILLS: THE FIRST GENERATION 7–8 (2011).

[21] These reports will include information on the CFC's aggregate credit exposure associated with all credit extensions, committed but undrawn lines of credit, deposits and money placements, repurchase agreements, reverse repurchase agreements, securities borrowing and lending, guarantees, investments, derivatives, and intra-day credit exposures along with any other type of transactions that result in credit exposure for the CFC.

[22] Certain industry professionals have suggested that such a short timeframe for submitting initial drafts and updates of living wills will not be feasible from the companies' perspective, and will not permit the FDIC sufficient time to review and digest the tens (if not hundreds) of complex, lengthy living wills it will receive at the same time.

location outside the United States, a 5% or more reduction in the market cap or book value, or the transfer, termination, suspension or revocation of any material license.[23]

The living wills are reviewed by the FDIC and Federal Reserve Board. If the FDIC or the Federal Reserve Board determines that a living will's resolution plan is not credible or is deficient, the CFC must remedy the deficiency or create a new living will. If the CFC does not remedy the deficiency within the prescribed time it will be submitted to more stringent capital, leverage and liquidity requirements, or restrictions on growth, activities or operations. These penalties for failing to propose an acceptable resolution plan may create an incentive for CFCs to rationalize their structures and operations that cannot easily be unwound.

Currently, most of the living will requirements are not finalized. The Federal Reserve Board and the FDIC have requested comments on the proposed rule implementing the requirements of section 165(d) of Dodd-Frank for resolution plans. Comments were due by June 10, 2011; it is therefore likely that this area will receive significant clarification in the near future. Dodd-Frank requires the Federal Reserve Board and the FDIC to jointly issue final rules implementing section 165(d) by January 21, 2012.

Industry Concerns – The OLA as an Alternative to Chapter 11

<u>Industry Concerns</u>

The financial industry has expressed several general concerns regarding the OLA process.

Uncertainty – When, and for Which Companies, Will the OLA Be Used?

First, it is difficult to predict how often, and to what extent, the OLA will be used—especially since Title II acknowledges that the Bankruptcy Code will govern most financial company restructurings, and the OLA will be used only as a last resort. This uncertainty makes it hard for creditors to determine when financial companies will be resolved by the FDIC under Title II as opposed to liquidated or reorganized in bankruptcy.[24] Therefore, creditors will need to pay close attention to developments that arise during the rulemaking process (and any final rules that result) and, ultimately, any resolutions under the OLA, to determine how, as a practical matter, Title II will be effectuated.

Protection of Creditors' Rights

Second, the fact that Title II's primary goal is not—and is not intended to be—the protection of creditors' rights and interests is of concern to the financial industry. Under Title II, creditors

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23 Certain commentators and industry professionals have noted that, especially for the less complex CFCs, some of the aforementioned material changes which act as interim update triggering events (for example, acquiring an additional bank, or a stock repurchase program that reduces the company's market cap by 5%) actually *reduce* the likelihood that the company will face financial distress—or at the very least have little to no impact on the company's viability. In their view, it is unclear why regulators have made these events trigger interim reporting even for smaller, less complex bank holding companies.

24 *See* Jamieson L. Hardee, *The Orderly Liquidation Authority: The Creditor's Perspective*, 15 N.C. BANKING INST. 259, 288 (2011).

lack the same degree of certainty with respect to their probable treatment in the OLA process as they have under Chapter 11. The question of how claim and asset valuation will be conducted under Title II is critical to reducing this uncertainty. It appears that the FDIC will make valuation determinations with almost no court oversight—and the details of how the FDIC will conduct such valuation process, such as by retaining financial advisors or valuation experts to assist in making its determinations, are not clear —and that creditors will be bound by the FDIC's determination of value.

Also, there is a concern that the FDIC's ability to determine the value of a secured claim and then bifurcate the claim into secured and unsecured portions, coupled with the FDIC's absolute discretion in disposing of assets, will deprive secured creditors of the right to be involved in developing and administering the sale process, as well as determining an acceptable sale price. Furthermore, the FDIC may favor certain creditors over similarly situated creditors or pay certain creditors before others, even without obtaining creditors' consent and court approval, leading to somewhat unpredictable claims treatment. While Title II guarantees creditors no less than the amount they would receive if the CFC were liquidated under Chapter 7, it is very difficult to state objectively what a creditor's probable recovery would be in a hypothetical Chapter 7.[25] Moreover, it is unclear who will make the comparison between recoveries under Title II and recoveries in a Chapter 7 liquidation, and who will prepare the liquidation analysis to demonstrate that the FDIC has met its burden.[26] If the final rules direct that independent third party arbiters will make such determinations, then Title II may achieve parity with the Bankruptcy Code with respect to creditors' guaranteed minimum recoveries; absent such clear rules there is a great risk to creditors in an OLA resolution.

Given the OLA's lesser focus on protection of creditors' rights, some commentators have suggested that a temporary reevaluation of lending strategies may be in order, and that creditors should look carefully at the riskiness of their loans, the type of credit instruments they hold, and the possibility that they are lending to a potential CFC. Creditors may also want to engage in such reevaluations to ensure that they avoid holding potential claims against a company that may end up in FDIC receivership and subject to the OLA process. While this reevaluation of lending strategies and practices may be necessary to protect creditors' interests, it may also have the effect of making it more difficult or more expensive for certain financial companies to obtain credit, because lending institutions may be warier of extending credit to them due to the potential risks involved if the financial company becomes distressed and is deemed to be a CFC.

Risks Relating to "Bridge Financial Companies"

Industry commentators and professionals have expressed concern that Title II offers little clarity regarding the consideration a bridge financial company will be required to pay in exchange for the assets transferred to it by the FDIC in its capacity as receiver. Such clarity is crucial for unsecured creditors whose liabilities are not assumed by the bridge financial company and who must rely on the proceeds of the transfer for distributions in respect of their claims. Moreover, there is no recourse for creditors who believe that the bridge financial company did not pay fair

25 *See* Miller & Horowitz, *supra* note 18, at 3.
26 *Id.*

value for the transferred assets. Also, a bridge financial company is authorized to issue debt with priming liens on the assets that it holds. Although adequate protection must be provided and a district court hearing is required, Title II does not define the nature of this process, which is likely to give rise to significant litigation over the collateral's value and what constitutes "adequate protection."

Other Industry Viewpoints

Title II Institutionalizes, Rather Than Eliminates, "Too Big To Fail"

Many commentators view the provisions of Title II as a net improvement over the Bankruptcy Code as a means for restructuring or liquidating failing CFCs.[27] However, even those who view Title II and the OLA process in a favorable light agree that this part of Dodd-Frank has its imperfections. For instance, although Title II removes shareholders' protection (beyond residual value after all creditors are paid in full), instead of eliminating the "too big to fail" doctrine, Title II actually institutionalizes it by permitting the protection of certain non-shareholder counterparties to qualified financial contracts, in effect offering a "bailout" to these counterparties.

Title II is Largely Consistent with the Bankruptcy Code

Other proponents of Title II assert that, while the terminology may be different, it is largely consistent with the basic principles of bankruptcy law. This assertion is strengthened by the fact that Title II's eligibility rules, minimal judicial involvement and consolidation of roles in a single governmental regulator derive from Title II's underlying premise that receivership should begin only when private solutions and ordinary judicial processes—including the Bankruptcy Code—have failed.[28]

The FDIC's Viewpoint – Lehman Resolved under Title II

Recently, the FDIC published an article examining how the government could have structured a resolution of Lehman if Title II had been enacted at the time, and how the results could have differed from the outcome in bankruptcy.[29] The report concludes that the FDIC's powers under Title II to act decisively to preserve asset value and structure a transaction to sell Lehman's valuable operations could have promoted systemic stability and would have generated a substantially greater recovery for creditors than the bankruptcy proceedings—at no cost to taxpayers.[30] The report further contends that the Lehman bankruptcy had an immediate and negative effect on U.S. financial stability and has proven to be a disorderly, time-consuming and expensive process. Lehman's default caused disruption in the derivatives market, with the

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27 See, e.g., Robert Bliss and George Kaufman, Resolving Insolvent Large Complex Financial Institutions: A Better Way, 128 THE BANKING L.J. 339, 341 (2011).

28 Of course, the distinctions between Title II and Chapter 11 described above and the industry concerns relating to Title II's apparent failure to offer the same level of creditor protections as Chapter 11 underscore that Title II is inconsistent with Chapter 11 in several important respects.

29 The Orderly Liquidation Of Lehman Brothers Holdings Inc. Under the Dodd-Frank Act, FDIC QUARTERLY, Volume 5, No. 2 (2011).

30 Id. at 18.

rapid, market-wide unwinding of trading positions under these contracts not subject to the automatic stay—which supposedly could not have happened if Title II's one-day moratorium for terminating, liquidating and closing out qualified financial contracts (such as swaps) had been in effect.

The FDIC report also identifies five of what it considers the most important elements of authority available to the FDIC as receiver under Dodd-Frank:

- Advance resolution planning: The FDIC's ability to conduct advance resolution planning for systemically important financial institutions (e.g., living wills). According to the report, such advance planning provides an advantage over bankruptcy proceedings, which are challenging for systemically important financial companies because parties-in-interest have little or no notice or opportunity for advance preparation. Likewise, the bankruptcy court itself may have little or no knowledge about the systemically important financial company, and would have to rely on management for such information.

- Funding: The immediate source of funding for an OLA liquidation—i.e., the Fund. Under Chapter 11, there is no guarantee that a debtor will be able to obtain, or that the bankruptcy court will approve, DIP financing.

- Dividends: The FDIC's ability to make advance dividends and prompt distributions to creditors based upon expected recoveries, which is not a right or power granted to a debtor-in-possession under the Bankruptcy Code.

- Continuing operations: The FDIC's ability to continue systemically important operations by forming a bridge financial company, among other means.

- Avoiding contract termination: The FDIC's ability to transfer all qualified financial contracts with a given counterparty to another entity (including a bridge financial company) and avoid the contracts' immediate termination and liquidation—which preserves asset value and promotes financial stability generally.

Referring to these key elements, the FDIC report sets out a roadmap for how Lehman's OLA resolution would have been prepared and implemented. First, the FDIC and Federal Reserve could have reviewed resolution plans for Lehman and other systemically important financial institutions in the wake of the Bear Stearns collapse. In addition, during this examination / due diligence exercise the FDIC could have identified problem asset pools. The report asserts that having regulators involved and informed in preparation for Lehman's resolution would have been very beneficial; armed with this knowledge, the FDIC could have structured bids to help deal with the problem assets. Furthermore, Lehman's management disavowed financial distress until immediately before the bankruptcy filing, and there was also a prevailing belief that the federal government would step in and rescue Lehman. Had Dodd-Frank been enacted, Lehman's management would have understood that they would not receive a government bailout. Lehman's management could have aggressively marketed the company pre-failure, which in turn would help ensure that an OLA resolution of Lehman would truly be a last resort.

The report continues that, under the OLA process, at the time the FDIC would have placed Lehman into receivership, Lehman's assets and liabilities would have been transferred to Barclays immediately upon submitting the winning bid. Barclays would then have seamlessly maintained Lehman's key operations, and disruptions to the market would have been minimal. The FDIC postulates that, taking Lehman's book equity and subordinated debt of $35 billion and problem assets of $50-70 billion, assuming a $40 billion loss on these assets, the sale to Barclays would have generated enough value to pay senior creditors in full less $5 billion, for an approximate 97-cent recovery—significantly more than creditors are expected to receive under Lehman's Chapter 11 plan.

Industry Suggestions – Alternatives to Title II as Proposed

In response to concerns regarding the ambiguities in Title II's current form (including uncertainty regarding treatment of secured claims), the FDIC's role as receiver, and the lack of oversight over the FDIC, some commentators have suggested creating a regime for resolving nonbank financial companies by aggregating appropriate provisions of the FDIA, Bankruptcy Code and Title II. Some commentators have suggested that the optimal result would be a hybrid or modified Chapter 11 restructuring regime. In this hybrid regime, the regulators (who may not necessarily be the FDIC) would have legal standing in the bankruptcy case and, using powers similar to those made available by Title II and the FDIA, could act quickly to put a troubled CFC into administration, receivership, conservatorship or liquidation. In addition, these actions would be subject to limited, speedy judicial oversight and final approval.[31] The proposed structure reins in the FDIC's absolute discretion by providing for enhanced court oversight and independent experts or special masters.

Along the same lines, other commentators have proposed creating a new Bankruptcy Code chapter—Chapter 14—as an alternative to Title II and the OLA.[32] These commentators assert that by tweaking some of the general bankruptcy principles, the Bankruptcy Code could deal with reorganizing or liquidating CFCs just as effectively as the OLA, while respecting the bedrock bankruptcy principles of equality of distribution and creditor protection. These "tweaks" include providing the FDIC with standing and greater involvement in the case, providing for more creditor participation and court oversight, and expressly authorizing the court to consider "public interest" as an applicable factor when reviewing a CFC's key restructuring decisions. In addition, proposed Chapter 14 would allow a CFC's primary regulator to file an involuntary petition, commencing a Chapter 7 or 11 without the debtor's consent. This view declares Chapter 14 to be the 21st century's "railroad bankruptcy" equivalent.

Lastly, a number of commentators contend that a more desirable means of addressing failing CFCs is to simply amend the Bankruptcy Code by incorporating certain powers and processes available under Title II without embedding all of Title II's provisions in the Bankruptcy Code. This approach relies on the similarities between Title II and the Bankruptcy Code, and may be somewhat easier to implement than the hybrid regime described above.

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31 See, e.g., Bliss and Kaufman, supra note 10.

32 See Bankruptcy Code Chapter 14: A Proposal, Hoover Institution, Stanford University, Resolution Project Publications (April 2011), http://media.hoover.org/documents/Resolution-Group-Bankruptcy-Code-Chapter%2014-Proposal-20110421.pdf.

Industry Concern – Living Wills

Which Institutions Should be Exempt?

Similar to the concerns over being designated as CFCs, some financial entities—such as insurance companies and money funds—claim that they should be exempt from the living will requirement as well, because they are already subject to other "prudential" oversight and insolvency regimes. Similarly, foreign banks with discrete U.S. operations claim that they should be exempt because they comply with "internationally recognized practices for prudential supervision" within their home jurisdictions.[33] In addition, a number of financial industry groups have asserted that it is important to distinguish even among bank holding companies with over $50 billion in assets. These groups contend that there needs to be a clear process to distinguish between "barely systemic" institutions and financial institutions that truly raise "too big to fail" concerns. To this end, a consortium of financial institutions has proposed a tailored living will requirement for smaller, less complex domestic bank holding companies predominantly composed of one or more insured depository institutions. Moreover, the consortium asserts that the requirement to constantly update the living will imposes substantial burdens on companies that are not especially large and / or complex.

What Will the First Generation of Living Wills Look Like and How Effective Will They Be?

Certain commentators have noted that there is a good deal of uncertainty as to the format, content and general effectiveness of the first generation of living wills that will be prepared and submitted under Dodd-Frank. Resolution planning for complex companies has never been attempted and is a very difficult task. Accordingly, living wills may evolve over time and may become more useful tools for oversight and possible resolution of troubled CFCs as they go through multiple iterations and become better developed and focused.

Confidentiality and Disclosure

Many commentators have suggested that regulators must be sensitive to confidentiality concerns, given the nature and volume of sensitive and competitive information that will be required by the living wills. In this vein, some financial companies are seeking a "bank examination" or similar status for the resolution plans, so that they will not need to be publicly disclosed under any financial disclosure law or requirement. Resolution plans will also raise complex issues regarding the timing of any disclosure under securities laws; companies may decide that under controlling securities laws they are required to disclose the outlines of their resolution plans or the occurrence of any events under the plan.

Rulemaking Activity

At this point in time, the Federal Reserve Board, in consultation with the Administrative Office of the U.S. Courts, is required to conduct a study on the following:

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[33] *See, e.g.*, Financial Stability Oversight Council, Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 12 C.F.R. Part 1310 (2011).

- The effectiveness of Chapter 7 and Chapter 11 of the Bankruptcy Code in facilitating the orderly resolution or reorganization of systemically important financial companies;

- Whether regulators should establish a special financial resolution court (or panel of special masters or judges) to oversee cases involving CFCs, in order to resolve CFCs under the Bankruptcy Code in a manner that minimizes adverse impacts on financial markets without creating "moral hazard";

- Whether amendments should be made to the Bankruptcy Code itself (that is, without establishing a new financial resolution authority) that will enhance the Code's ability to resolve financial companies in a manner that minimizes adverse impacts on financial markets without creating "moral hazard";

- Whether the Bankruptcy Code, the FDIA, and other insolvency laws should be amended to address the manner in which a CFC's qualified financial contracts are treated; and

- The implications, challenges, and benefits of creating a new chapter or subchapter of the Bankruptcy Code to deal with CFCs.

On July 6, 2011, the FDIC adopted a final rule adopting with certain changes the proposed rules and the interim final rules previously issued by the board of directors of the FDIC. Certain key recommended changes in the final rule that are relevant to the treatment of secured creditors under Title II include the following:

- Secured creditors' collateral will be valued at the time of the proposed use or disposition of the property by the receiver, as opposed to the date of the appointment of the receiver; this approach to the timing of valuation of collateral more closely follows the Bankruptcy Code; and

- Secured creditors may request the consent of the receiver to obtain possession of their collateral, with the receiver to provide such consent unless it decides to use, sell or lease the collateral itself, in which event the receiver must provide adequate protection to the secured creditor.

Importantly, the recommendations would not change the method of calculating post-insolvency interest, which would continue to be based on the discount rate set on the three-month Treasury bill, as opposed to the "legal" rate or the "contract" rate as provided under the Bankruptcy Code.

As discussed above, the FDIC's deadline for industry comments on the living will ended very recently, and there is still a great deal of uncertainty as to what companies will be required to include in their living wills and the frequency with which a company will have to update its living will and provide regulators with the updated version.

Conclusion

Because of non-finalized rulemaking, there remains a great deal of uncertainty, especially regarding the manner and extent to which the OLA process will be used, and to what degree the OLA will replace the Bankruptcy Code as the vehicle for restructuring complex and systemically important financial companies. While commentators have expressed some wariness over the effectiveness of Title II and its impact on creditors' rights, the true import of Title II will likely not be known until a critical number of CFCs have been resolved under Title II, at which point an informed comparison can be made between resolution under Title II and reorganization under the Bankruptcy Code, both from the company and creditor perspectives. In addition, while the key elements of a living will are relatively finalized, there remains uncertainty as to what type of financial institution will be required to provide a living will, what information must be included in the first generation of living wills, whether submitting a living will triggers some form of financial disclosure requirement, and, of course, whether living wills will actually prove to be useful restructuring tools for CFCs in distress.

LITIGATION AND ENFORCEMENT IMPLICATIONS OF DODD-FRANK

BY MARK J. STEIN, ALAN C. TURNER AND NICHOLAS S. GOLDIN

Although the full impact of Dodd-Frank on securities litigation and regulatory enforcement remains to be seen, the legislation includes several provisions that are certain to shape these areas for the foreseeable future.

Subprime-Related Litigation Has Straddled Dodd-Frank

As it did before Dodd-Frank was enacted, the subprime mortgage meltdown continues to spawn a wide array of regulatory investigations and enforcement actions. On the enforcement front, the Securities and Exchange Commission ("SEC") has reached several large mortgage-related settlements, including the recent $200 million settlement in which Morgan Keegan resolved allegations that it fraudulently inflated subprime mortgage-backed securities. And last year, Goldman Sachs paid $550 million to settle allegations by the SEC concerning the marketing of CDOs.

Private plaintiffs have also filed many lawsuits concerning mortgage-related activities. Simpson Thacher currently represents banks and other financial institutions in more than a dozen residential mortgage-backed security ("RMBS") cases pending in state and federal courts across the country. The plaintiffs in these cases have brought claims under state and federal securities laws involving tens of billions of dollars worth of RMBS, alleging that the offering documents contained material misstatements and omissions regarding: (1) the mortgage lending standards used to underwrite the collateral supporting the securities; (2) the credit ratings assigned to various classes of the securities; and (3) the appraisals conducted on the mortgaged properties underlying the securities. Most of these cases are still in their initial stages.

On behalf of its clients, Simpson Thacher has obtained orders dismissing claims in a number of these cases based on (1) lack of standing to bring class-action claims relating to offerings in which the plaintiffs did not purchase RMBS; (2) the non-actionable "opinion" nature of credit ratings; and (3) failure to tie appraisal and loan underwriting guideline allegations to the specific mortgages supporting the RMBS at issue.

In the first RMBS putative class action to reach the class certification stage, Simpson Thacher also successfully opposed a motion for class certification, convincing the court that the proposed class failed to meet the predominance and superiority requirements of Federal Rule of Civil Procedure 23(b)(3). Simpson Thacher is representing the defendants in an appeal by the plaintiffs to the United States Court of Appeals for the Second Circuit.

One issue to watch on the litigation front is how the courts will interpret Dodd-Frank's answer to Morrison v. National Australia Bank Ltd, 130 S. Ct. 2869 (2010), a decision handed down by the Supreme Court shortly before Dodd-Frank was enacted. In short, Morrison held that Section 10(b) of the Securities Exchange Act of 1934 does not apply to so-called "F-cubed" securities transactions, which are transactions in which the investor, issuer, and exchange are all foreign. Section 929P(b) of Dodd-Frank conferred jurisdiction in the federal courts over securities cases brought by the SEC involving "conduct occurring outside the United States that has a foreseeable substantial effect within the United States."[1] The impact of this provision, however, remains to be seen as its language is interpreted by the courts.

The Sweeping Whistleblower Program Tucked Inside Dodd-Frank

The sections of Dodd-Frank that have been receiving increasing attention among compliance professionals are Sections 922 and 748, which contain this country's most sweeping whistleblower program. These sections were in part a response to a perceived reluctance among individuals to notify regulators about potential financial misconduct. As early as September 2009, reflecting on the Bernard Madoff case, the SEC's inspector general recommended that the SEC find ways to encourage whistleblowers to come forward, including by rewarding individuals who report public information.

Dodd-Frank's whistleblower provisions, which amended both the Securities Exchange Act of 1934 and the Commodity Exchange Act, offer potentially enormous financial bounties to individuals who share information with the SEC or the Commodity Futures Trading Commission ("CFTC") concerning any misconduct that falls within the jurisdiction of these agencies.

The Dodd-Frank whistleblower provisions contemplate the SEC and / or CFTC providing cash rewards for original information where such information leads to a judicial or administrative action that results in monetary sanctions exceeding $1 million. Under these provisions, whistleblowers are eligible to receive between 10 and 30 percent of any penalty recovered in such judicial or administrative action. A key condition, however, is that the tip must be "derived from the independent knowledge or analysis of the whistleblower" and was not known to the government from any other source. The SEC and CFTC have discretion to decide the exact amount of the award based on the "significance" of the information and the level of assistance provided by the whistleblower. Because the "significance" of the information in part drives the amount of the reward, Dodd-Frank incentivizes disclosure of information about the most serious misconduct. Dodd-Frank enables whistleblowers to report misconduct under the cloak of anonymity by reporting tips through their lawyers and not disclosing their identities unless and until they claim an award.

On May 25, 2011, the SEC adopted its final rules to implement the Dodd-Frank whistleblower program. The new rules, which go into effect on August 12, 2011, resolve a number of issues that had been left in suspense pending the final SEC action. For example, Dodd-Frank extended eligibility for whistleblower rewards to a broad class of people. However, in response to concerns voiced by corporations and others during the rulemaking process, the final rules exclude certain individuals from receiving awards, including:

- Officers, directors, trustees or partners of an entity, when those individuals learned of information about the misconduct in question from another person or in connection with the company's processes for identifying potential illegal conduct.

[1] Pub. L. No. 111-203, § 929P(b), 124 Stat. 1376, 1864–65.

- Employees whose main job functions involve compliance or internal audit, or persons who are employed by a firm hired to (a) perform audit or compliance functions or (b) investigate possible violations of the law.

- Employees of public accounting firms performing an engagement required by the securities laws, when the information relates to a violation by the client or the client's officers, directors or employees.

There are two important limitations to these exclusions in the final rules:

- These individuals are still eligible for reward under Dodd-Frank if they have a reasonable belief that disclosure to the SEC is necessary to prevent the company from engaging in conduct that could cause substantial injury to investors, or if they have a reasonable belief that the company is acting in a way that would interfere with an investigation of the misconduct.

- These individuals are eligible to report information as whistleblowers if 120 days have passed since they brought the information to their company's audit committee, legal / compliance officer or supervisor, or if 120 days have passed since they received the information and the circumstances indicate that the audit committee, legal / compliance officer or supervisor was already aware of the information.

Despite a chorus of requests from companies that the SEC adopt rules requiring employees to report problems internally to management before qualifying for rewards under Dodd-Frank, the final rules do not require internal whistleblowing. Nonetheless, the rules do try to encourage internal reporting in several ways:

- Under the rules, a whistleblower who reports wrongdoing to the SEC within 120 days of lodging a complaint through internal corporate channels will be considered to have provided the information to the SEC as of the date of the original internal disclosure.

- If a whistleblower reports original information internally before or at the same time that the whistleblower reports it to the SEC, and the company later discloses to the SEC the whistleblower's information or the results of an investigation initiated by the whistleblower's information, and this information leads to a successful enforcement action, the whistleblower will receive full credit for the information provided by the company and will be eligible for a reward (even if the information the whistleblower originally provided to the company would not have led, by itself, to a successful enforcement action).

- When deciding whether to increase the amount of a whistleblower's reward, the SEC will consider whether the tipster reported through internal compliance channels and assisted in any internal corporate investigation. Similarly, in reducing the amount of a reward, the SEC will consider whether the whistleblower interfered with internal reporting systems or made any false statements that hindered any investigation.

Dodd-Frank's whistleblower program has already imposed new challenges for companies that identify wrongdoing within their ranks and that wish to position themselves for leniency in the resolution of the issues with regulators. In announcing the new rules, the SEC chairwoman Mary Schapiro reported that Dodd-Frank's whistleblower provisions had already had a noticeable impact because "the quality of the tips we have received has been better" since Dodd-Frank was enacted last summer. Indeed, Chairwoman Schapiro added that she had "heard stories from our investigators about how whistleblowers have saved us weeks of investigation time because of the specific, credible and timely information they provided."

Beyond enhancing internal compliance measures designed to identify misconduct, these new rules make it more important than ever for companies to promptly investigate all claims of wrongdoing and reinvigorate their internal whistleblower procedures. In this way, companies can maximize the opportunity, after remediating any problems, to self-report to regulators—before a Dodd-Frank whistleblower gets to the government first.

Dodd-Frank's Measures to Curtail Perceived Abusive Mortgage Lending Practices

Given that Dodd-Frank was a response to the subprime mortgage meltdown and resulting financial crisis, it is not surprising that Congress included several provisions designed to curtail perceived abuses in the mortgage lending industry. For example, Section 1411 addresses so-called "liar loans" – or loans involving borrowers who represent their income and assets without sufficient proof. The "ability to pay" provision in Section 1411 requires residential mortgage lenders to make "a reasonable and good faith determination based on verified and documented information that . . . the consumer has a reasonable ability to repay the loan." Section 1412 includes a safe harbor provision that permits lenders to presume a borrower's ability to pay where certain conditions are met, including where the total points and fees do not exceed three percent.

Another provision in Dodd-Frank aimed at reducing perceived misconduct in the mortgage industry is the "anti-steering" provision, which seeks to reduce the incentive of mortgage originators to push loans with terms that are inappropriate for a particular borrower. Section 1403 prohibits mortgage officers and brokers from receiving compensation that varies based on the terms of a mortgage, other than the amount of the principal. The penalties for violating this provision include the greater of actual damages or three times the direct and indirect gain from the violation, plus costs and attorney's fees. Borrowers may assert a violation of the anti-steering and ability to pay provisions as a defense in foreclosure proceedings.

In addition to these rules governing the mortgage lending industry, Dodd-Frank includes restrictions on issuers of asset-backed securities. Section 941 is the so-called "skin in the game" provision. It directs regulators to require issuers of these products to retain a material portion of the credit risk of the underlying assets. As the Senate Banking Committee explained: "When securitizers retain a material amount of risk, they have 'skin in the game,' aligning their economic interests with those of investors in asset-backed securities. Securitizers who retain risk have a strong incentive to monitor the quality of the assets they purchase from originators, package into securities, and sell."

SIMPSON THACHER

KEY DEVELOPMENTS ON THE EXECUTIVE COMPENSATION FRONT

BY ANDREA K. WAHLQUIST AND MARK CHORAZAK

Over the past year, there have been a number of rulemaking developments under Dodd-Frank relating to executive compensation matters. Below is a high-level summary of certain key developments that are of relevance to the financial services community.

Prohibition on Certain Compensation Practices at Covered Financial Institutions

Section 956 of Dodd-Frank requires that the major banking and financial regulators jointly issue regulations or guidelines that prohibit incentive-based payment arrangements (or any features of such arrangements) that encourage inappropriate risks by a financial institution by providing "excessive" compensation or that could lead to a "material financial loss" to the institution.

On April 14, 2011, seven U.S. federal financial regulators, including the Federal Reserve and the SEC, published proposed rules—not mere guidelines—governing incentive-based compensation arrangements at major financial institutions, including new reporting requirements and prohibitions on compensation arrangements that are excessive in nature or that could expose such institutions to material financial loss.[1] In the case of financial institutions that have $50 billion or more in consolidated assets, at least 50% of incentive-based compensation payable to the executive officers of such institutions must be deferred for a period of no less than three years, with the deferred amount subject to a look-back review based on actual losses or other performance measures that become better known during the deferral period. The rules are intended to supplement, rather than replace, existing rules and guidance adopted by these regulators regarding compensation practices.[2]

<u>Scope</u>

"Covered Financial Institutions"

The proposed rules apply to a range of "covered financial institutions" that have, on a consolidated basis, assets of $1 billion or more. Below is a list of selected institutions that will be covered by the rules, along with information regarding the method by which the relevant regulators will calculate total consolidated assets:

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1 *See* Proposed Rule Regarding Incentive-Based Compensation Arrangements, Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, National Credit Union Administration, Securities and Exchange Commission and Federal Housing Finance Agency, Final Rule Regarding Rules Implementing Amendments to the Investment Advisers Act of 1940, Securities and Exchange Commission, 76 Fed. Reg. 21170 (Apr. 14, 2011).

2 These rules and guidance include the Guidance on Sound Incentive Compensation Policies (75 Fed. Reg. 36935 (June 25, 2010)), which was adopted by the federal banking regulators last year; the Standards for Safety and Soundness (60 Fed. Reg. 35678 (July 10, 1995), as amended at 61 Fed. Reg. 43950 (Aug. 27, 1996)); and the compensation-related disclosure requirements adopted by the SEC for public companies (*see, e.g.*, Item 402(s) of Regulation S-K, 17 C.F.R. § 229.402(s), adopted in Securities Act Release No. 9080, 74 Fed. Reg. 68334 (Dec. 23, 2009)).

Selected Covered Financial Institutions and Asset Calculation Method		
Regulator	Covered Financial Institution	Total Consolidated Assets
Federal Reserve	bank holding company	average of total assets reported in the four most recent Consolidated Financial Statements for Bank Holding Companies (FR Y-9C)
	thrift holding company	average of total assets reported in the four most recent Thrift Financial Reports
	state member bank	average of total assets reported in the four most recent Call Reports
	state-licensed uninsured foreign bank or agency	average of total assets reported in the four most recent Reports of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks
	U.S. operations of a foreign bank	as determined by the Federal Reserve
OCC	national bank	average of total assets reported in the four most recent Call Reports
	federally-chartered thrift	average of total assets reported in the four most recent Thrift Financial Reports
	federal branch or agency of a foreign bank	average of total assets reported in the four most recent Reports of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks
FDIC	state nonmember bank	average of total assets reported in the four most recent Call Reports
	state-chartered thrift	average of total assets reported in the four most recent Thrift Financial Reports
	insured U.S. branch of foreign bank	average of total assets reported in the four most recent Reports of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks
SEC	broker-dealer registered under Section 15 of the Securities Exchange Act	total consolidated assets reported in most recent year end audited Consolidated State of Financial Condition filed pursuant to Rule 17a-5 of the Securities Exchange Act
	investment adviser (registered or unregistered), as defined in Section 202(a)(11) of the Investment Advisers Act	total assets shown on the balance sheet for most recent fiscal year end[3]

[3] The proposed method of calculation for investment advisers is consistent with the SEC's new requirement that each investment adviser filing Form ADV Part 1A indicate whether the adviser had $1 billion or more in "assets," defined as the total assets shown on the balance sheet for the adviser's most recent fiscal year end. *See* 76 Fed. Reg. 21176 (Apr. 14, 2011). Based on the instructions to the revised Form ADV, the term "assets" refers to "total assets, rather than the assets . . . manage[d] on behalf of clients." Final Rule Regarding Rules Implementing Amendments to the Investment Advisers Act of 1940, Securities and Exchange Commission, 76 Fed. Reg. 43029 (July 19, 2011).

Significantly, it is not clear from the proposed rules whether regulators will evaluate all entities within a financial institution on a group-wide basis or whether each entity that has at least $1 billion of total consolidated assets will be subject to the incentive-based compensation rules of its applicable regulator. This distinction will be critical for financial institutions in understanding the full scope of their compliance obligations.

"Covered Persons"

Only incentive-based compensation paid by covered financial institutions to "covered persons" would be subject to the requirements of the proposed rules. The term "covered person" includes any executive officer, employee, director, or principal shareholder (i.e., any individual that directly or indirectly, or acting in concert through one or more persons, owns or controls 10% or more of any class of voting securities) of a covered financial institution. An "executive officer" is defined broadly to include any person who holds the title of (or, without such title, performs the duties of) one the following positions: president, chief executive officer, executive chairman, chief operating officer, chief financial officer, chief investment officer, chief lending officer, chief legal officer, chief risk officer, or the head of a major business line.

"Incentive-Based Compensation"

Incentive-based compensation means "any variable compensation that serves as an incentive for performance." The definition of "compensation" covers all direct and indirect payments, fees or benefits, both cash and non-cash (including equity-based compensation), awarded or granted to, or earned by or for the benefit of, any covered person in exchange for services rendered to the covered financial institution. Examples of compensation included in the definition are: payments or benefits pursuant to an employment contract, compensation or benefit arrangement, fee arrangement, perquisites, stock option plan, post-employment benefit or "other compensatory arrangement."

Compensation that is specifically excluded from these rules is, generally: compensation awarded solely for, and the payment of which is solely tied to, continued employment (e.g., salary); compensation that provides rewards solely for activities or behaviors that do not involve risk-taking (e.g., payments for achieving or maintaining professional certification); and compensation based solely on the employee's level of fixed compensation that does not vary based on performance metrics (e.g., employer contributions to a 401(k) plan based on a fixed percentage of the employee's salary).

Prohibition on "Excessive" Compensation Arrangements and Those Arrangements That May Lead to "Material Financial Loss"

The proposed rules prohibit a covered financial institution from establishing or maintaining incentive-based compensation arrangements that encourage inappropriate risk-taking by providing excessive compensation or that could otherwise lead to a material financial loss to the covered financial institution.

“Excessive” Compensation

Under the proposed rules, a covered financial institution is prohibited from establishing or maintaining incentive-based compensation arrangements, or any individual features of such arrangements, that encourage a covered person to expose a covered financial institution to inappropriate risks by providing that person with excessive compensation.

Compensation will be considered “excessive” when amounts paid are unreasonable or disproportionate to, among other things, the amount, nature, quality, and scope of services performed by the covered person. The relevant regulators are to assess whether compensation is excessive using the following standards, which are part of the “safety and soundness” compensation standards contained in Section 39 of the Federal Deposit Insurance Act:

- the combined value of all cash and non-cash benefits provided to the covered person;
- the compensation history of the covered person and other individuals with comparable expertise at the covered financial institution;
- the financial condition of the institution;
- comparable compensation practices at peer institutions, based upon such factors as asset size, geographic location, and the complexity of the institution’s operations and assets;
- the projected total costs and benefit to the covered financial institution, with regard to post-employment benefits;
- any connection between the individual and any fraudulent acts or omissions, fiduciary duty or trust breaches, or insider abuse with regard to the covered financial institution; and
- any other factors that the applicable regulator considers to be important.

Incentive-Based Compensation Arrangements and the Prospect for “Material Financial Loss” at the Covered Financial Institution

The proposed rules also ban incentive-based compensation arrangements for individual covered persons, or groups of covered persons, whose particular activities may expose the covered financial institution to “inappropriate risks that could lead to a material financial loss.”[4] The types of covered persons contemplated by this portion of the rules are: (i) executive officers and other persons who are responsible for oversight of firm-wide activities or material business lines; (ii) other individual covered persons, including non-executive employees, based on the nature of their activities (such as traders with large position limits relative to the institution’s overall risk tolerance); and (iii) groups of covered persons who are subject to the same or similar incentive-based compensation arrangements and who, in the aggregate, could expose the institution to a material financial loss, even if no individual covered person in the group could

[4] The proposed rules do not define “material financial loss.”

expose the institution to such loss (such as loan officers who, as group, originate loans that account for a material amount of the institution's credit risk).

An incentive-based compensation arrangement will not be compliant with the rules unless it (i) balances risk and financial rewards, (ii) is compatible with effective controls and risk management, and (iii) is supported by strong corporate governance. Covered financial institutions will be required to establish and maintain policies and procedures related to these standards, as described in more detail below.

Balance of Risks and Rewards

A central theme underlying the proposed rules is that of balance. Incentive-based compensation arrangements must balance risk and financial rewards in such a way that covered persons lack incentives to take excessive risks that could lead to a material financial loss at the covered financial institution. The proposed rules state specifically that an incentive-based compensation arrangement will be deemed "balanced" when the amounts paid to a covered person appropriately take into account the risks, as well as the financial benefits, from the covered person's activities and the impact of those activities on the institution. In this regard, regulators will consider a full range of risks associated with a covered person's activities (including credit, market, liquidity, operational, legal, compliance and reputational risks), as well as the time horizon over which those risks may be realized.

The proposed rules cite four methods that covered financial institutions may use to ensure compensation is more sensitive to risk: (i) deferring payment of the compensation beyond the end of a performance period and adjusting the amount payable based on actual losses or other performance criteria; (ii) adjusting awards on account of risk, based on quantitative or other measures that take into account the risk the covered person's activities pose to the institution; (iii) extending performance periods, so that some or all risk outcomes associated with the covered person's activities are realized or better known at the time of payment; and (iv) reducing the rate at which awards increase as a covered person achieves higher levels of the relevant performance measure or measures used in the person's incentive-based compensation arrangement.

Compatibility with Effective Controls and Risk Management

A covered financial institution's risk management processes and internal controls must buttress the development and maintenance of balanced incentive-based compensation arrangements. Among other things, regulators will look to whether risk-management personnel are engaged in the institution's design of incentive-based compensation arrangements, as well as in the monitoring and assessment of such arrangements to ensure they are balanced with the overall risks of the institution. The proposed rules also require a covered financial institution's policies to provide for the monitoring described above to be done by a group or person "independent" of the covered person. To be considered independent, the group or person must have a separate reporting line to senior management from the covered person who is creating the risks.

Strong Corporate Governance

A covered financial institution's board of directors (or committee thereof) must actively oversee the development and operation of incentive-based compensation arrangements and related control processes. This would include the review and approval by the institution's board of directors (or committee thereof) of the overall goals of any incentive-based compensation program to ensure they are consistent with the institution's risk tolerance, as well as the receipt and analysis of data to test whether the overall design is consistent with the goals and purposes of Section 956 of Dodd-Frank.

Special Considerations for Executive Officers and Certain Designated Employees of Very Large Covered Financial Institutions With Consolidated Assets of $50 Billion or More

Not all covered financial institutions are treated equally under the proposed rules. Covered financial institutions with consolidated assets of $50 billion or more[5] will have to comply with the following additional requirements with respect to their executive officers and certain of their employees designated as having the individual ability to expose such institutions to substantial loss.

Holdback of Incentive-Based Pay for Executive Officers

These covered financial institutions will be required to defer at least 50% of incentive–based compensation otherwise payable to their executive officers over at least a three-year period. The purpose of such deferral is to allow for risks not previously discernable or quantifiable to materialize by the end of the deferral period, in recognition of the fact that executive officers, unlike other employees, make strategic and high-level decisions, the risks of which may not become apparent for many years. Importantly, these amounts must be adjusted for actual losses incurred by the institution or based on other measures or aspects of performance that become known during the relevant deferral period. Covered financial institutions will be able to release (or allow vesting of) these deferred amounts in a lump-sum at the conclusion of the deferral period or, alternatively, in equal increments, *pro rata*, for each year of the deferral period. For example, an institution required to apply a three-year deferral to a $150,000 incentive-based compensation amount could release a maximum of $50,000 each year, or it could withhold the entire amount for the entire deferral period and release it as a lump-sum at the conclusion of the three-year period. The institution could also employ a less rapid distribution schedule by, for instance, releasing no amount after the first year, and then releasing a maximum of $100,000 the second year, and then $50,000 for the third year.

Identification of Individual Employees Capable of Exposing an Institution to Substantial Losses

The proposed rules would also require these covered financial institutions to identify individual non-executive officer employees who have the ability to inflict substantial losses on the institution, based on its size, capital, or overall risk tolerance. The rules specifically identify traders with large position limits relative to an institution's overall risk tolerance, and other

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5 As of June 30, 2011, there were 35 bank holding companies that had at least $50 billion in total consolidated assets. *See* National Information Center Website, available at http://www.ffiec.gov/nicpubweb/nicweb/Top50Form.aspx.

individuals who have the authority to place a substantial part of an institution's capital at risk, as examples of such employees.

The institution's board of directors (or committee thereof) is charged with the responsibility of indentifying those employees, other than executive officers, who individually may present a substantial risk to the institution. In addition, the board of directors (or committee thereof) will be required to approve the incentive-based compensation arrangements applicable to such individuals, and such approval may not be given unless the board (or committee) determines that the arrangement (including the method of paying such compensation) effectively balances the financial rewards to the employee and the range and time horizon of risks associated with the employee's activities. The rules identify the following methods that can be used to establish this balance: risk-adjustment of awards, deferral of payments, extended performance periods, or "other appropriate methods." The board (or committee) must evaluate the overall effectiveness of the balancing methods used in the applicable incentive-based compensation arrangement in reducing incentives for inappropriate risk-taking by the identified employee, as well as the ability of the methods used to make payments sensitive to the full range of risks presented by the employee's activities.

Policies, Procedures, and Reporting Requirements

The proposed rules require all covered financial institutions to have policies and procedures governing the award of incentive-based compensation that balance the risk and reward for institutions of their respective size, complexity, and business activity, as well as the scope and nature of the incentive-based compensation arrangements. The policies and procedures should be particularly focused on those employees who, individually or as a group, may expose the institution to material financial loss. Under the rules, examples of employees who are unlikely to meet this test include, for example, tellers, bookkeepers, couriers and data processing personnel.

In order for regulators to assess whether incentive-based compensation structures are excessive in nature or could lead to material financial loss, all covered financial institutions will be required to submit an annual report to their respective regulators that describes the structure of their incentive-based compensation arrangements. The report will need to contain, at a minimum: (i) a description of the components of the institution's incentive-based compensation arrangements to covered persons, as well as the types of covered persons to which they apply; (ii) a description of the institution's related policies and procedures on incentive-based compensation; (iii) any material changes to such arrangements and policies and procedures since the prior report; and (iv) the specific reasons why the institution views the structure of its incentive-based compensation arrangements as not encouraging inappropriate risks by providing covered persons with excessive compensation or incentive-based compensation that could lead to a material financial loss to the covered financial institution. In addition, covered financial institutions with $50 billion or more in consolidated assets will be required to report on their policies and procedures governing executive officers and other employees that have been identified by the institution as capable of exposing the institution to substantial losses. However, covered financial institutions will not be required to disclose the actual compensation of any particular covered persons in the report.

Looking Ahead

The comment period on the proposed rules expired on May 31, 2011. Regulators are now in the process of finalizing the proposed rules, which are expected to become effective in early 2012. In the meantime, there a number of steps that a financial institution can take to prepare for the new requirements. For example, institutions may find it worthwhile to: (i) perform an audit of all compensation arrangements that have been established or maintained to date; (ii) identify those individual non-executive officer employees who have the ability to expose the financial institution to substantial losses; (iii) evaluate existing policies, procedures and practices to determine whether risk management or internal compliance personnel have a separate reporting line to senior management and whether such personnel are currently engaged in the institution's design of incentive-based compensation arrangements; and (iv) prepare a template for the annual report to be provided to the appropriate regulator.

Compensation "Claw Back" for Senior Executives and Directors of Failed Covered Financial Companies

On July 6, 2011, the FDIC issued a final rule regarding its ability, as receiver, to recoup compensation from senior executives and directors of "covered financial companies," or nonbank financial companies whose failure would pose significant risk to the financial stability of the United States.[6] The rule is part of the FDIC's new orderly liquidation authority under Title II of Dodd-Frank.

The final rule authorizes the FDIC to recover, from senior executives and directors who were "substantially responsible" for the failed condition of a covered financial company, "any compensation" (*e.g.*, salary, bonuses, benefits, severance pay, deferred compensation, golden parachute benefits, stock options) they received during the two-year period preceding the date on which the FDIC was appointed as receiver of the company, or for an unlimited period in the case of fraud.[7] A senior executive or director will be deemed to be substantially responsible if he or she failed to conduct his or her responsibilities with the degree of skill and care an ordinarily prudent person in a like position would exercise under similar circumstances and, as a result, individually or collectively, caused a loss to the covered financial company that materially contributed to the failure of the covered financial company under the facts and circumstances. In this regard, the standard of care that will be applied is a negligence standard; a higher standard, such as gross negligence, is not required. If a covered financial company is liquidated under the FDIC's new authority, the FDIC will undertake an analysis of whether the individual exercised his or her business judgment. However, the burden of proof will be on the senior executive or director to establish that he or she exercised his or her business judgment. State "business judgment rules" and "insulating" statutes will not shift the burden of proof to the FDIC or increase the standard of care under which the FDIC as receiver may recoup compensation.[8]

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6 *See* Final Rule Regarding Certain Orderly Liquidation Authority Provisions Under Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Federal Deposit Insurance Corporation, 76 Fed. Reg. 41626 (July 15, 2011).

7 *See* 12 C.F.R. § 380.7.

8 *See* 76 Fed. Reg. 41631.

A senior executive or director will be presumed to be substantially responsible for the failed condition of a covered company if he or she:

- served as the chairman of the board of directors, chief executive officer, president, chief financial officer or in any other similar role, regardless of title, if he or she had responsibility for strategic, policymaking or company-wide operational decisions;
- is judicially determined to have breached his or her duty of loyalty to the covered financial company; or
- was removed from the management or board of directors of the covered financial company by the FDIC pursuant to its new orderly liquidation authority under Dodd-Frank.[9]

These presumptions do not apply to a senior executive who has been hired by the covered financial company during the two years prior to the FDIC's appointment as receiver to assist in preventing further deterioration of the financial condition of the company. Also, they do not apply to directors who have joined a covered financial company's board of directors during the two years prior to the FDIC's appointment as receiver under an agreement or resolution to assist in preventing further deterioration of the company's financial condition.

Some in the financial services industry have argued that the FDIC's compensation clawback authority could encourage a revolving door of senior executives and directors seeking to avoid recoupment based on having been in those positions during the two-year period running up to the failure of an institution. However, it remains to be seen whether the FDIC's new rule will lead to such a result.

"Say-on-Pay"

Since the enactment of Dodd-Frank, the SEC has adopted final rules regarding the new requirement that public companies provide their shareholders with a non-binding "say-on-pay" vote to approve the compensation of named executive officers at least once every three years and in connection with certain business combination transactions.[10]

Shareholder Advisory Votes

The SEC's new Rule 14a-21(a) under the Securities Exchange Act requires issuers, at least once every three years, to provide for a separate, non-binding shareholder vote in proxy statements to approve the compensation of named executive officers. This say-on-pay vote is required only when proxies are solicited for an annual or other meeting of shareholders, occurring on or after January 21, 2011, at which directors will be elected. In addition, pursuant to the SEC's new Rule 14a-21(b), issuers will be required, at least once every six calendar years, to provide for a separate, non-binding shareholder vote on the frequency of such say-on-pay votes, beginning with the first annual or other meeting of shareholders occurring on or after January 21, 2011 at

9 *See* Dodd-Frank § 206; 12 U.S.C. § 5386.

10 *See* Final Rule Regarding Shareholder Approval of Executive Compensation and Golden Parachute Compensation, Securities and Exchange Commission, 76 Fed. Reg. 6010 (Feb. 2, 2011).

which directors will be elected. Shareholders will be asked to decide whether the say-on-pay votes should occur every one, two or three years.

The SEC's final rules provide a two-year delay from these requirement for "smaller reporting companies," which are generally companies that have a public float of less than $75 million. Also, financial institutions that have outstanding obligations under the U.S. Treasury Department's Troubled Asset Relief Program are not required to hold a separate say-on-pay vote or a say-on-pay "frequency" vote because they are already required under TARP to conduct advisory votes on executive compensation annually.[11]

Disclosure and Shareholder Advisory Vote on "Golden Parachute" Compensation in Business Combination Transactions

For proxy statements and other schedules and forms initially filed on or after April 25, 2011, the SEC has imposed new disclosure requirements and separate non-binding shareholder advisory votes on "golden parachute" compensation arrangements at meetings for which the company's shareholders are asked to approve certain business combination transactions, including mergers, acquisitions, consolidations, proposed sales or other dispositions of all or substantially all assets.[12] The new disclosure obligations cover golden parachute arrangements triggered by an agreement between either the target company or the acquiring company with the named executive officers of each of the target company and the acquiring company. Under new Item 402(t) of Regulation S-K, companies must disclose information regarding golden parachute arrangements for each executive in both tabular and narrative formats. Among other requirements, issuers will need to provide separate identification of amounts attributable to "double-trigger" arrangements and "single-trigger" arrangements, so that shareholders can readily discern these amounts.[13]

[11] *See* id. at 6023; 17 C.F.R. § 240.14a-21(b).

[12] 17 C.F.R. §§ 229.402(t), 240.14a-21(c).

[13] A "double-trigger" arrangement requires that the executive's employment be terminated without cause or that the executive resign for good reason within a limited period of time after the change-in-control to trigger payment. A "single-trigger" arrangement does not require such a termination or resignation after the change-in-control to trigger payment. *See* 76 Fed. Reg. 6025 n.214.

AN UPDATE ON INSURANCE REGULATORY REFORMS

BY STEVEN R. DELOTT, PETER J. GORDON AND GARY I. HOROWITZ

Although insurance regulation in the United States traditionally has been left exclusively to the states, proposals for the federal government to play a role in insurance regulation had been circulating in Congress for many years. The collapse and subsequent federal bailout of American International Group in 2008 likely was the impetus for Congress to include a limited number of insurance provisions in Dodd-Frank, a small, first step perhaps in the direction of federal regulation of insurance.

Potentially, the most significant part of Dodd-Frank for the insurance industry is the creation of the Federal Insurance Office (the "FIO") within the Treasury Department. However, the FIO explicitly is not provided with general supervisory or regulatory authority over the business of insurance, meaning it has no authority to regulate premium rates, policy forms, sales practices or other dealings between insurers and policyholders, nor does it have authority to establish capital requirements for insurance companies.[1] All such authority remains with state insurance regulators.

The FIO has the following statutory mandate:

- 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 Financial Stability Oversight Council[2] 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.

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1 Likewise, persons regulated by a state insurance regulator are carved out from the authority of the new Bureau of Consumer Financial Protection.

2 As discussed in "Oversight and Regulation of Systemically Important Financial Institutions," the Financial Stability Oversight Council will have 10 voting and five non-voting members. One of the voting members is required to have insurance expertise. Accordingly, on June 24, 2011, President Obama announced his intention to nominate Roy Woodall, a former Commissioner of Insurance for the Commonwealth of Kentucky, and most recently a Senior Insurance Policy Analyst at the Treasury Department, as a voting member. The Director of the FIO is a non-voting member, as is John Huff, the Director of the Department of Insurance, Financial Institutions and Professional Regulation for the State of Missouri.

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

Dodd-Frank authorizes the FIO 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 FIO must first notify and consult with the relevant state regulator and engage in a notice and comment process with potentially interested parties.

Unlike the many sections of Dodd-Frank that call for federal agencies to promulgate regulations, Dodd-Frank's insurance provisions are largely self-executing. In addition to the creation of the FIO, Dodd-Frank contains a number of measures primarily designed to streamline the regulation of nonadmitted insurance and reinsurance. Under Dodd-Frank, nonadmitted insurance (*i.e.*, insurance placed with an insurer that is not licensed in a particular state) is to be regulated only by the insured's home state. With respect to reinsurance, Dodd-Frank provides that only the domiciliary state of the reinsured may regulate statutory credit for reinsurance, and only the domiciliary state of the reinsurer may regulate the financial solvency of the reinsurer.[3]

As of this date, the principal regulatory activity undertaken by the Treasury Department relating to the FIO has been the establishment of a Federal Advisory Committee on Insurance (the "Committee"). The purpose of the Committee is to present advice and recommendations to the FIO to assist the FIO in carrying out its duties. The Committee is to have no more than 15 members, and will be composed of state insurance regulators, insurance industry executives, academics and consumers.

On June 13, 2011, Michael T. McRaith, formerly the Director of the Illinois Department of Insurance, took office as the first Director of the FIO.

Dodd-Frank requires the Director of the FIO to deliver a report to Congress by January 21, 2012 on how to modernize and improve the system of insurance regulation in the United States. The report could be of great consequence to the insurance industry. Although we are unable to predict the conclusions of the report at this time, it certainly is possible that the report will call for a more significant federal presence in the area of insurance regulation, in the interest of furthering uniformity and greater regulatory efficiency.

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3 *See* "Simpson Thacher & Bartlett Memorandum, U.S. Congress Nears Completion of Landmark Financial Services Reform," July 6, 2010.

REGULATION OF THE OVER-THE-COUNTER DERIVATIVES MARKET

BY JOYCE Y. XU

Title VII of Dodd-Frank introduces enhanced regulations designed to reduce risk, increase transparency, and expand the CFTC's and SEC's regulatory authority of derivatives transactions and the participants in the over-the-counter (OTC) derivatives markets. The major changes include:

- the expansion of the types of derivatives regulated under the U.S. commodities and securities laws and the allocation of regulatory authority among the CFTC, the SEC and the prudential regulators;[1]
- the designation of certain market participants to be subject to enhanced regulations including margin requirements, segregation of assets, reporting and compliance policies;
- the Lincoln Amendment, more commonly known as the "dealer push-out rule," which limits the derivatives-related activities conducted within an insured depositary institution;
- the imposition of mandatory clearing and exchange trading requirements on standardized derivative products to reduce counterparty risk, subject to "end-user exception";
- the creation of comprehensive recordkeeping and real-time reporting requirements; and
- the expansion of anti-fraud and anti-manipulation regulations with respect to OTC derivatives.

Many provisions of Dodd-Frank by their terms take effect 360 days from the date of enactment, which is July 16, 2011. Other provisions that require a rulemaking take effect on the later of July 16, 2011 and at least 60 days following the publication of the final rule. However, many of the self-effectuating provisions that have become effective on July 16, 2011 reference terms whose definitions are the subject of proposed rulemaking. Since the enactment of Dodd-Frank, the CFTC and the SEC have issued a significant number of proposed rules, though few have been finalized. The comment periods for many rules have been extended or re-opened repeatedly. In the 60 days leading up to the one-year anniversary of Dodd-Frank, in an effort to alleviate uncertainty in the marketplace over the effectiveness of significant provisions in Dodd-Frank, both the CFTC and the SEC have issued guidance as to the effective dates of various requirements under Dodd-Frank and provided temporary relief from the application of various provisions of Dodd-Frank to various market participants and derivative products.

Although the regulatory landscape remains in flux until the issuance of final rules by the CFTC and SEC and the effectiveness of key parts of Dodd-Frank is deferred, this article discusses the

1 Prudential regulators include the Department of the Treasury Office of the Comptroller of the Currency, the Federal Reserve, the Federal Deposit Insurance Corporation ("FDIC"), the Farm Credit Administration and the Federal Housing Finance Agency, as applicable.

significant sections of Title VII of Dodd-Frank, the rules proposed thereunder and their implications in order to assist market participants in anticipating the scope of the final regulatory regime.

Regulation of Dealers and Major Participants

Dodd-Frank creates four main categories of dealers and major participants who will be subject to additional scrutiny and regulation: swap dealers, major swap participants, security-based swap dealers and major swap participants (each, a "swap entity" and collectively, "swap entities"). Sections 721(c) and 761(b) of Dodd-Frank provide the CFTC and the SEC with rulemaking authority to further define these terms and implement regulations regarding the operation of swap entities. We discuss below some of the significant rules that have been proposed or adopted by the CFTC and the SEC pursuant to such authority.

<u>Defining Swap Dealer and Security-Based Swap Dealer; Major Swap Participant and Major Security Based Swap Participant</u>

The CFTC and the SEC jointly proposed a rule[2] to clarify the definitions of swap entities while avoiding rigid standards that would fail to provide the necessary flexibility to react to innovation in the ways that market participants enter into "swaps" and "security-based swaps." The proposed rule defines a person as a dealer based on the functional role such person fulfills in the swap and security-based swap markets and such person's relationships with counterparties, while major swap participants and major security-based swap participants are defined based on the focus on the market and the inherent risks associated with an entity's positions.

More specifically, the proposed rule lists the following characteristics of swap dealers and security-based swap dealers:

- dealers tend to accommodate demand for "swaps" and "security-based swaps" from other parties;

- dealers are generally available to enter into "swaps" and "security-based swaps" to facilitate other parties' interest in entering into those instruments;

- dealers tend not to request that other parties propose the terms of "swaps" and "security-based swaps"; rather, dealers tend to enter into those instruments on their own standard terms or on terms they arrange in response to other parties' interest; and

- dealers tend to be able to arrange customized terms for "swaps" and "security-based swaps" upon request or create new "swaps" or "security-based swaps" at the dealers' own initiative.

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2 Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," 76 Fed. Reg. 80174 (proposed Dec. 21, 2010) (to be codified at 17 C.F.R. Parts 1 & 240).

The CFTC and the SEC define "major swap participant" and "major security-based swap participants" (jointly referred to as "major participants") as persons that satisfy any of three alternative tests:

- persons that maintain a "substantial position" in any of the "major" categories of "swaps" or "security-based swaps," as those categories are determined by the CFTC or the SEC, as applicable. This test excludes both "positions held for hedging or mitigating commercial risk" and positions maintained by, or contracts held by, any employee benefit plan for the primary purpose of hedging or mitigating risks directly associated with the operation of the plan;

- persons whose outstanding "swaps" or "security-based swaps" create "substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets"; or

- any "financial entity" that is "highly leveraged relative to the amount of capital such entity holds and that is not subject to capital requirements established by an appropriate Federal banking agency" and that maintains a "substantial position" in "swaps" or "security-based swaps" for any of the "major" categories of "swaps" or "security-based swaps."

In the same proposed rule, the CFTC and the SEC also define the meanings of: "substantial position," "hedging or mitigating commercial risk," "substantial counterparty exposure," "highly leveraged" and "financial entity."

Registration Requirements

Dodd-Frank amends both the Commodity Exchange Act and the Securities and Exchange Act of 1934 (the "Exchange Act") to provide for a new regulatory framework for "swaps" and "security-based swaps," respectively. Among other things, these amendments provide for the registration of swap entities with the SEC and the CFTC, as applicable. The SEC has provided temporary relief from this registration requirement for securities-based swap dealers and major securities-based swap participants until the rules defining "security-based swaps" are finalized.[3] Likewise the CFTC has indicated that the registration requirements will not apply to swap dealers or major swap participants until 60 days after such registration rules are finalized.[4]

Business Conduct Standards for Swap Entities

Section 764 of Dodd-Frank amends the Exchange Act by adding a new Section 15F. Paragraph (h) of the new section authorizes and requires the SEC to adopt rules specifying business conduct standards for security-based swap dealers and major securities-based swap participants in their dealings with counterparties to "security-based swaps," including with counterparties that are "special entities" such as: 1) a federal agency, 2) a state, state agency or political subdivision of a state, 3) any employee benefit plan as defined by the Employee

[3] Exemptions for Security-Based Swaps, 76 Fed. Reg. 40605 (July 11, 2011).
[4] Effective Date for Swap Regulation, 76 Fed. Reg. 42508 (June 19, 2011).

Retirement Income Security Act ("ERISA"), 4) any governmental plan as defined by ERISA, and 5) any endowment.[5] The proposed SEC rules specify certain standards depending on whether a security-based swap dealer is acting as an advisor to a special entity, or whether a security-based swap dealer or major security-based swap participant is a counterparty to a special entity in a "securities-based swap." The CFTC has proposed a similar rule[6] pursuant to Section 731 of Dodd-Frank, which provides the CFTC with both mandatory and discretionary rulemaking authority to impose business conduct requirements on swap dealers and major swap participants in their dealings with counterparties, including special entities.

Special Entities

(i) Dealer as Advisor to Special Entity

Under the proposed rules, subject to certain exceptions, where a swap dealer or security-based swap dealer is deemed to be an advisor to a special entity in connection with "swaps" or "security-based swaps," the swap dealer or security-based swap dealer has a duty to act in the best interests of the special entity, including a duty to obtain necessary information to determine whether a particular transaction is in the best interests of the special entity, and a duty not to defraud the special entity or engage in fraudulent, deceptive or manipulative practices.

(ii) Swap Entity as Counterparty to Special Entity

Pursuant to the rule proposed by the SEC, prior to entering into a "security-based swap" with a special entity, a security-based swap dealer or major security-based swap participant must first have a reasonable basis to believe that the special entity is represented by a qualified independent representative (as defined in the rule). Further, a security-based swap dealer must disclose in writing that it is acting in its capacity as a dealer, and where such security-based swap dealer is engaged in other types of business with the special entity, it must disclose the differences between its representation in the "security-based swap" and its representation in other businesses or transactions. Similarly, the CFTC proposed rule sets forth standards of fair dealing of swap dealers and major swap participants with special entity counterparties.

Counterparties to "Swaps" and "Security-Based Swaps"

Under the proposed rules by the CFTC and the SEC, swap entities must follow certain standards and procedures in dealing with counterparties to "swaps" or "security-based swaps." For example, they must first verify that the counterparty meets the eligibility requirements for an eligible contract participant, and then if such counterparty is a special entity. Before recommending a "swap," "security-based swap" or a trading strategy involving a "swap" or "security-based swap" to a counterparty, a swap entity must have a reasonable basis to believe, based on diligence, that the product is suitable for the particular counterparty. Similarly, the proposed rules provide for certain "Know Your Counterparty" information-gathering

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5 Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants, 76 Fed. Reg. 42396 (proposed July 18, 2011) (to be codified at 17 C.F.R. Part 240).

6 Business Conduct Standards for Swap Dealers and Major Swap Participants With Counterparties, 75 Fed. Reg. 80638 (proposed Dec. 22, 2010) (to be codified at 17 C.F.R. Parts 23 & 155).

requirements, similar to the "Know Your Customer" rules under the USA Patriot Act. The proposed rules also impose a duty on a swap entity to communicate with counterparties in a fair and balanced manner, and in good faith.

In addition, the proposed rules impose disclosure requirements on swap entities, including (but not limited to) with respect to: (i) the material risks and characteristics of the "swap" or "security-based swap," (ii) the material incentives of the "swap" or "security-based swap," (iii) a daily mark based on certain criteria depending on whether "swap" or "security-based swap" is cleared or uncleared and (v) such counterparty's clearing rights with respect to the "swap" or "security-based swap."

Further, the proposed rules include provisions designed to ensure compliance with the laws, rules and regulations governing "swaps" and "security-based swaps." These provisions include establishing and maintaining written policies and procedures dealing with compliance with the rules, and diligent supervision of such compliance, including, under the SEC rules, designating a qualified supervisor with the authority to carry out supervisory responsibilities with respect to the compliance system.

Political Contributions

The proposed rules establish guidelines and prohibitions with respect to swap dealers or security-based swap dealers and political contributions. These rules are designed to prevent certain "pay to play" situations, and prohibit, for example, entering into "swaps" or "security-based swaps" with a municipal entity, where such dealer has made a political contribution to an official of such municipal entity.

Capital and Margin Requirements for Uncleared Swaps and Security-Based Swaps

Sections 731 and 764 of Dodd-Frank mandate that the prudential regulators, the SEC and the CFTC impose initial and variation margin requirements on all uncleared "swaps" and "security-based swaps." These regulators are to institute margin requirements that (i) help ensure the safety and soundness of the swap entity and (ii) are appropriate for the risks associated with the uncleared "swaps" and "security-based swaps."

Margin Requirements

The prudential regulators released a proposed new rule requiring swap entities that fall under their jurisdiction ("PR-covered swap entities") to collect collateral from counterparties to certain uncleared "swaps" and "security-based swaps."[7] The CFTC proposed a similar rule that would govern swaps entered into by swap dealers and major swap participants that do not fall under the jurisdiction of one of the prudential regulators ("CFTC-covered swap entities").[8]

7 Margin and Capital Requirements for Covered Swap Entities, 76 Fed. Reg. 27564 (proposed May 11, 2011) (to be codified at 12 C.F.R. Parts 45, 237, 324, 624 & 1221).

8 Capital Requirements of Swap Dealers and Major Swap Participants, 76 Fed. Reg. 27802 (proposed May 12, 2011) (to be codified at 17 C.F.R. Parts 1, 23 & 140).

(i) Prudential Regulators' Rule and CFTC Proposed Rule: Initial and Variation Margin Requirements

The proposed rules by the prudential regulators and the CFTC recognize that one of the key factors that affect the risk profile of a particular derivative is the credit profile of the counterparty to a particular transaction.

The prudential regulators' proposed rule distinguishes among four different categories of derivatives counterparties, which are listed below in descending order from highest risk to lowest risk as viewed by the prudential regulators:

(1) counterparties that are themselves swap entities;

(2) counterparties that are high-risk financial end-users of derivatives;

- high-risk financial end users are financial end users[9] that do not meet the criteria of a low risk financial end user.

(3) counterparties that are low-risk financial end users of derivatives; and

- A low-risk financial end users is an end user that (i) has limited exposure on its "swaps" or "security-based swaps"; (ii) predominantly uses "swaps" or "security-based swaps" to hedge or mitigate the risk of its business activities; and (iii) is subject to capital requirements established by a prudential regulator or state insurance regulator.

(4) counterparties that are nonfinancial end users of derivatives.

- Nonfinancial end users are end user counterparties who are not swap entities or financial end users.

The CFTC rule similarly creates categories of counterparties, classified according to their risk, listed below in decreasing order of riskiness:

(1) counterparties that are themselves swap dealers or major swap participants;

(2) counterparties that are financial entities[10]; and

[9] Financial end users are defined as any counterparty, other than a swap entity, that is: (i) a commodity pool (as defined in Section 1(a)(5) of the Commodity Exchange Act); (ii) a private fund (as defined in Section 202(a) of the Investment Advisors Act of 1940); (iii) an employee benefit plan (as defined in paragraphs (3) and (32) of Section 3 of the ERISA); (iv) a person that is predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature (as defined in Section 4(k) of the Bank Holding Company of 1956); (v) a person that would be a financial end user described in (i) or (ii) if it were organized under the laws of the United States or any state thereof; (vi) the government of any foreign country or a political subdivision, agency, or instrumentality thereof; or (vii) any other person that the CFTC or the SEC, as applicable, may designate.

- Certain financial entities that (i) are subject to capital requirements established by a prudential regulator or state insurance regulator, (ii) do not have significant exposure to swaps, and (iii) use swaps predominantly to hedge have no margin requirements.

(3) Counterparties that are nonfinancial entities

- Any entity that is not properly classified as a financial entity, swap dealer, or major swap participant is a nonfinancial entity

The proposed rules set varying initial margin and variation margin requirements for PR-covered swap entities and CFTC-covered swap entities depending on to which one of the four categories their counterparty belongs.

(ii) Collateral

The proposed rules also detail the forms of collateral that satisfy both initial and variation margin requirements. The eligible collateral is limited to immediately available cash and certain high-quality, highly liquid U.S. government and agency obligations. Other than cash funds, all types of eligible collateral may be discounted in determining their value for margin purposes. The CFTC proposal allows nonfinancial end users to post non-cash collateral to the extent agreed upon by the parties, so long as the asset's value can be reasonably determined on a periodic basis.

The proposed rules mandate that both a PR-covered swap entity and CFTC-covered swap entity engaging in an uncleared "swap" or "security-based swap" with a counterparty that is itself a swap entity must segregate any collateral posted as initial margin. The initial margin must be placed with an independent third party.

Capital Requirements

The prudential regulators have preserved the regulations on capital requirements in place before the enactment date of Dodd-Frank, stating that they are sufficient to mitigate the systemic risk of uncleared "swaps" and "security-based swaps."[11] The prudential regulators have left open the possibility that they will issue future regulation on this issue.

The CFTC has proposed new regulations governing the capital requirements for CFTC-covered swap entities.[12] To ensure that a regulated entity can meet its financial obligations and have adequate resources on hand should a wind-down be required, these proposed regulations require the entity to maintain a minimum level of highly liquid assets. The CFTC proposal

[10] A financial entity is any entity, that is not a swap dealer or major swap participant, classified as (i) a commodity pool, (ii) a private fund, (iii) an employee benefit plan, (iv) a person primarily engaged in the business of banking or financial activity, (v) foreign entity that would qualify as a commodity pool or private fund if organized in the U.S., (vi) the government or political subdivision of a foreign country, and (vii) any person the CFTC may designate as such.

[11] Margin and Capital Requirements for Covered Swap Entities, supra note 7.

[12] Capital Requirements of Swap Dealers and Major Swap Participants, supra note 8.

separates the capital requirements for CFTC-covered swap entities into two categories: entities that are not futures commission merchants and entities that are. Those entities that are not futures commission merchants are further divided into nonbank subsidiaries of U.S. bank holding companies, and non-subsidiaries of U.S. bank holding companies.

Certain Requirements for "Swaps" and "Security-based Swaps"

Product Definitions

Dodd-Frank sets forth basic definitions for key terms such as "swap," "security-based swap," "security-based swap agreement" and "mixed swaps" and provides that the CFTC and the SEC, in consultation with the Federal Reserve, shall jointly further define such terms.

Accordingly, the CFTC and the SEC, in consultation with the Federal Reserve, jointly issued proposed rules and proposed interpretive guidance[13] under the Commodity Exchange Act and the Exchange Act to further define the terms "swap," "security-based swap," "security-based swap agreement" and "mixed swap." So far none of these proposed rules has been adopted.

The proposed rules and proposed interpretive guidance address, among others:

- Insurance products: In order to qualify as an insurance product and not a "swap," an agreement, contract or transaction must (1) meet the product requirements, namely, (A) must require the beneficiary to have an insurable interest that is the subject of such agreement, contract or transaction and thereby carry the risk of loss with respect to the interest continuously throughout the duration of such agreement, contract or transaction, (B) must require that loss to occur and be proved, and that any payment or indemnification therefore be limited to the value of the insurable interest, (C) must not be traded separately from the insurable interest, and (D) with respect to financial guaranty insurance, in the event of payment default or insolvency of the obligor, any acceleration of payments must be at the sole discretion of the insurer; and (2) be provided by one of the persons or entities listed in the proposed rules, which includes, among others, a company that is organized as an insurance company whose primary and predominant business activity is the writing of insurance or the reinsuring of risks underwritten by insurance companies and that is subject to supervision by the state or federal insurance commissioner or the U.S. or any of its agencies.

- Forward contract exclusion: The proposed rules further clarify the scope of the exclusion from the definitions of "swap" or "security-based swap" set forth in Dodd-Frank for "any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled."[14] In this context, the CFTC and the SEC discuss different products such as forward contracts in nonfinancial commodities, forward contracts that contain embedded commodity options or options, security forwards, consumer and commercial agreements, contracts and transactions,

[13] Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 76 Fed. Reg. 29818 (proposed May 23, 2011) (to be codified 17 C.F.R. Parts 1 & 240).

[14] Commodity Exchange Act, 7 U.S.C. § 1a(47)(B)(ii).

and loan participations. In particular, the CFTC and the SEC state that security forwards are excluded from the definitions of "swap" and "security-based swap" if they were intended to be physically settled.

- Foreign exchange products: The CFTC and the SEC are proposing to explicitly define by rule that the term "swap" includes foreign exchange forwards and foreign exchange swaps (unless the Secretary of the Treasury issues a written determination to contrary). On April 29, 2011, the U.S. Department of the Treasury issued a proposed determination[15] that would exempt both foreign exchange swaps and foreign exchange forwards from the definition of "swap" for most provisions of Dodd-Frank. The CFTC and the SEC are also proposing to explicitly define the term "swap" to include foreign currency options, non-deliverable foreign contracts involving foreign exchange, currency swaps and cross-currency swaps (with limited exceptions) irrespective of the Treasury Secretary's determination.

- Distinguishing between swaps and security-based swaps: Under the CFTC's and the SEC's proposed rules, an instrument is a "swap," and not a "security-based swap," when payments exchanged under such instrument are based solely on the levels of certain interest rates or other monetary rates that are not themselves based on one or more securities (such as Interbank Offered Rates, Money Market Rates, Government Target Rates, etc). The CFTC and the SEC also propose that except in cases of certain exempted securities (e.g., U.S. Treasury securities), when one of the underlying references of an instrument is the "yield" of a debt security, loan or narrow-based security index, such that the term "yield" is used as a proxy for the price or value of such underlying asset, the instrument is a "security-based swap." The proposed rules also clarify the terms "narrow-based security index" and "issuers of securities in a narrow-based security index."

- Mixed swaps: The CFTC and the SEC provide examples of "mixed swaps" and propose rules that set forth regulatory framework for bilateral uncleared "mixed swaps" entered into by dually-registered dealers or major participants. The CFTC and the SEC further propose rules establishing a process pursuant to which any person may request the CFTC and the SEC to publicly issue a joint order permitting such persons to comply with "parallel provisions" of either the Commodity Exchange Act or the Exchange Act, but not both.

- Security-based swap agreements: The CFTC and the SEC clarify certain types of "swaps" that clearly fall within the definition of "security-based swap agreements" which include a "swap" based on an index of securities that is not a narrow-based security index, an index credit default swap that is not based on a narrow-based security index or on the "issuer of securities in a narrow-based security index" as defined under the proposed rules, and a swap based on a U.S. Treasury security or on certain other exempted securities other than municipal securities.

[15] Determination of Foreign Exchange Swaps and Foreign Exchange Forwards under the Commodity Exchange Act, 76 Fed. Reg. 25774 (May 5, 2011).

Mandatory Central Clearing

Sections 723 and 763 of Dodd-Frank prohibit any person from transacting in a "swap" or a "security-based swap" unless that person submits such "swap" or "security-based swap" for clearing to a registered clearinghouse (derivative clearing organization for "swaps" and clearing agency for "security-based swaps") that is registered under Dodd-Frank or otherwise is exempt from registration under Dodd-Frank if such "swap" or "security-based swap" is required to be cleared.

Dodd-Frank requires the CFTC and the SEC to review each "swap" or "security-based swap," respectively, to make a determination as to whether such "swap" or "security-based swap" 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 "swaps" or "security-based swaps." 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 "swap" or "security-based swap" listed for clearing by a registered clearinghouse as of the enactment date of Sections 723 and 763 is automatically deemed to have been submitted to the appropriate agency for review. The CFTC or the SEC may also initiate such a review on its own. In either case, once the CFTC or the SEC makes a determination that a "swap" or a "security-based swap" must be cleared, a 30-day public comment period on such determination must be provided. Dodd-Frank mandates the agencies to adopt rules for a registered clearinghouse's submission for review of a "swap" or "security-based swap" (or group, category, type or class thereof) that it seeks to accept for clearing within one year of the date of the enactment of the Sections 723 and 763.

The CFTC and SEC have each proposed a regulation that sets out the process for clearinghouses to follow, including what information a clearinghouse must include in its submission to assist the agencies in their review, and the CFTC adopted a final rule on July 19, 2011.[16] In particular, rules proposed by the CFTC[17] set forth that a derivative clearing organization has to provide, among others: (A) a statement that the clearinghouse is eligible to accept "swaps" for clearing; (B) specific information regarding the "swap" sufficient to provide the CFTC a reasonable basis to make a quantitative and qualitative assessment of the five factors[18] that Dodd-Frank requires

16 Process for Review of Swaps for Mandatory Clearing, 75 Fed. Reg. 67277 (July 19, 2011) (to be codified at 17 C.F.R. Parts 39 & 140) (the text of the final rule was not available as of the date of this article); Process for Submissions for Review of Security-Based Swaps for Mandatory Clearing and Notice Filing Requirements for Clearing Agencies; Technical Amendments to Rule 19b–4 and Form 19b–4 Applicable to All Self-Regulatory Organizations, 75 Fed. Reg. 82490 (proposed Dec. 30, 2010) (to be codified at 17 C.F.R. Parts 240 & 249).

17 Process for Review of Swaps for Mandatory Clearing, supra note 16.

18 These five factors are: (i) the existence of significant outstanding notional exposure, trading liquidity and adequate pricing data, (ii) the availability of rule framework, capacity, operational expertise and resources, and credit support infrastructure to clear the contract on terms that are consistent with the material terms and trading conventions on which the contract is then traded, (iii) the effect on the mitigation of systemic risk (balanced against the size of the relevant market and the resources of the clearinghouse available 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.

the CFTC to take into account when reviewing a swap submission; (C) product specifications, including copies of any standardized legal documentation, generally accepted contract terms and standard practices, among others; (D) participant eligibility standards; (E) pricing sources and models demonstrating an ability to obtain sufficient price data to measure credit exposure in a timely and accurate manner; (F) risk management procedures; (G) measures of market liquidity and trading activity; (H) an analysis of the effect of a clearing requirement on the market; and (I) a description of the manner in which the derivatives clearing organization has provided notice of the submission to its members and a summary of any opposition to the swap submission expressed by members. The proposed rules by the SEC have similar requirements for security-based swap submissions.[19] Specifically, clearing agencies would be required to submit quantitative and qualitative information to assist the SEC in the consideration of the five factors Dodd-Frank requires the SEC to take into account in reviewing the security-based swap submissions.[20]

End User Clearing Exception

A "swap" or a "security-based swap" is subject to an elective exception from the mandatory clearing requirement if at least one of the parties to the "swap" or "security-based swap" (i) is not a "financial entity,"[21] (ii) is using "swaps" or "security-based swaps" 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 "swaps" or "security-based swaps."

Both CFTC and the SEC have proposed rules further clarifying the phrase "hedging or mitigating commercial risk.[22] The CFTC's proposal deems a "swap" to be used to hedge or mitigate commercial risk when such "swap" (i) is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise, where the risks arise from: (A) the potential change in the value of assets of a person, (B) the potential change in the value of liabilities of a person, (C) the potential change in the value of services of a person, (D) the potential change in the value of assets, services, inputs, products or commodities, (E) any potential change in value related to any of the foregoing arising from foreign exchange rate movements, or (F) any fluctuation in interest, currency or foreign exchange rate exposures from a person's current or anticipated assets or liabilities, in each case in the ordinary course of business of the enterprise; (ii) qualifies as bona fide hedging for purposes of an exemption from position limits under the Commodity Exchange Act; or (iii) qualifies for hedging treatment under Financial Accounting Standards Board Accounting Standards Codification Topic 815,

19 Process for Submissions for Review of Security-Based Swaps for Mandatory Clearing and Notice Filing Requirements for Clearing Agencies; Technical Amendments to Rule 19b–4 and Form 19b–4 Applicable to All Self-Regulatory Organizations, supra note 16.

20 These five factors are the same as the five factors provided for the CFTC in note 18, supra.

21 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.

22 End-User Exception to Mandatory Clearing of Swaps, 75 Fed. Reg. 80747 (proposed Dec. 23, 2010) (to be codified 17 C.F.R. Part 39); End-User Exception to Mandatory Clearing of Security-Based Swaps, 75 Fed. Reg. 79992 (proposed Dec. 21, 2010) (to be codified 17 C.F.R. Part 240).

Derivatives and Hedging. A "swap" is disqualified from the clearing exception if it is held for a speculative, investing, or trading purpose, or if it hedges another "swap" or "security-based swap" that is not held for hedging purposes.[23] The SEC proposed rules set forth similar requirements. A security-based swap position shall be deemed to be held for the purpose of hedging or mitigating commercial risk when: (i) such position is economically appropriate to the reduction of risks that are associated with the present conduct and management of a commercial enterprise, or are reasonably expected to arise in the future conduct and management of the commercial enterprise, where such risks arise from (A) the potential change in the value of assets of a person, (B) the potential change in the value of liabilities of a person, or (C) the potential change in the value of services of a person, in each case in the ordinary course of business of the enterprise; (ii) such position is not (A) held for a purpose that is in the nature of speculation or trading, and (B) held to hedge or mitigate the risk of another security-based swap position or swap position that is not held for the purpose of hedging or mitigating commercial risk; and (iii) the person holding the position (A) identifies and documents the risks that are being reduced by the security-based swap position, (B) establishes and documents a method of assessing the effectiveness of the "security-based swap" as a hedge; and (C) regularly assesses the effectiveness of the "security-based swap" as a hedge.[24]

Both the CFTC and the SEC proposed rules further requiring an entity electing to avail itself of the end-user clearing exception to notify the relevant agency by providing certain specified information to a registered swap or security-based swap data repository or, if no registered swap or security-based swap data repository is available, the CFTC or the SEC.[25] For example, such entity must provide (i) its identity; (ii) whether it is a "financial entity"; (iii) whether it is a "finance affiliate"; (iv) whether the "swap" or the "security-based swap" is used to hedge or mitigate commercial risks; (v) whether it generally meets its financial obligations associated with non-cleared "swaps" or "security-based swaps" and provide additional information regarding the methods used to mitigate credit risk in connection with non-cleared transactions including information regarding credit support; and (vi) whether it is an entity that is an issuer of securities registered under Section 12 of, or is required to file reports under Section 15(d) of the Exchange Act.[26] When the counterparty invoking the end-user clearing exception is an SEC filer, the counterparty must also provide its SEC Central Index Key and also must explain whether an appropriate committee of the board of directors (or equivalent body) of the counterparty the clearing exception has reviewed and approved the decision to enter into a "security-based swap" or not to clear a "swap."

An affiliate of a non-financial entity qualifying for the end-user clearing exception may also qualify for the end-user clearing exception if the affiliate (i) acts on behalf of the non-financial entity and as agent, and (ii) uses a "swap" or "security-based swap" to hedge or mitigate the commercial risk of such non-financial entity or another affiliate of such non-financial entity that is not a "financial entity." However, the exemption does not apply if the affiliate itself is a

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[23] End-User Exception to Mandatory Clearing of Swaps, supra note 22.

[24] End-User Exception to Mandatory Clearing of Security-Based Swaps, supra note 22.

[25] End-User Exception to Mandatory Clearing of Swaps, supra note 22; End-User Exception to Mandatory Clearing of Security-Based Swaps, supra note 22.

[26] Id.

dealer or major participant, an investment company, a commodity pool or a bank holding company with more than $50 billion in consolidated assets.[27]

Dodd-Frank also provides that an affiliate, subsidiary or a wholly-owned entity of a person that qualifies for the non-financial entity exemption and that is predominantly engaged in providing financing for the purchase or lease of merchandise or manufactured goods of the person shall be excepted from the clearing requirement, provided that the "swaps" or "security-based swaps" in question are entered into to mitigate the risk of the financing activities. Additionally, excluded from the definition of financial entity are those entities (i) whose primary business is providing financing and (ii) who are using derivatives to hedge underlying commercial risks related to interest rate and foreign currency exposures, if 90% or more of those risks arise from the finance or lease of products, and if 90% or more of those products are manufactured by the parent company or another subsidiary of the parent.[28]

Swaps and Security-Based Swaps Grandfathered from the Clearing Requirement

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 Dodd-Frank and reported within 180 days after the effective date of Dodd-Frank; 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.

Exchange Trading Requirement

Sections 723 and 763 of Dodd-Frank amended the Commodity Exchange Act to require "swaps" and "security-based swaps" subject to the clearing requirement to 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. Section 733 of Dodd-Frank added to the Commodity Exchange Act requiring that no person may operate a facility for the trading or processing of swaps unless the facility is registered as a swap execution facility ("SEF") or as a designated contract market ("DCM"). If a "swap" or "security-based swap" is with a party that is not an eligible contract participant, 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."

27 Id.

28 Id.

In its final order, effective July 14, 2011[29], the CFTC designated certain provisions of Section 723 as Category 2 provisions (i.e., statutory provisions which do not by their express terms require rulemaking to implement, but which reference one or more of the terms under Sections 712(d) and 721(c) for which rulemaking is required to provide further definition) and provided temporary exemption but only to the extent of those requirements or portions of such provisions that specifically relate to such referenced terms. This temporary exemption expires upon the earlier of (i) the effective date of the applicable final rule further defining the relevant term referenced in the provision and (ii) December 31, 2011.

Recordkeeping Requirements

Over the course of the past year, the CFTC and the SEC have proposed rules regarding the recordkeeping obligations of parties to OTC derivatives in light of Dodd-Frank and, notably, have issued interim final rules regarding the reporting of "swaps" and "security-based swaps" entered into prior to the enactment of Dodd-Frank which took place on July 21, 2010.[30] The interim final rules generally require that parties to such transactions maintain all records, information and documents relating to the transaction and all terms relating to the transaction, which encompasses the actual documents, the date and time of execution of the transaction and all information from which the price of the transaction was derived.

The CFTC has issued further rulemaking specifically focused on "swaps" entered into prior to the enactment of Dodd-Frank on July 21, 2010 but which did not expire as of such date ("Pre-Enactment Swaps") and "swaps" entered into after the enactment of Dodd-Frank but prior to a compliance date to be determined (the "Reporting Date") (such swaps, "Transition Swaps").[31] The CFTC proposed rule further distinguishes Transition Swaps that were in existence on or after April 25, 2010, the date of the proposing release, and those which expired or terminated prior to such date.

Recordkeeping for Pre-Enactment Swaps and Transition Swaps Terminated Prior to April 25, 2011

With respect to Pre-Enactment Swaps which terminated or expired prior to April 25, 2011, each counterparty must retain any information and documents regarding the terms of such swaps in its possession on or after October 14, 2010, when the CFTC issued its interim final rule regarding recordkeeping and reporting.[32] The CFTC's proposed rule makes clear that counterparties are not required to create records or information, or to retain any records or

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[29] Effective Date for Swap Regulation, 76 Fed. Reg. 35372 (June 17, 2011) (to be codified at 17 C.F.R. ch. 1).

[30] Swap Data Recordkeeping and Reporting Requirements: Pre-Enactment and Transition Swaps, 76 Fed. Reg. 22833 (proposed Apr. 25, 2011) (to be codified at 17 C.F.R. Part 46); Reporting of Security-Based Swap Transaction Data, 75 Fed. Reg. 64643 (Oct. 20, 2010) (to be codified at 17 C.F.R. Part 240).

[31] Interim Final Rule for Reporting Pre-Enactment Swap Transactions, 75 Fed. Reg. 63080 (Oct. 14, 2010) (17 C.F.R. Part 44); Reporting Certain Post-Enactment Swap Transactions, 75 Fed. Reg. 78892 (Dec. 17, 2010) (at 17 C.F.R. Part 44).

[32] Reporting Certain Post-Enactment Swap Transactions, supra note 31, which required the retention of records regarding post-enactment, pre-effective swaps from and after that date. Such records must include the transaction confirmation and the time, if available, that the transaction was executed, as well as any information relating to the terms of the transaction more generally.

information, that were not in their possession on or after October 14, 2010. Additionally, counterparties may retain any existing records "as is" and are under no obligation to alter any formatting or organization of such records. All records required to be kept must be retained until five years from the final termination of the transaction.

The retention and recordkeeping obligations for Transition Swaps which terminated prior to April 25, 2011 are identical to those for Pre-Enactment Swaps. However, the obligations are only applicable for information and documents in a counterparty's possession on or after December 17, 2010.

Recordkeeping for Transition Swaps in Existence as of April 25, 2011

Records regarding Transition Swaps in existence on or after April 25, 2011 must be maintained by each counterparty to the swaps. The records must consist of, at a minimum, the "primary economic terms" of a "swap"[33] and, if the counterparty has in its possession the following documents on or after April 25, 2011, the terms of a confirmation, any master agreement and modifications or amendments thereto and any credit support agreement or similar agreement and modifications or amendments thereto. Furthermore, should any Transition Swap remain in existence on or after the Reporting Date, a counterparty must retain, from the Reporting Date onward, records only to the extent such records are created by or become available to such counterparty on or after the Reporting Date.

Accessibility of Records

Records required to be retained pursuant to the proposed rule must be available for inspection by and upon the request of the CFTC, the Department of Justice, the SEC, or by any representative of a prudential regulator. The accessibility of records required to be retained pursuant to the proposed rule depends on the status of the counterparty under Dodd-Frank. Counterparties that are swap dealers or major swap participants must have "real time electronic access" to records until two years following the final termination or expiration of a "swap." After those two years have elapsed, the records must be accessible within three business days until such records are no longer required to be retained. All other counterparties must be able to access any records within three business days until such records are no longer required to be retained.

Best Practices

Due to the uncertainty surrounding what the final rules will look like from both the CFTC and the SEC, counterparties would be wise to maintain all documentation and records regarding "swaps" irrespective of the proposed rules, and to adopt and enforce compliance policies to that end.

[33] The "minimum primary economic terms" of a swap are transaction type-specific as set forth in an appendix to the proposed rule and generally consist of information including, but not limited to, (1) the name of each counterparty, (2) whether any counterparty is a swap dealer or major swap participant, (3) the effective and expiration dates of the swap, (4) economic terms, including notional amounts, interest rates, day count fractions, and exchange rates, (5) the direction of payments and (6) whether the swap is physically or cash settled.

Reporting Requirements

The CFTC and the SEC have proposed rules regarding the reporting obligations of parties to OTC derivatives in light of Dodd-Frank.[34] Dodd-Frank provides that at least one counterparty to a "swap" or "security-based swap" must report data regarding the transaction to a swap data repository or a security-based swap data repository, as the case may be, and such requirement applies regardless of whether a "swap" or "security-based swap" is cleared or not, and regardless of whether foreign exchange swaps and forwards are exempted from mandatory clearing by the Secretary of the Treasury. In the event no data repository will accept reporting by a counterparty, the reporting counterparty must report directly to the relevant agency. Reporting will commence on a date to be established by each agency.

Reporting Party

The proposed rules set forth which counterparty is obligated to report based on the status of the counterparty as either a dealer, a major participant or neither. For example, in a transaction where a swap dealer and a major swap participant are counterparties, the swap dealer will be obligated to submit any reports. Similarly, in a transaction where a swap entity is a counterparty, and the other counterparty is not a swap entity, only the swap entity will be obligated to submit reports. Should both counterparties be of the same status, the choice of reporting party must be agreed upon as a term of the "swap." However, notwithstanding the status of the counterparties, should only one counterparty be a U.S. person, that counterparty must fulfill all reporting obligations.

Responsibility to Report

Under the SEC proposed rule, the reporting obligations are ultimately the responsibility of the reporting party, although nothing prevents a reporting party from contracting with a third party to report the transaction on its behalf, such as through a swap execution facility. The CFTC takes an alternate approach depending on how the "swap" was executed. For "swaps" executed on swap execution facilities, for example, the reporting obligation is actually with the swap execution facility, although the reporting party retains responsibility to correct errors or omissions in any reported data within certain specified timeframes.

Certain categories of information generally relating to the identity of the parties and the primary economic terms of a transaction are subject to real-time reporting, and such information, except for the identity of the parties, will be publicly disseminated by a data depository. The SEC defines this to mean "as soon as reasonably practicable, but in no event later than 15 minutes after the time of execution," while the CFTC uses the same definition but without any time limitation. Certain other additional information relating to payment streams and more generally the terms of the confirmation must be reported in its entirety, whether by

[34] Regulation SBSR—Reporting and Dissemination of Security-Based Swap Information, 75 Fed. Reg. 75208 (proposed Dec. 2, 2010) (to be codified at 17 C.F.R. Parts 240 & 242); Swap Data Recordkeeping and Reporting Requirements, 75 Fed. Reg. 76574 (proposed Dec. 8, 2010) (to be codified at 17 C.F.R. Part 45); Real-Time Public Reporting of Swap Transaction Data, 75 Fed. Reg. 76140 (proposed Dec. 7, 2010) (to be codified at 17 C.F.R. Part 43).

the reporting party or a swap execution facility, within specified time frames, but such information will not be publicly disseminated.

Regulation of Certain Derivative Market Participants and Data Repositories

Registered Clearinghouses

Dodd-Frank requires central registered clearinghouses 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.

Dodd-Frank 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.

SEC Proposed Rules

Pursuant to proposed SEC rules,[35] each registered clearing agency must have a chief compliance officer, whose compensation and removal require majority board approval and who is required to sign an annual report indicating compliance with Dodd-Frank and the policies and which is required to be filed with the SEC. Security-based swap clearing agencies must maintain sufficient financial resources to be able to withstand defaults by its two largest participants in extreme but plausible market conditions. A clearing agency must permit membership access by persons with net capital equal to or greater than $50 million, when aggregated with the participant's affiliates and subsidiaries. Additionally, registered clearing agencies cannot require participants to maintain a minimum portfolio size or transaction volume.

To protect against conflicts of interest, registered clearing agencies have two options to structurally organize themselves. In the first method, clearing agencies cannot allow any participant to own, directly or indirectly, any beneficial ownership interest greater than 20% entitled to vote or cause the voting of 20% of the clearing agency's voting power. Additionally, participants, together with all other participants, cannot together own or vote (or provide a proxy to vote) greater than 40% of a clearing agency's voting power and, in either case, the rules of the clearing agency must provide for divestiture of interests above those thresholds. The board of directors must be at least 35% independent and all committees exercising board

[35] Clearing Agency Standards for Operation and Governance, 76 Fed. Reg. 14472 (proposed Mar. 16, 2011) (to be codified at 17 C.F.R. Part 240); Ownership Limitations and Governance Requirements for Security-Based Swap Clearing Agencies, Security-Based Swap Execution Facilities, and National Securities Exchanges With Respect to Security-Based Swaps Under Regulation MC, 75 Fed. Reg. 65882 (proposed Oct. 26, 2010) (to be codified at 17 C.F.R. Part 242).

authority must meet this same requirement. In the second method, security-based swap clearing agencies cannot allow any participant to own, directly or indirectly, any beneficial ownership interest greater than 5% entitled to vote of such clearing agency, with no limitation on aggregation. The rules of the clearing agency must provide for divestiture of interests above this threshold. As this alternative does not provide a cap on the percentage of the clearing agency that may be owned in the aggregate by participants, to protect against conflicts of interest the board of directors must be at least majority independent and all committees exercising board authority must meet this same requirement.

CFTC Proposed Rules

The CFTC has proposed rules that are similar to the SEC requirements for derivatives clearing organizations, although they include certain notable differences.[36] Each derivatives clearing organization must have a chief compliance officer whose compensation must be approved by either the board of directors or the senior officer of the clearing agency, and the chief compliance officer must sign an annual report indicating compliance with Dodd-Frank and its policies which is required to be filed with the CFTC. Like registered security-based swap clearing agencies, derivatives clearing organizations must permit membership access by persons with net capital equal to or greater than $50 million. A derivatives clearing organization must maintain sufficient financial resources to be able to withstand a default by its largest participant in extreme but plausible market conditions and, with respect to its one-year operating costs capital requirement, must maintain at least six months' of capital in liquid assets. The board of directors must be composed of at least 10% by representatives of its customers. Each derivatives clearing agency must have a Risk Management Committee composed of at least 35% of public directors and at least 10% of representatives of its customers. Pursuant to the CFTC proposed rules, if the board of directors of a derivatives clearing agency rejects a recommendation or supersedes an action of the Risk Management Committee, a report must be made to the commission.

Similar to the corresponding SEC rules, the CFTC allows derivatives clearing organizations two options of how to structurally organize themselves to prevent against conflicts of interest. In the first option, participants may not beneficially own or vote greater than 20% of the voting power of the organization. Additionally, the organization shall not permit certain enumerated entities, such as bank holding companies, swap dealers and major swap participants, to beneficially own or vote in the aggregate greater than 40% of the voting power of the organization.

[36] Risk Management Requirements for Derivatives Clearing Organizations, 76 Fed. Reg. 3698 (proposed Jan. 20, 2011) (to be codified at 17 C.F.R. Part 39); Governance Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities; Additional Requirements Regarding the Mitigation of Conflicts of Interest, 76 Fed Reg. 722 (proposed Jan. 6, 2011) (to be codified at 17 C.F.R. Part 1, 37, 38, 39 & 40); General Regulations and Derivatives Clearing Organizations, 75 Fed. Reg. 77576 (proposed Dec. 13, 2010) (to be codified at 17 C.F.R. Parts 1 & 39); Requirements for Derivatives Clearing Organizations, Designated Contract Markets and Swap Execution Facilities Regarding the Mitigation of Conflicts of Interest, 75 Fed. Reg. 63732 (proposed Oct. 18, 2010) (to be codified at 17 C.F.R. Parts 1, 37, 38, 39 & 40); the CFTC's Part 40 final rulemaking was adopted on July 19, 2011 but the text of the final rulemaking was not available as of the date of this article.

Alternatively, in lieu of the above, the derivatives clearing organization can restrict the beneficial ownership or voting power of participants and the certain enumerated entities to 5% each.

Swap Execution Facilities

Section 733 of Dodd-Frank introduces the concept of a SEF. A SEF is a 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. Dodd-Frank requires each SEF to be registered with the CFTC and/or the SEC, as the case may be. SEFs that are registered with one agency, such as the CFTC, are not exempt from registration with the other applicable agency, such as the SEC, should they execute or trade both "swaps" and "security-based swaps." Like registered clearinghouses, registered SEFs must abide by certain core principles. A SEF must monitor trading and trade processing, position limits and the financial integrity of the transactions.

CFTC Proposed Rules

The CFTC has issued three proposed rules[37] regarding SEFs which execute or trade "swaps" over the course of the past year, and the releases predominantly focus on the internal governance and self-regulatory aspects of SEFs. A SEF must have "structural" independence; specifically, at least 35% of its board of directors must be "public directors," with at least two directors being public directors. This requirement extends to all committees of the board of directors that exercise any delegated management authority. Additionally, SEFs cannot agree to be operated by another entity, whether by ownership of voting equity, contract or otherwise, on a day-to-day basis unless such entity agrees to comply with the board of directors composition requirements. SEF members and related persons, including parents, subsidiaries under common control, partners, directors, officers or other employees of a member, including immediate family members who share the same home with a member, cannot own or vote more than 20% of any class of voting equity in a registered SEF. If the SEF is a subsidiary, this 20% ownership limit applies to its direct or indirect parent. Each SEF must have a Regulatory Oversight Committee composed entirely of public directors, whose job it is to oversee self regulation. Additionally, the compensation of directors must not be linked to the business performance of the SEF. To ensure non-discriminatory access to the markets, each SEF must have a Membership or Participation Committee which must be constituted of at least 35% public directors. Such a committee would possess the ability to determine the standards and requirements for initial and continuing membership or participation eligibility, would review appeals of staff denials of membership or participation, and would approve rules resulting in differing categories of members or participants receiving disparate access. The CFTC's

[37] Governance Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities; Additional Requirements Regarding the Mitigation of Conflicts of Interest, supra note 36; Core Principles and Other Requirements for Swap Execution Facilities, 76 Fed. Reg. 1214 (proposed Jan. 7, 2011) (to be codified 17 C.F.R. Part 37); Requirements for Derivatives Clearing Organizations, Designated Contract Markets and Swap Execution Facilities Regarding the Mitigation of Conflicts of Interest, supra note 36.

proposed rules also require that SEFs establish and enforce a broad array of internal rules relating to trade monitoring, position limits, electronic data capture, conflicts of interests, risk analysis, emergency back-up and disaster recovery.

SEFs may seek registration with the CFTC by completing Form SEF, pursuant to which the SEF would be required to provide documents and descriptions relating to its business organization, financial resources, its compliance program and its technological capabilities. A SEF would be required to demonstrate operational capability via documentation including technical manuals and third-party service provider agreements. A SEF must maintain sufficient financial resources to cover its operating costs for at least one year, calculated on a rolling basis, and to maintain at least six months' worth of operating expenses in unencumbered liquid assets. Such financial resources include the SEF's own capital and any other financial resource deemed acceptable by the CFTC. Compliance with this requirement must be calculated on a quarterly basis.

SEFs must provide for pre-trade transparency by giving market participants the ability to make executable bids or offers and indicative quotes and to display them to multiple parties on a central screen, including all other parties participating in the SEF, if the market participants wish to do so. Such a requirement prohibits trades executed by voice. However, pre-trade transparency is not required for (1) block trades, (2) trades that are not required to be cleared, whether pursuant to the application of the "end user exception" or because the CFTC has not made a determination regarding the clearing of a particular type of "swap" or (3) illiquid or bespoke swaps such that they are not made available for trading on the SEF.

SEC Proposed Rules

The SEC has issued proposed Regulation MC[38] to mitigate conflicts of interest in security-based swap execution facilities, which contains provisions similar to those in the CFTC proposals yet touches on fewer issues. Regulation MC, like the CFTC proposals, includes a 20% ownership and voting limitation on members or participants in a SEF. The SEC proposal goes further, however, in extending those ownership limitations to a participant or member that beneficially owns more than 25% of an entity that itself owns more than 20% of a SEF. The SEC requires that SEFs have the ability to dilute or not give effect to any offending participants' or members' voting or equity interest, as applicable, above the 20% threshold. Additionally, the board of directors of a SEC-registered SEF must be composed of a majority of independent directors, and this board composition requirement extends to any committee of the board of directors authorized to act on behalf of the board of directors. The SEC proposal otherwise contains similar requirements with regard to Regulatory Oversight Committees. The SEC is proposing that Regulation MC go into effect for SEFs 60 days after July 15, 2011, though the regulation will not go into effect until the final regulation is adopted. Under the current regulatory framework, the corresponding CFTC proposed rules would go into effect 60 days after their final publication.

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[38] Ownership Limitations and Governance Requirements for Security-Based Swap Clearing Agencies, Security-Based Swap Execution Facilities, and National Securities Exchanges With Respect to Security-Based Swaps under Regulation MC, *supra* note 35.

The SEC has also issued proposed Regulation SB SEF[39] providing for the registration and regulation of security-based SEFs. A security-based SEF may register with the SEC on Form SB SEF, which is similar to Form 1 required of national securities exchanges. Security-based SEFs, similar to the corresponding CFTC requirement, can be flexibly structured so long as they allow "more than one participant to interact with the trading interest of more than one other participant" on that platform and that the security-based SEF not be able to restrict the number of participants from which a quote could be requested. Unlike the CFTC proposal, the SEC proposal requires security-based SEFs to establish a Swap Review Committee whose job it is to determine the "security-based swaps" that trade, as well as which "security-based swaps" should no longer trade. However, such determinations are not relevant in determining whether a "security-based swap" is "available to trade" under the Exchange Act and thus must be cleared unless another exemption is applicable. Instead, such a determination will be made by reference to objective criteria to be developed by the SEC.

Temporary Relief Granted by the SEC

On July 1, 2011, the SEC issued an order[40] providing a temporary exemption from the requirement to register as national securities exchange in Section 5 and 6 of the Exchange Act to any person, other than a clearing agency, acting as a "central counterparty" (as defined in the order) in "security-based swaps," that solely due to its activities relating to "security-based swaps" would fall within the definition of an exchange and thus be required to register as an exchange. In reliance of the temporary exemption, the SEC also provided a temporary exemption to brokers and dealers from the prohibition in Section 5 on effecting transactions in "security-based swaps" on an exchange that is not a national securities exchange. The SEC also further extended a specific existing exemption from clearing agency registration under Section 17A of the Exchange Act and provided a temporary conditional exemption from the exchange registration requirements of Sections 5 and 6 of the Exchange Act to ICE Trust U.S. LLC, Chicago Mercantile Exchange Inc. and Ice Clear Europe, Limited, solely in connection with its calculation of mark-to-market prices for open positions in "Cleared CDS" (as defined in the order). The order extends the temporary exemption of any broker or dealer effecting any transaction in a security, or reporting any such transaction, on any of ICE Trust U.S. LLC, Chicago Mercantile Exchange Inc. and Ice Clear Europe, Limited with respect to Section 5 of the Exchange Act.

Segregation of Funds

Sections 724 and 763 of Dodd-Frank require collateral posted by a counterparty to a cleared "swap" or "security-based swap" to be held in a designated collateral account where such funds are prohibited from being used to margin, secure or guarantee any trades or obligations of another customer.

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39 Registration and Regulation of Security-Based Swap Execution Facilities, 76 Fed. Reg. 10948 (proposed Feb. 28, 2011) (to be codified 17 C.F.R. Parts 240, 242 & 249).

40 Order Granting Temporary Exemptions under the Securities Exchange Act of 1934 in Connection with the Pending Revision of the Definition of "Security" to Encompass Security-Based Swaps, and Request for Comment, 76 Fed. Reg. 39927 (Jul. 7, 2011).

To implement this mandate the CFTC issued a proposed rule[41] that would require futures commission merchants and derivatives clearing organizations to maintain separate entries in their books for each individual counterparty's respective collateral. Although the collateral of various counterparties may be operationally comingled in one account, an individual counterparty's funds may not be used to cover the liabilities of another counterparty or of the future commission merchant itself. In the event that a futures commission merchant simultaneously defaults with one or more of its cleared swap customers, the derivatives clearing organization would be allowed to access the collateral of the futures commission merchants' defaulting customers, but not the collateral of the non-defaulting customers. The CFTC is currently considering whether the final rule should allow a derivatives clearing organization to access the non-defaulting customers' collateral after it applies its own capital and the guaranty fund contributions of its non-defaulting futures commission merchant members.

Although collateral for uncleared "swaps" or "security-based swaps" is not required to be segregated, Dodd-Frank does give counterparties to uncleared "swaps" or "security-based swaps" the right to elect to have their collateral segregated. Dodd-Frank requires each swap entity to inform its counterparty to an uncleared "swap" that it has the right to segregate the funds or other property that it posts to secure its obligations. At the counterparty's request, the funds or other property must be segregated with an independent third party.

The CFTC issued a proposed rule that provides details about this notification process. The proposed rule requires the swap dealer or major swap participant to notify the counterparty's Chief Risk Officer or CEO of the counterparty's right to segregate its initial margin collateral. The counterparty to an uncleared "swap" must confirm with the swap dealer or major swap participant that it received this notification before the terms of the "swap" can be finalized. If the counterparty elects to segregate its collateral, its initial margin will be kept with an independent party. This party is contractually obligated to turn over control of the collateral to the entitled party at the appropriate time. If the counterparty decides not to segregate the collateral, the swap dealer or major swap participant must submit quarterly reports to the counterparty certifying that its procedures relating to margin and collateral requirements are in compliance with the terms of the party's agreement.

The SEC has granted temporary relief from the segregation requirements of uncleared "security-based swaps" as they relate to security-based swap dealers or major security-based swap participants, but not to cleared "security-based swaps."[42] Therefore, segregation requirements for cleared "security-based swaps" are effective as of July 16, 2011. The CFTC

[41] Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions, 76 Fed. Reg. 33818 (proposed June 9, 2011) (to be codified 17 C.F.R. Parts 22 & 190).

[42] Temporary Exemptions and Other Temporary Relief, Together With Information on Compliance Dates for New Provisions of the Securities Exchange Act of 1934 Applicable to Security-Based Swaps, 76 Fed. Reg. 36287 (June 22, 2011) (to be codified at 17 C.F.R. Part 240).

granted temporary relief from the segregation requirements relating to both cleared "swaps"[43] and uncleared swaps.[44]

Expansion of the CFTC's Regulatory Authority over Swaps

Anti-Disruptive Practices Authority

Section 747 of Dodd-Frank added to the Commodity Exchange Act anti-disruption provisions which prohibit any person from engaging in any disruptive trading practices on a designated contract market or swap execution facility, such as (A) violating a bid or offer, (B) demonstrating intentional or reckless disregard for the orderly trade execution during the closing period or (C) what is commonly known in the industry as "spoofing" (bidding or offering with the intent to cancel the bid or offer before execution).

The CFTC has issued a proposed interpretive order[45] to clarify the foregoing prohibitions on anti-disruptive practices. The new anti-disruptive provisions will not apply to block trades if executed pursuant to the rules of the SEF or DCM, and will also not apply to bilaterally negotiated swap transactions. The prohibition on violating a bid or offer set forth in (A) above is interpreted to mean buying a contract at a price that is higher than the lowest available offer price and/or selling a contract at a price that is lower than the highest available bid price on the particular trading platform. Violation of this is a per se offense with no requirement to prove intent. The CFTC notes in the proposed order that this prohibition would not be relevant with respect to transactions traded on a system where, for instance, a computer matches bids and offers. With respect to (B), the CFTC notes that accidental or even negligent trading conduct will not suffice, and that it is only applicable for "swaps" if a closing period or daily settlement price exists. The CFTC interprets "spoofing" to mean that a person intends to cancel a bid or offer before execution, and thus even reckless trading will not run afoul of this prohibition. According to the CFTC, "spoofing" includes submitting or cancelling bids or offers to overload a quotation system of a registered entity, submitting or cancelling bids or offers to delay another's execution of trades and submitting or cancelling multiple bids or offers to create an appearance of false market depth. Nevertheless, "spoofing" only implicates executable market communications and does not encompass requests for quotes and other pre-trade communications. The CFTC notes that in all cases it will examine the facts and circumstances surrounding an incident to determine if the anti-disruption provisions were breached.

Anti-Manipulation Authority

Section 753 of Dodd-Frank added to the Commodity Exchange Act anti-manipulation provisions prohibiting the use of any manipulative or deceptive device in connection with any "swap" in interstate commerce. Dodd-Frank prohibits (1) any false report concerning market information or conditions that affect the price of any "swap" and (2) any false or misleading statement of material fact, or omission thereof, to the CFTC, including in any registration

43 Effective Date for Swap Regulation, 76 Fed. Reg. 42508 (June 19, 2011).

44 Application of certain CEA provisions after July 16, 2011–the general effective date of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, CFTC No-Action Letter (July 14, 2011), available at www.cftc.gov/ucm/groups/public/@newsroom/documents/file/noactionletter071411.pdf

45 Antidisruptive Practices Authority, 76 Fed. Reg. 14943 (proposed Mar. 18, 2011).

application or report filed with the CFTC under the Commodity Exchange Act or any other information relating to any "swap" in interstate commerce. Dodd-Frank also prohibits any person from entering 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.

The CFTC has adopted final rules,[46] effective 30 days after their publication, to implement its authority under Section 753 of Dodd-Frank in the form of a broad, catch-all prohibition on fraud and manipulation that is modeled after Rule 10b-5 of the Exchange Act and which is designed to prohibit, among other things, fraud and fraud-based manipulative schemes, employed intentionally or recklessly, irrespective of whether the conduct actually was intended to or did create an artificial price.

Looking to the SEC's and courts' interpretations of Rule 10b-5 as a guidepost, the CFTC's rules are designed to capture the use or attempted use of any manipulative or deceptive contrivance and the making or attempt to make (or omit) a misleading statement of a material fact necessary in order to make the statements made not untrue or misleading for the purpose of impairing, obstructing or defeating the integrity of the markets subject to the CFTC's jurisdiction. Actions involving negligence or gross negligence will not violate the rule; only intentional or reckless conduct will suffice. Additionally, the relevant conduct must be made in a manner reasonably calculated to influence market participants. Given the purposeful similarity to Rule 10b-5 and the intent requirements, market participants engaged in legitimate market activity undertaken in good faith will not run afoul of this rule.

In response to comments from market participants, the CFTC clarified the potential scope of the rules. The final rules do not impose new affirmative duties of inquiry, diligence or disclosure and silence, absent a preexisting duty to disclose information, is not deceptive within the meaning of the new rules. However, market participants must disclose information as necessary to make any statement made to the other person in or in connection with a transaction not misleading in any material respect. The CFTC in its adopting release specifically referred to Commodity Exchange Act Section 6(c)(1) which provides that no rule of the CFTC shall require a person to "disclose nonpublic information that may be material to the market price, rate, or level of the commodity transaction, except as necessary to make any statement made to the other person in or in connection with the transaction not misleading in any material respect." The final rules do not prohibit trading on the basis of material nonpublic information except if the trader engages in deceptive or manipulative conduct, for example by trading on the basis of material nonpublic information in breach of a pre-existing duty.

<u>Whistleblower Incentives and Protections</u>

Dodd-Frank provides incentives and protections for whistleblowers through the payment of an award to those who voluntarily provide original information that leads to the successful enforcement of a judicial or administrative action for more than $1 million.

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[46] Prohibition of the Employment, or Attempted Employment, of Manipulative and Deceptive Device; Prohibition on Price Manipulation, 76 Fed. Reg. 41398 (July 14, 2011) (to be codified at 17 C.F.R. Part 180).

Pursuant to a proposed rule,[47] original information means information that is (1) derived from independent knowledge or independent analysis of the whistleblower, (2) not already known to the CFTC from any source and (3) not exclusively derived from allegations made in governmental hearings, reports, audits, investigations or from the news.

The independent knowledge requirement involves facts not generally known or available to the public and specifically excludes facts (1) from sources generally available to the public, (2) through attorney-client privileged communication, (3) as a result of legal representation or (4) because the person was in a position whereby the information was communicated to them with a reasonable expectation that they would take steps to remedy the violation or through legal, compliance and audit processes, unless the entity did not disclose the information to the CFTC within 60 days or acted in bad faith.

A whistleblower's information must have either (1) caused the CFTC to open or reopen an investigation or to make an inquiry concerning different conduct that the CFTC was already focused on and where the information significantly contributed to the success of the action or (2) if the information related to conduct already under investigation, the information must not have otherwise been obtained and was essential to the success of the action.

Whistleblowers who meet these and other eligibility requirements outlined in the proposed rule, including making a claim within 60 days of the publication of a notice on the CFTC's website, would be eligible for an award of between 10% and 30% of the total monetary sanctions imposed.

Expansion of the SEC's Regulatory Authority over Security-Based Swaps

Dodd-Frank contains a number of amendments to the U.S. securities laws which expand the SEC's regulatory authority over derivatives, pursuant to which the SEC has issued certain final and proposed rules and interpretive guidance.

Beneficial Ownership Rules

Section 13 of the Exchange Act, as amended by Section 766 of Dodd-Frank, states that the purchase, sale, assignment or termination of a "security-based swap" may be deemed to be a purchase or sale of the underlying security for the purposes of determining beneficial ownership. New Section 13(o) of the Exchange Act, after amendment by Section 766 of Dodd-Frank, requires that the SEC determine when a person is deemed to acquire "beneficial ownership" of an equity security based upon the purchase or sale of a "security-based swap." In a final rule,[48] the SEC readopted Rules 13d-3 and 16a-1 of the Exchange Act to preserve the application of the beneficial ownership rules after the effectiveness of new Section 13(o).

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[47] Implementing the Whistleblower Provisions of Section 23 of the Commodity Exchange Act, 75 Fed. Reg. 75728 (proposed Dec. 6, 2010) (to be codified at 17 C.F.R. Part 165).

[48] Beneficial Ownership Reporting Requirements and Security-Based Swaps, 76 Fed. Reg. 34579 (June 14, 2011) (to be codified at 17 C.F.R. Part 240).

The adopting release[49] for this final rule notes that the SEC staff is engaged in a separate project to develop proposals to modernize beneficial ownership reporting. Accordingly, additional rulemaking initiatives from the SEC in this area may be forthcoming.

Anti-Manipulation Authority

Section 763(g) of Dodd-Frank expands the anti-manipulation provision of Section 9 of the Exchange Act and authorizes the SEC to adopt rules to prevent fraud, manipulation and deception in connection with "security-based swaps." Specifically, Section 763(g) adds new subparagraph (j) to Section 9 to make it unlawful for "any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange, to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any "security-based swaps," in connection with which such person engaged in any fraudulent, deceptive, or manipulative act or practice, makes any fictitious quotation, or engages in any transaction, practice, or course of business which operates as a fraud or deceit upon any person." In addition, Section 9(j) of the Exchange Act directs the SEC to "by rules and regulations define, and prescribe means reasonably designed to prevent, such transactions, acts, practices, and courses of business as are fraudulent, deceptive, or manipulative, and such quotations as are fictitious."

The SEC has proposed a new rule[50] under the Exchange Act to help prevent fraud, manipulation and deception in connection with the offer, purchase or sale of any "security-based swap," as well as in connection with the exercise of any right or performance of any obligation under a "security-based swap," including the avoidance of such exercise or performance. Under the proposed rule (Rule 9j-1), "security-based swaps" will be subject to the general anti-fraud and anti-manipulation provisions of the federal securities law. Proposed Rule 9j-1 prohibits the same categories of misconduct as Section 10(b) of the Exchange Act and Rule 10b-5 thereunder and Section 17(a) of the Securities Act in the context of "security-based swaps." In addition, the proposed rule explicitly reaches misconduct in connection with ongoing payments or deliveries throughout the life of a "security-based swap." The proposed rule prohibits (1) a person from engaging in fraudulent and deceptive schemes in order to increase or decrease the price or value of a "security-based swap," (2) the dissemination of false financial information or data in connection with the sale of a "security-based swap" and (3) insider trading in a "security-based swap." The proposed rule also prohibits misconduct in connection with the "exercise of any right or performance of any obligation under" a "security-based swap" or "the avoidance of such exercise or performance." Thus, the SEC concluded that the proposed rule would prohibit fraudulent conduct that affects the value of cash flows, payments or deliveries under a "security-based swap," such as taking manipulative action that triggers the obligation of a counterparty to make a large payment or to post additional collateral. The proposed rule also prohibits a person from making false or misleading statements to avoid having to make a large payment, post additional collateral or perform another obligation under a "security-based swap."

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49 Id.

50 Prohibition Against Fraud, Manipulation and Deception in Connection with Security-Based Swaps, 75 Fed. Reg. 68560 (proposed Nov. 8, 2010) (to be codified at 17 C.F.R. Part 240).

Because the proposed rule would apply to conduct "in connection with… a security-based swap," the SEC stated that it would apply to fraud, manipulation, or deception involving the assets underlying the "security-based swap" (referred to in the proposing release as the "reference underlying") to the extent that such misconduct is in connection with the offer, purchase or sale of any "security-based swap," the exercise of any right or performance of any obligation under a "security-based swap," or the avoidance of such exercise or performance.

Temporary Relief for Certain Security-Based Swaps

The SEC has proposed to further define and provide guidance regarding the terms "security-based swap,"[51] "security-based swap agreement," and "eligible contract participant."[52] These proposed rules have not been adopted by the Effective Date. The SEC has expressed concern about such legal uncertainty causing disruptions to the operation of the security-based swap markets. To reduce uncertainty in the markets, the SEC has issued an exemptive order[53] to allow persons currently participating in the security-based swap markets who are eligible contract participants as that term is defined prior to Dodd-Frank but who could potentially be considered non-eligible contract participants under the definition of "eligible contract participant" as amended by Title VII to continue to do so until the term "eligible contract participant" is further defined in final rulemaking.

In addition, on July 1, 2011, the SEC adopted interim final rules,[54] providing for certain conditional exemptions under the Securities Act, the Exchange Act and the Trust Indenture Act of 1939 applicable to "security-based swaps" that under current law are "security-based swap agreements" (which under such definition must be entered into between eligible contract participants (as defined in Section 1a(12) of the Commodity Exchange Act as in effect prior to July 16, 2011) and subject to individual negotiation) and that will be defined as "securities" under the Securities Act on July 16, 2011 due solely to the provisions of the Title VII of Dodd-Frank ("exempted security-based swap agreements").

More specifically, under the Securities Act Rule 240, the SEC exempted from all provisions of the Securities Act, except for the anti-fraud provisions of Section 17(a), subject to certain conditions, the offer or sale of exempted security-based swap agreements. Under the Exchange Act Rule 12a-11 and Rule 12h-1(i), the SEC exempted any "security-based swap" offered and sold in reliance on Securities Act Rule 240 from the provisions of Sections 12(a) and 12(g) of the Exchange Act. Under the Trust Indenture Act Rule 4d-12, the SEC exempted any "security-based swap" offered or sold in reliance on Securities Act Rule 240 from having to comply with the provisions of the Trust Indenture Act. These rules will expire on the compliance date for

[51] Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, supra note 13.

[52] Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," supra note 2.

[53] Order Pursuant to Section 15F(b)(6) and 36 of the Securities Exchange Act of 1934 Granting Temporary Exemptions and Other Temporary Relief, Together with Information on Compliance Dates for New Provisions of the Securities Exchange Act of 1934 Applicable to Security-Based Swaps, 76 Fed. Reg. 36287 (June 22, 2011).

[54] Exemptions for Security-Based Swaps, 76 Fed. Reg. 40605 (Jul. 11, 2011).

final rules that the SEC may adopt further defining both the terms "security-based swap" and "eligible contract participant."

The definition of "security-based swap agreement" under the current law limits its application to a swap agreement of which a material term is based on the price, yield, value or volatility of any security or group or index of securities, or any interest therein. As a result, "security-based swaps" referencing loans or indices of loans ("Loan SBS") would not qualify as "security-based swap agreements" and would not have qualified for the above exemptions. To close this gap, on July 15, 2011, the SEC issued a no action letter[55] and stated that there will be no SEC enforcement actions if "eligible contract participants" (as defined in Section 1a(12) of the Commodity Exchange Act as in effect prior to the Effective Date, other than a person who is an eligible contract participant under Section 1a(12)(C) of the Commodity Exchange Act as in effect prior to the Effective Date) engage in offers or sales of Loan SBS without compliance with the provisions of the Securities Act (other than Section 17(a) thereof), Sections 12(a) and (g) of the Exchange Act, or the Trust Indenture Act, subject to the following conditions: (A) the Loan SBS are within the definition of "swap agreement" under Section 206A of the Gramm-Leach-Bliley Act as in effect prior to July 16, 2011, but not the definition of "security-based swap agreement" (as defined in Section 2A of the Securities Act as in effect prior to July 16, 2011) and (B) such "eligible contract participants" satisfy the conditions in Securities Act Rule 240, Exchange Act Rules 12a-11 and 12h-1(i) and Trust Indenture Act Rule 4d-12 as if such Loan SBS were "security-based swap agreements" under such Rules. Additionally, there will be no enforcement action with respect to the Exchange Act Sections 12(a) and (g) if the "eligible contract participants" do not register under Section 12(g) of the Exchange Act a class of Loan SBS offered or sold without registration under the Securities Act in reliance on the provisions of the no action letter. The SEC position in the no action letter will remain in effect for so long as Securities Act Rule 240, Exchange Act Rules 12a-11 and 12h-1(i) and Trust Indenture Act Rule 4d-12 remain in effect or until such time the SEC modifies or withdraws the position taken in the letter.

On July 1, 2011, the SEC also issued an order[56] granting temporary exemptive relief from compliance with certain provisions of the Exchange Act that otherwise would apply to security-based swap activities as of July 16, 2011. The temporary exemption will be available to any person that meets the definition of "eligible contract participant" that was in effect as of July 20, 2010 (the day prior to the enactment of Dodd-Frank), other than (A) a registered broker-dealer or (B) except in limited circumstances, self-regulatory organizations. Subject to certain exclusions, persons covered by the temporary exemption will be exempt from the provisions of the Exchange Act, and the applicable rules and regulations thereunder, solely in connection with their activities involving "security-based swaps." In particular, the temporary exemption applicable to "security-based swaps" does not extend to the antifraud and anti-manipulation provisions of the Exchange Act, and underlying rules and regulations prohibiting fraud,

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55 Response of the Office of Capital Market Trends, Division of Corporate Finance, Re: Cleary Gottlieb Steen & Hamilton LLP Incoming Letter dated July 15, 2011, available at http://sec.gov/divisions/corpfin/cf-noaction/2011/clearygottliebsteenhamilton-071511-sec5.htm

56 Order Granting Temporary Exemptions under the Securities Exchange Act of 1934 in Connection with the Pending Revision of the Definition of "Security" to Encompass Security-Based Swaps, and Request for Comment, supra note 40.

manipulation or insider trading. The order also carves out specific sections of the Exchange Act and underlying rules and regulations from this temporary exemption. In the order, the SEC separately provided exemptive relief to a broker or dealer registered under Section 15(b) of the Exchange Act solely with respect to its activities and positions involving "security-based swaps," subject to certain exclusions.

The SEC also temporarily exempted any "security-based swap" contract entered into on or after July 16, 2011 from being void or considered voidable by reason of Section 29 of the Exchange Act on the basis that a party to the "security-based swap" is alleged to have violated any of the provisions for which the SEC has provided exemptive relief within the order. Such exemptions remain in effect until the compliance date for final rules that the SEC may adopt further defining the terms "security-based swap" and "eligible contract participant."

REGULATION OF PRIVATE FUNDS

BY THOMAS H. BELL, OLGA GUTMAN AND CHI H. SHUM

Dodd-Frank made numerous changes to the registration, reporting and recordkeeping requirements of the Investment Advisers Act of 1940, as amended (the "Advisers Act"). Most significantly, Dodd-Frank eliminated the "private adviser" exemption that many investment advisers to private funds relied on and replaced it with several narrower exemptions. This article focuses on the rules recently adopted by the Securities and Exchange Commission ("SEC"), which implement these new exemptions from registration and certain amendments to the Advisers Act. To the extent an adviser that relied on the private adviser exemption as of July 21, 2011 is unable to meet the requirements of these new exemptions, it is required to register with the SEC by March 30, 2012.[1] Since an initial application for registration may take up to 45 days for approval by the SEC, a registering adviser should file its Form ADV no later than February 14, 2012.

Investment advisers that are registered with the SEC as of January 1, 2012 must file by March 30, 2012 an amendment to their Form ADV containing information necessary to identify whether they should transition to state registration.

Exemptions from Registration

Foreign Private Advisers

Newly revised Section 203(b)(3) of the Advisers Act provides for an exemption from registration for foreign private advisers.[2] A foreign private adviser, as defined in Section 202(a)(30), is any investment adviser that (i) has no place of business[3] in the U.S., (ii) has, in total, fewer than 15 clients in the U.S. and investors in the U.S. in private funds (including those formed in non-U.S. jurisdictions) advised by the adviser, (iii) has aggregate assets under management[4] attributable to clients in the U.S. and investors in the U.S. in private funds (including those formed in non-U.S. jurisdictions) advised by the adviser of less than $25 million and (iv) does not hold 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.

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1 July 21, 2011 is the effective date of the changes to the Advisers Act made by Dodd-Frank. Advisers that do not rely on the private adviser exemption as of this date (because, for example, they are newly formed and are not yet engaged in an investment advisory business) must first register before engaging in an investment advisory business, unless such adviser meets an exemption or exclusion from registration.

2 *See* Section II.C of the Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers, Investment Advisers Act Release No. IA-3222 (June 22, 2011), *available at* http://sec.gov/rules/final/2011/ia-3222.pdf (the "Exemptions Release").

3 A "place of business" means any office where the investment adviser regularly provides advisory services, solicits, meets with, or otherwise communicates with clients, and any location held out to the public as a place where the adviser conducts any such activities.

4 Assets under management are calculated the same way as "regulatory assets under management" for purposes of Item 5 of Form ADV, as described further in this memorandum.

Counting clients. In determining the number of clients and investors for purposes of the foreign private adviser exemption, an adviser is permitted to treat as a single "client" (i) an entity to which the adviser provides investment advice based on such entity's investment objectives, and (ii) two or more entities that have identical owners. The adviser is required to count both paying and non-paying clients. In addition to counting clients, this exemption requires the adviser to count the number of "investors"[5] of an issuer that is a "private fund"[6] managed by the adviser. Advisers must look through nominee and similar arrangements (*e.g.*, master-feeder structures or total return swap arrangements relating to private funds) to the underlying investors in the private fund. Holders of both equity and debt securities count as investors; however, knowledgeable employees[7] are not treated as investors. To avoid double-counting, a private fund would not be counted as a client if an investor in such fund is counted as an investor, and a person would not be counted as an investor if such person is counted as a client.

Defining U.S. status. The foreign private adviser exemption uses the term "in the U.S." in several instances, in particular, with respect to the number of clients and investors, the amount of assets under management, the adviser's place of business, and where the adviser holds itself out to the public as an investment adviser. The definition of "in the U.S." for purposes of this exemption generally incorporates the definition of a U.S. person and U.S. under Regulation S promulgated under the Securities Act of 1933, as amended. The adviser may also treat an investor as not being in the U.S. if the adviser reasonably believes that the investor is not in the U.S. A person who is in the U.S. may be treated as not being in the U.S. if the person was not in the U.S. at the time of becoming a client or, in the case of an investor in a private fund, each time the investor acquires securities issued by the fund.

It should be noted that a non-U.S. adviser with an affiliated registered broker-dealer in the U.S. may be considered as having a place of business in the U.S. due to its solicitation activities in the U.S., and therefore may be ineligible for the foreign private adviser exemption.

An adviser that qualifies for and relies on the foreign private adviser exemption would not be required to register under the Advisers Act, and would not be subject to the reporting or recordkeeping provisions thereunder, nor be subject to SEC examination. However, such adviser, to the extent it becomes ineligible to rely on this exemption due to an increase in the value of assets under management attributable to clients and investors in the U.S., would not be given a period within which to register with the SEC that is available to a non-U.S. adviser relying on the private fund adviser exemption.

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5 An "investor" is a person who would be included in determining the number of beneficial owners of the outstanding securities of a private fund under Section 3(c)(1) of the Investment Company Act of 1940, as amended (the "Investment Company Act"), or whether the outstanding securities of a private fund are exclusively owned by qualified purchasers under Section 3(c)(7) of that Act, except that beneficial owners of short term paper issued by the private fund will also be included in determining the number of beneficial owners of the outstanding securities.

6 A "private fund" is an issuer that relies (or is entitled to rely) on exemptions provided in Sections 3(c)(1) or 3(c)(7) of the Investment Company Act.

7 *See* Rule 3c-5(a)(4) under the Investment Company Act.

Private Fund Advisers

Rule 203(m)-1 exempts an adviser that advises solely private funds and has assets under management in the U.S. of less than $150 million.[8] Under this rule, such adviser would not be required to register as long as (i) it has no client that is a U.S. person except for qualifying private funds,[9] and (ii) any assets managed by such adviser at a place of business in the U.S. are solely attributable to private fund assets[10] valued at less than $150 million.

In determining whether assets are managed at a place of business in the U.S., the SEC would look to an adviser's principal office and place of business as the location whether the adviser controls the management of private fund assets, although day-to-day management of certain assets may take place at another location. An adviser's principal office and place of business is the executive office of the adviser from which the officers, partners or managers of the adviser direct, control, and coordinate the activities of the adviser. Advisers relying on this private fund adviser exemption are "exempt reporting advisers," and will be subject to certain reporting and recordkeeping requirements as described below under "Reporting Requirements."

If the adviser has any client that is a U.S. person, other than a qualifying private fund, it would be unable to rely on this private fund adviser exemption. Similarly, any assets managed from a U.S. place of business for clients other than private funds would make the exemption unavailable.

(i) Distinction between U.S. and Non-U.S. Advisers

An adviser with its principal office and place of business in the U.S. (a "U.S. Adviser") must count all private fund assets, including those from non-U.S. (offshore) clients toward the $150 million assets under management calculation. Any assets managed by a U.S. Adviser for clients other than qualifying private funds, such as separately managed accounts,[11] would make the exemption unavailable.

An adviser with its principal office and place of business outside of the U.S. (a "Non-U.S. Adviser") needs to count only private fund assets it manages at a place of business in the U.S.

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8 *See* Section II.B of the Exemptions Release.

9 A qualifying private fund is any private fund (*i.e.*, an investment vehicle that relies on exemptions provided by Sections 3(c)(1) or 3(c)(7) of the Investment Company Act) that is not registered under the Investment Company Act and is not a business development company, as well as any fund that qualifies for an exclusion from the definition of an investment company under the Investment Company Act, even if it is not a 3(c)(1) or 3(c)(7) fund, as long as the fund is treated as a private fund under the Advisers Act for all purposes.

10 "Private fund assets" means the investment adviser's assets under management attributable to a qualifying private fund.

11 In the Exemptions Release, the SEC indicated that whether a fund with a single investor could be a "private fund" for purposes of the private fund exemption depends on the facts and circumstances. The SEC expressed concern that an adviser, in seeking to rely on this exemption, could convert separately managed accounts to single-investor funds. However, this could be viewed as a violation of Section 208(d) of the Advisers Act, which prohibits a person from doing indirectly, or through or by another person, any act or thing which it would be unlawful for such person to do directly.

toward the $150 million assets limit. The type or number of a Non-U.S. Adviser's non-U.S. clients[12] or the amount of assets it manages outside of the U.S. would not be taken into account. Hence, an adviser with no U.S. place of business and no U.S. clients other than qualifying private funds with less than $150 million of assets under management would qualify for this registration exemption regardless of the amount of capital under management from U.S investors in its non-U.S. private funds. In addition unlike the foreign private adviser exemption, a Non-U.S. Adviser relying on this exemption may have a U.S. place of business so long as only qualifying private funds are managed from its U.S. places of business and it manages less than $150 million of assets under management from qualifying private funds from its U.S. places of business. Non-U.S. Advisers with a U.S. affiliate or U.S. office will need to determine whether they are managing assets in the U.S. for purposes of this exemption. Specifically, the SEC noted that providing research or conducting due diligence at a U.S. place of business would not be viewed as causing assets to be covered if a person outside of the U.S. makes independent investment decisions and implements those decisions.

(ii) Determination of Assets Under Management

In the Implementing Release,[13] the SEC revised the instructions to Form ADV to provide a uniform method to calculate assets under management for regulatory purposes. Assets under management include the value of any securities portfolios (*i.e.*, any portfolio at least 50% of the total value of which consists of securities) or any private fund for which the adviser provides continuous and regular supervisory or management services, regardless of the nature of the assets held by the portfolio and/or the fund. Advisers must include in their calculation any proprietary assets, assets managed without receiving compensation, uncalled capital commitments and assets of non-U.S. clients.[14] In addition, an adviser must determine the amount of its private fund assets based on the market value of those assets, or the fair value of those assets where market value is unavailable, and must calculate the assets on a gross basis, *i.e.*, without deducting liabilities, such as accrued fees and expenses or the amount of any borrowing.

An adviser must annually calculate the amount of the private fund assets it manages and report the amount in its annual updating amendments to its Form ADV. If an adviser has $150 million or more of private fund assets and therefore becomes ineligible to rely on this exemption, it will have 90 days after filing the annual updating amendment to register as an investment adviser with the SEC if it has complied with all SEC reporting requirements. However, this 90 day grace period is not available to advisers that have failed to comply with the applicable SEC reporting requirements or that have accepted a client that is not a private fund. In such a case, the adviser's registration must be approved prior to its acceptance of a non-private fund client.

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[12] Importantly, a fund formed under non-U.S. law (*i.e.*, an "offshore fund") would be considered a non-U.S. client for this purpose.

[13] *See* Section II.A of the Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Act Release No. IA-3221 (June 22, 2011), *available at* http://sec.gov/rules/final/2011/ia-3221.pdf (the "Implementing Release").

[14] With respect to the foreign private adviser exemption, the non-U.S. adviser would only include assets under management that are attributable to clients in the U.S. and investors in the U.S. in private funds advised by the adviser.

Venture Capital/Family Office

Venture Capital Fund Advisers. Advisers solely to "venture capital funds," regardless of their size, are not required to register.[15] A venture capital fund is defined as a private fund that (i) holds no more than 20 percent of the fund's aggregate capital commitments in non-qualifying investments[16] (other than short-term holdings); (ii) does not borrow, issue debt obligations, provide guarantees or otherwise incur leverage in excess of 15% of the fund's capital contributions and uncalled committed capital, and any such borrowing, indebtedness, guarantee or leverage is for a non-renewable term of no longer than 120 calendar days (except that certain guarantees of qualifying portfolio company obligations by the fund are not subject to the 120 calendar days limit); (iii) does not offer its investors redemption or other similar liquidity rights except in extraordinary circumstances; (iv) represents itself as pursuing a venture capital strategy to its investors and prospective investors; and (v) is not registered under the Investment Company Act, and is not a business development company. An existing private fund would be deemed to meet the definition of "venture capital fund" if it: (i) represented to investors and potential investors at the time the fund offered its securities that it pursues a venture capital strategy; (ii) has sold securities to one or more investors (that are not related persons) prior to December 31, 2010; and (iii) does not sell any securities to, including accepting any capital commitments from, any person after July 21, 2011. Similar to private fund advisers, advisers solely to venture capital funds are "exempt reporting advisers," and will be subject to certain reporting and recordkeeping requirements as described below under "Reporting Requirements."

Family Office Advisers. Dodd-Frank provides that any "family office" does not fall within the definition of "investment adviser" as such term is defined in the Advisers Act and thus will not be subject to regulation under the Advisers Act. A "family office" is any company that: (i) provides investment advice only to family clients; (ii) is wholly owned by family clients and is exclusively controlled by family members and / or family entities; and (iii) does not hold itself out to the public as an investment adviser.[17] This family office exclusion applies only to family offices serving one family, and does not extend to multifamily offices. Family offices that obtained exemptive orders from the SEC will be able to continue operating under their existing exemptive orders.

Subadvisers and Advisory Affiliates

The SEC generally interprets advisers to include subadvisers. As a result, subadvisers may also rely on the exemptions described herein, provided that such subadvisers must satisfy the conditions for the applicable exemption. For a subadviser that has a contract with the primary

15 *See* Rule 203(l) of the Advisers Act in the Exemptions Release.

16 "Qualifying investments" generally consist of equity securities issued by a qualifying portfolio company that is directly acquired by a qualifying fund and certain equity securities exchanged for the directly acquired securities. A qualifying portfolio company is any company that (i) is not a reporting or foreign traded company and does not have a control relationship with a reporting or foreign traded company; (ii) does not incur leverage in connection with the investment by the private fund and distribute the proceeds of any such borrowing to the private fund in exchange for the private fund investment; and (iii) is not itself a fund (*i.e.*, is an operating company).

17 Rule 202(a)(11)(G)-1(b) under the Advisers Act.

adviser and not the fund, the subadviser may rely on the private fund adviser exemption if its services to the primary adviser relate solely to private funds, or rely on the venture capital exemption if its services relate solely to venture capital funds, and all other conditions of the applicable rules are satisfied. In determining the assets under management for the private fund adviser exemption, a subadviser counts only that portion of the private fund assets for which it has responsibility.

For advisers with advisory affiliates, the SEC will treat as a single adviser two or more affiliated advisers that are separately organized but operationally integrated, which could result in a requirement for one or both advisers to register. In previous no action letters, the SEC has stated that it would not recommend enforcement if (i) a non-U.S. advisory affiliate of a registered adviser shares personnel with, and provides certain services through, such registered affiliate without such non-U.S. advisory affiliate registering under the Advisers Act and (ii) where such non-U.S. advisory affiliate provides advisory service to its non-U.S. clients.[18] The SEC has confirmed that the new rules in the Exemptions Release are not intended to withdraw any statements or views in such prior no action letters (which were developed in the context of the private adviser exemption, which has been repealed), but expects there will be further guidance regarding the application of such no action letters in the context of the new exemptions.

Small and Mid-Sized Advisers; State Registration

Dodd-Frank reallocated the regulatory responsibility for smaller investment advisers to the state securities agencies in order to reduce the burden on the SEC that is expected to result from the elimination of the private adviser exemption. Previously, advisers with less than $25 million in assets under management generally were prohibited from registering with the SEC. The rules adopted by the Implementing Release raise this threshold for SEC registration to $100 million by creating a new category of advisers called "mid-sized adviser," which is defined as an adviser that: (i) manages between $25 million and $100 million of assets; (ii) is required to be registered with the state in which it maintains its principal office and place of business; and (iii) would be subject to examination by that state, if so required to register. Minnesota, New York or Wyoming are states where state-registered mid-sized advisers would not be subject to examination. Therefore, mid-sized advisers having their principal office and place of business in Minnesota, New York or Wyoming will not switch to state registration. A mid-sized adviser may not register with the SEC unless: (i) it would be required to register in 15 or more states; or (ii) it is an adviser to a registered investment company or a business development company. Mid-sized advisers that are no longer eligible for SEC registration must withdraw the SEC registration by filing Form ADV-W by June 28, 2012 and complete the switch to state registration.

For advisers with close to $100 million in assets under management, the SEC has adopted a "buffer" to prevent an adviser from having to switch frequently between state and SEC registration as a result of changes in the value of its assets under management or the departure of one or more clients. Advisers with greater than $100 million in assets under management but less than $110 million are permitted, but not required, to register with the SEC. Advisers that

[18] See, e.g., Uniao de Bancos de Brasileiros S.A., SEC Staff No-Action Letter (July 28, 1992).

are registered with the SEC and have at least $90 million in assets under management need not withdraw their SEC registrations.

Reporting Requirements

Exempt Reporting Advisers

Advisers exempt from SEC registration in reliance on the private fund adviser exemption or the venture capital exemption are known as "exempt reporting advisers." Exempt reporting advisers will not be required to register with the SEC but will be required to file, and periodically update, reports to the SEC by completing limited portions of Form ADV, Part 1A.[19] Such items include: Items 1 (Identifying Information), 2.B. (SEC Reporting by Exempt Reporting Advisers), 3 (Form of Organization), 6 (Other Business Activities), 7 (Financial Industry Affiliations and Private Fund Reporting) with Items 6 and 7 requiring disclosure of business activities that the adviser and its affiliates are engaged in, and information on the private funds they advise, 10 (Control Persons) which would require disclosure of ownership and control of the adviser and 11 (Disclosure Information) which would require disclosure of disciplinary history for the adviser and certain of its employees.

The initial filing of Form ADV must be made between January 1 and March 30, 2012. Unlike advisers registering under the Advisers Act that must initially submit Form ADV for approval over a 45-day period, the filing by an exempt reporting adviser is considered to be filed with the SEC upon receipt by the Investment Adviser Registration Depository ("IARD"). Form ADV filed with IARD would be publicly available on the SEC's website.[20] It is required to be amended at least annually, within 90 days of the end of the adviser's fiscal year, and more frequently under certain specific circumstances (e.g., promptly if Items 1, 3 or 11 become inaccurate in any way, or if Item 10 becomes materially inaccurate).

The SEC is authorized under Section 204(a) of the Advisers Act to require an exempt reporting adviser to maintain records and provide reports, and to examine such adviser's records, which means an exempt reporting adviser's books and records would be subject to SEC inspection. The SEC currently does not intend to perform routine examinations of exempt reporting advisers, but it retains the authority to do so in its discretion.

Form ADV Amendments

The Implementing Release adopted a number of amendments to Form ADV which, among other things, requires advisers to provide additional information with respect to the advisers' (i) private funds, (ii) advisory business and business practices that may present significant conflicts of interest and (iii) non-advisory activities and financial industry affiliations.

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[19] *See* Appendix D of Implementing Release, available at http://sec.gov/rules/final/2011/ia-3221-appd.pdf.

[20] The Investment Adviser Public Disclosure System, available at http://www.adviserinfo.sec.gov, allows the public to access Form ADVs, including those filed by an exempt reporting adviser.

(i) Private Fund Reporting

Amendments to Item 7.B and Schedule D of Form ADV expand the information advisers (both registered and exempt reporting advisers) must report about the private funds they advise. An adviser must file a separate Section 7.B.(1) (Parts A and B) for each private fund it manages, which requires the following information: (i) name of the fund, (ii) state or country of organization, (iii) identity of other persons involved in the fund's management, (iv) whether the fund is a master-feeder arrangement or fund of funds, (v) regulatory status of the fund, (vi) whether the fund is subject to a foreign regulatory authority, (vii) whether the fund relies on an exemption from registration under the Securities Act of 1933, (viii) type of investment strategy the fund employs, (ix) whether the fund invests in registered investment companies, (x) gross asset value of the fund and (xi) the fund's investors, including minimum required investment amount, approximate number of beneficial owners of the fund and approximate percentage beneficially owned by the adviser and its related persons, funds of funds and non-U.S. persons and the extent to which clients are solicited to invest. An adviser must also provide information concerning five types of service providers that act as "gatekeepers" for each private fund, including the auditors, prime brokers, custodians, administrators and marketers. The adviser must also complete a separate Schedule D for each private fund managed by the adviser, but is no longer required to report on funds of its related persons.[21]

(ii) Other ADV Amendments

Other amendments to Form ADV include (i) disclosure on the number and types of clients of the adviser, the approximate percentage of assets under management attributable to each client type, and additional types of advisory services provided by the adviser, (ii) expanding the list of types of financial services businesses that an adviser or its related person provides, (iii) additional disclosure of the adviser's other business or services other than investment advice, (iv) additional information on related persons, subject to certain exceptions, (v) disclosure by an adviser with discretionary authority to appoint brokers or dealers on whether such brokers or dealers are related persons, disclosure whether "soft dollar benefits" qualify for the safe harbor for eligible research or brokerage services, (vi) disclosure on whether its related persons receive direct or indirect compensation for client referrals, (vii) disclosure of total number of qualified custodians for the adviser's clients and (viii) disclosure on whether the adviser has $1 billion or more in total assets on its balance sheet to identify advisers that could be subject to rules regarding excessive incentive-based compensation arrangements.

<u>Proposed Form PF</u>

Dodd-Frank established the Financial Stability Oversight Council (the "Council") to identify and manage systemic risk in the financial system and improve interagency cooperation. Proposed rule 204(b)-1, which was the subject of extensive industry comments and may be significantly revised before its final adoption, would require advisers registered with the SEC to

[21] An adviser with a principal office and place of business outside the U.S. would not be required to complete Schedule D for any private fund that, during the adviser's last fiscal year, was not a U.S. person, was not offered in the U.S. and was not beneficially owned by any U.S. person.

file a Form PF,[22] which is designed to assist the Council to assess systemic risk in the U.S. financial system. Private fund advisers are divided into two groups by size: (i) large private fund advisers, which include any adviser with at least $1 billion in assets under management, and (ii) all other private fund advisers, which are regarded as smaller private fund advisers. Importantly, exempt reporting advisers and foreign private advisers would be exempt from filing Form PF.

Smaller private fund advisers would file Form PF annually, and report basic information about their private funds relating to funds' assets, leverage, credit providers and investor concentration. Hedge fund advisers would also report information about fund strategy, counterparty credit risk and use of trading and clearing mechanisms.

Large private fund advisers would file Form PF quarterly and would be subject to heightened reporting requirements with additional information on Form PF based on fund type. Large private equity fund advisers would provide information on the leverage incurred by portfolio companies, the uses of bridge financing and their funds' investments in financial institutions. Large hedge fund advisers would report on an aggregated basis information regarding exposures by asset class, geographical concentration and turnover, and for hedge funds with a net asset value of at least $500 million, certain information relating to such fund's investments, leverage, risk profile and liquidity.

<u>Books and Records Requirements for Newly Registered Advisers</u>

Advisers of private funds that are required to register with the SEC will be subject to recordkeeping requirements upon registration. Advisers that relied on the private adviser exemption who register by March 30, 2012 must comply with all Advisers Act provisions and rules by that date. These advisers would not be obligated to keep certain performance-related records for any period prior to their registration; however, to the extent such advisers preserved such records previously (even though not required to do so), they must continue to preserve them.

Pay to Play Clarification

The SEC had previously adopted a rule to address "pay to play" practices by investment advisers,[23] which applied to registered advisers and advisers that relied on the private adviser exemption. In light of the new exemptions adopted by the SEC, the Implementing Release amends the pay to play rule so that it also applies to exempt reporting advisers and foreign private advisers. Another amendment is to permit an adviser to pay a "regulated municipal advisor" to act as a placement agent to solicit government entities on its behalf, if the municipal advisor is subject to a pay to play rule adopted by the Municipal Securities Rulemaking Board

[22] *See* Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, Investment Advisers Act Release No. IA-3145 (Jan. 26, 2011), *available at* http://www.sec.gov/rules/proposed/2011/ia-3145.pdf.

[23] *See* Political Contributions by Certain Investment Advisers, Investment Advisers Act Release No. IA-3043 (July 1, 2010), *available at* http://www.sec.gov/rules/final/2010/ia-3043.pdf and our memorandum, "The Final SEC Rule on Political Contributions by Investment Advisers," which is *available at* http://simpsonthacher.com/content/Publications/pub1017.pdf.

that is at least as stringent as the Advisers Act pay to play rule (previously, only registered investment advisers and registered broker-dealers could be retained for this purpose). Due to these amendments, the SEC has extended the compliance deadline by which advisers must comply with the ban on third-party solicitation from September 13, 2011 to June 13, 2012.

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